

INNOVATIVE SOLUTIONS & SUPPORT INC  
Form 10-Q  
February 11, 2014  
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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

**FORM 10-Q**

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

**For the quarterly period ended December 31, 2013**

**OR**

- o 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 day.

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, 2014, there were 16,894,531 shares of the Registrant's Common Stock, with par value of \$.001 per share, outstanding.

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**INNOVATIVE SOLUTIONS AND SUPPORT, INC.**

**FORM 10-Q December 31, 2013**

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|  | December 31,<br>2013<br>(unaudited) | September 30,<br>2013 |
|--|-------------------------------------|-----------------------|
| <b><u>ASSETS</u></b>   |                                     |                       |
| Current Assets   |                                     |                       |
| Cash and cash equivalents  | \$ 15,827,439                       | \$ 16,386,207         |
| Accounts receivable, net   | 4,759,853                           | 4,489,434             |
| Unbilled receivables   | 7,314,710                           | 6,539,442             |
| Inventories  | 4,975,541                           | 4,377,513             |
| Deferred income taxes  | 2,297,334                           | 2,002,679             |
| Prepaid expenses and other current assets  | 513,274                             | 642,210               |
| Total current assets   | 35,688,151                          | 34,437,485            |
| Property and equipment, net  | 7,527,584                           | 7,320,495             |
| Non-current deferred income taxes  | 24,447                              | 650,998               |
| Other assets   | 231,981                             | 221,533               |
| Total Assets   | \$ 43,472,163                       | \$ 42,630,511         |
| <b><u>LIABILITIES AND SHAREHOLDERS' EQUITY</u></b>   |                                     |                       |
| Current Liabilities  |                                     |                       |
| Accounts payable   | \$ 2,288,971                        | \$ 2,372,137          |
| Accrued expenses   | 3,703,053                           | 3,672,909             |
| Deferred revenue   | 245,727                             | 447,525               |
| Total current liabilities  | 6,237,751                           | 6,492,571             |
| Non-current deferred income taxes  | 132,401                             | 132,202               |
| Other liabilities  | 11,579                              | 11,491                |
| Total Liabilities  | 6,381,731                           | 6,636,264             |
| 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, 2013 and September 30, 2013 |                                     |                       |

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Common stock, \$.001 par value: 75,000,000 shares  
authorized, 18,644,893 and 18,632,328 issued at December 31,  
2013 and September 30, 2013, respectively

|  |               |               |
|--|---------------|---------------|
|  | 18,645        | 18,632        |
| Additional paid-in capital   | 49,968,147    | 49,880,571    |
| Retained earnings  | 7,493,230     | 6,484,634     |
| Treasury stock, at cost, 1,756,807 and 1,756,807 shares at<br>December 31, 2013 and September 30, 2013, respectively | (20,389,590)  | (20,389,590)  |
| Total Shareholders' Equity   | 37,090,432    | 35,994,247    |
| Total Liabilities and Shareholders' Equity   | \$ 43,472,163 | \$ 42,630,511 |

The accompanying notes are an integral part of these statements.

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**INNOVATIVE SOLUTIONS AND SUPPORT, INC.**  
**CONDENSED CONSOLIDATED STATEMENTS OF INCOME**

(unaudited)

|                                      | Three Months Ended December 31, |              |
|--------------------------------------|---------------------------------|--------------|
|                                      | 2013                            | 2012         |
| Net sales:                           |                                 |              |
| Product                              | \$ 7,738,614                    | \$ 4,739,448 |
| Engineering development contracts    | 3,367,197                       | 1,797,286    |
| Total net sales                      | 11,105,811                      | 6,536,734    |
| Cost of sales:                       |                                 |              |
| Product                              | 3,798,857                       | 2,160,448    |
| Engineering development contracts    | 3,526,518                       | 1,336,034    |
| Total cost of sales                  | 7,325,375                       | 3,496,482    |
| Gross profit                         | 3,780,436                       | 3,040,252    |
| Operating expenses:                  |                                 |              |
| Research and development             | 626,921                         | 850,852      |
| Selling, general and administrative  | 1,744,891                       | 1,804,809    |
| Total operating expenses             | 2,371,812                       | 2,655,661    |
| Operating income                     | 1,408,624                       | 384,591      |
| Interest income                      | 10,467                          | 17,572       |
| Other income                         | 5,666                           | 11,545       |
| Income before income taxes           | 1,424,757                       | 413,708      |
| Income tax expense                   | 416,161                         | 96,119       |
| Net income                           | \$ 1,008,596                    | \$ 317,589   |
| Net income per common share:         |                                 |              |
| Basic                                | \$ 0.06                         | \$ 0.02      |
| Diluted                              | \$ 0.06                         | \$ 0.02      |
| Cash dividends per share:            | \$                              | \$ 1.50      |
| Weighted average shares outstanding: |                                 |              |
| Basic                                | 16,888,086                      | 16,608,507   |
| Diluted                              | 17,094,346                      | 16,608,513   |

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, |               |
|---|---|---------------|
|   | 2013                                    | 2012          |
| <b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>                                    |   |               |
| Net income  | \$ 1,008,596                            | \$ 317,589    |
| Adjustments to reconcile net income to net cash (used in) operating activities: |   |               |
| Depreciation and amortization   | 129,484                                 | 119,159       |
| Share-based compensation expense:   |   |               |
| Stock options   | 184,224                                 | 133,691       |
| Nonvested stock awards  | 50,029                                  | 50,018        |
| Tax adjustment from share-based compensation                                    | (146,664)                               | (10,304)      |
| Excess and obsolete inventory cost  | 25,000                                  |               |
| Deferred income taxes   | 332,096                                 | 53,869        |
| (Increase) decrease in:   |   |               |
| Accounts receivable   | (270,419)                               | (260,114)     |
| Unbilled receivables  | (775,268)                               | (1,412,335)   |
| Inventories   | (623,028)                               | 333,853       |
| Prepaid expenses and other current assets                                       | 128,936                                 | (225,749)     |
| Other non-current assets  | (10,448)                                |               |
| Increase (decrease) in:   |   |               |
| Accounts payable  | (83,166)                                | (360,176)     |
| Accrued expenses  | 124,502                                 | (57,963)      |
| Income taxes payable  | (94,272)                                | (77,447)      |
| Deferred revenue  | (201,798)                               | (265,020)     |
| Net cash used in operating activities   | (222,196)                               | (1,660,929)   |
| <b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>                                    |   |               |
| Purchases of property and equipment   | (336,572)                               | (43,231)      |
| Net cash used in investing activities   | (336,572)                               | (43,231)      |
| <b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>                                    |   |               |
| Purchase of treasury stock  |   | (695)         |
| Dividend paid   |   | (25,007,519)  |
| Proceeds from exercise of stock options   |   | 762,759       |
| Net cash used in financing activities   |   | (24,245,455)  |
| Net decrease in cash and cash equivalents                                       | (558,768)                               | (25,949,615)  |
| Cash and cash equivalents, beginning of year                                    | 16,386,207                              | 42,977,501    |
| Cash and cash equivalents, end of period  | \$ 15,827,439                           | \$ 17,027,886 |
| <b>SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION</b>                         |   |               |
| Cash paid for income tax  | \$ 325,000                              | \$ 130,000    |

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, primary flight guidance and cockpit display systems for retrofit applications and original equipment manufacturers (OEMs). The Company supplies integrated Flight Management Systems (FMS) and advanced Global Positioning System (GPS) receivers that enable reduced carbon footprint navigation. The Company also continues to position itself as a system integrator, which 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, the 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, 2013 is derived from audited financial statements. Operating results for the three months ended December 31, 2013, are not necessarily indicative of the results that may be expected for the fiscal year ending September 30, 2014. 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, 2013.

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*

Preparation of consolidated financial statements in conformity with GAAP 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 revenues 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 liability, 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, 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, 2013 and September 30, 2013 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 estimated useful lives of the assets (the lesser of three to seven years or over the lease term), except for the corporate airplane and manufacturing facility, which are depreciated using the straight-line method over estimated useful lives of ten years and thirty-nine years, respectively. During fiscal 2014, no depreciation was provided for the airplane since 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.

#### ***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* ( ASC Topic 360-10 ). This statement requires that long-lived assets be reviewed for impairment whenever events or changes in circumstances indicate the carrying amount

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of an asset may not be recoverable. In addition, long-lived assets to be disposed of must 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 charges were recorded during the three months ended December 31, 2013 or 2012.

***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, engine display systems, large flat-panel display systems, and advanced monitoring systems that measure and display critical flight information, including data relative to aircraft separation, airspeed, altitude, as well as 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 statement 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 Standards Update 2009-14, *Revenue Arrangements That Include Software Elements*, (ASU 2009-14), 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 then considers the appropriate recognition method for each deliverable. The Company's multiple element arrangements can include defined design and development activities and/or functional upgrades, along with product sales.

The Company utilizes the selling price hierarchy that has been established by 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 identified deliverables 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 statement of income.

#### Single Element Arrangements

#### *Products -*

To the extent that a single element arrangement provides for product sales and repairs, the Company recognizes sales when revenue recognition criteria for the product deliverables have been met based on the provisions of ASC Topic 605. In addition, the Company receives orders for equipment and parts. Generally, revenue from the sale of such products is recognized upon shipment to the customer.

The Company offers its customers extended warranties for additional fees. These warranty sales are recorded as deferred revenue and

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recognized as sales on a straight-line basis over the warranty period.

*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. Certain of these contracts are accounted for under the percentage-of-completion method of accounting when the Company determines that progress toward completion is reasonable and reliably estimable, and the contract is long-term in nature. The Company uses the completed contract method for all others 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 (for development effort).

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. These 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. These 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 reliably estimated 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.

For contracts for which uncertainty regarding the performance against certain contract terms remains and in which no loss is expected, the Company uses the zero profit margin approach to applying the percentage of completion method following the guidance included in FASB ASC Topic 605-35.

The Company typically reviews estimates of profit margins for contracts on a quarterly basis. If the initial estimates of sales and costs under a contract are accurate, the percentage-of-completion method results in the profit margin being recorded evenly as revenue is recognized under the contract. Changes in these underlying estimates because of revisions in sales and cost estimates or to 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 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 operations in the period in which the revised estimate is made. Cumulative catch-up adjustments resulting from changes in estimates are disclosed in the notes to consolidated financial statements.

*Income Taxes*

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Income taxes are recorded in accordance with FASB 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 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 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 interim periods.

Deferred tax assets are reduced by valuation allowances 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 allowances recorded against net deferred tax assets. The Company evaluates deferred income taxes on a quarterly basis to determine if valuation allowances are 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 carry-forwards, taxable income in carry-back years, and tax planning strategies which are both prudent and feasible. The current balance of the deferred tax valuation allowance relates principally to NOL of certain state taxing jurisdictions. The Company believes that its estimate of future taxable income is inherently uncertain, and if its current or

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future operations generate losses, further adjustments to the valuation allowance are possible. There is currently no assurance of such future income before 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 because 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 adequate accruals have been made 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 adverse 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 in engineering development, both research and development ( R&D ) and EDC. At December 31, 2013, approximately 40% of the Company's employees were engineers engaged in various engineering development projects. IS&S invests a large percentage of its sales in EDC and R&D projects to allow its customers to benefit from the latest technological advancements. Total engineering development expense is comprised of both design and EDC related to specific customer contracts and R&D. EDC 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. EDC and design charges related to specific customer arrangements 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.

***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 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 ending December 31, 2013 and 2012, comprehensive income consisted of net income only. There were no items of other comprehensive income or accumulated other comprehensive income balances in the equity accounts for any of the periods presented.

*Fair Value of Financial Instruments*

The net carrying amounts of cash and cash equivalents, accounts receivable, cash overdraft, accounts payable, and short-term debt 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.



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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, 2013 and September 30, 2013, according to the valuation techniques the Company used to determine their fair values.

|                            | Fair Value Measurement on December 31, 2013                            |  |  |
|----------------------------|--|--|--|
|                            | Quoted Price in<br>Active Markets for<br>Identical Assets<br>(Level 1) | Significant Other<br>Observable<br>Inputs<br>(Level 2) | Significant<br>Unobservable<br>Inputs<br>(Level 3) |
| Assets                     |  |  |  |
| Cash and cash equivalents: |  |  |  |
| Money market funds         | \$ 14,396,556  | \$   | \$   |

|                            | Fair Value Measurement on September 30, 2013                           |  |  |
|----------------------------|--|--|--|
|                            | Quoted Price in<br>Active Markets for<br>Identical Assets<br>(Level 1) | Significant Other<br>Observable<br>Inputs<br>(Level 2) | Significant<br>Unobservable<br>Inputs<br>(Level 3) |
| Assets                     |  |  |  |
| Cash and cash equivalents: |  |  |  |
| Money market funds         | \$ 14,396,014  | \$   | \$   |

**Stock-Based Compensation**

The Company accounts for stock-based compensation under FASB ASC Topic 505-50, *Equity-Based Payments to Non-Employees* (ASC Topic 505-50) and FASB 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. That cost is recognized over the period during which an employee is required to provide service in exchange for the award.

**Warranty**

The Company offers warranties of various lengths on some products. At the time of shipment, the Company establishes a reserve for estimated costs of warranties based upon 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 warranty period, the product's failure rates, and the customer's usage each 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. Although 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.

***Concentrations***

***Major Customers and Products***

For the three months ended December 31, 2013, four customers - the DoD, Pilatus Aircraft Limited ( Pilatus ), Eclipse Aerospace, Inc. ( Eclipse ) and FedEx Corp. ( FedEx ), accounted for 22%, 13%, 12%, and 11% of net sales, respectively. For the three months ended December 31, 2012, two customers - Eclipse and American Airlines, Inc. ( AAI ) accounted for 29% and 13% of net sales, respectively.

On November 29, 2011, AMR Corporation, the parent company of AAI and certain of its other U.S. based subsidiaries filed voluntary

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petitions for Chapter 11 reorganization in the U.S. Bankruptcy Court for the Southern District of New York (the Bankruptcy ). AAI continued to purchase and pay for products from the Company in the ordinary course of business after November 29, 2011. For the three months ended December 31, 2013 and 2012, AAI accounted for approximately 4% and 13%, respectively, of net sales. As of September 30, 2013, the Company had pre-Bankruptcy outstanding accounts receivable of \$760,000 from AAI. The Bankruptcy Court recently approved the merger of AAI and U.S. Airways which was consummated on December 9, 2013. Shortly thereafter, the Company collected the full \$760,000.

*Major Suppliers*

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

For the three months ended December 31, 2013, the Company had one supplier which accounted for greater than 10% of the Company's total inventory related purchases. For the three months ended December 31, 2012, the Company had one supplier which accounted 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 banks. Certain 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 has no reserve for doubtful accounts as of December 31, 2013 and September 30, 2013 because of the favorable history of collections and a specific analysis of amounts outstanding.

*Recent Accounting Pronouncements*

In July 2013, the FASB issued ASU 2013-11, *Presentation of an Unrecognized Tax Benefit when a Net Operating Loss Carryforward, a Similar Tax Loss, or a Tax Credit Carryforward Exists* ( ASU 2013-11 ). ASU 2013-11 provides that a liability related to an unrecognized tax benefit should be offset against a deferred tax asset for a NOL carryforward, a similar tax loss or a tax credit carryforward if such liability is to be settled by reducing an available tax carryforward in the event the uncertain tax position is disallowed. ASU 2013-11 is effective for fiscal years, and interim periods within those years, beginning after December 15, 2013 for public entities, with early adoption permitted. The adoption of ASU 2013-11 did not have a material impact on the Company's consolidated financial statements as of December 31, 2013.

**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 customer payments, were \$7.3 million and \$6.5 million at December 31, 2013 and September 30, 2013, respectively.

The percentage-of-completion method of accounting for EDC revenue requires estimates of profit margins for contracts be reviewed by the Company on a quarterly basis. If the initial estimates of revenues and costs under a contract are accurate, the percentage-of-completion method results in the profit margin being recorded evenly as revenue is recognized under the contract. Changes in these underlying estimates due to revisions in revenue and cost estimates or the exercise of contract options may result in profit margins being recognized unevenly over the life of a contract because such changes are accounted for on a cumulative basis in the period in which the 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 operations in the period in which the revised estimates are made. Cumulative catch-up adjustments resulting from changes in estimates reduced operating income by \$183,000 and \$0 for the three months ended December 31, 2013 and 2012, respectively.

Table of Contents***Inventories***

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

|                 | December 31,<br>2013 |    | September 30,<br>2013 |
|-----------------|----------------------|----|-----------------------|
| Raw materials   | \$ 3,624,157         | \$ | 3,126,592             |
| Work-in-process | 1,123,403            |    | 857,602               |
| Finished goods  | 227,981              |    | 393,319               |
|                 | \$ 4,975,541         | \$ | 4,377,513             |

***Prepaid expenses and other current assets***

Prepaid expenses and other current assets consist of the following:

|                   | December 31,<br>2013 |    | September 30,<br>2013 |
|-------------------|----------------------|----|-----------------------|
| Prepaid insurance | \$ 186,743           | \$ | 350,913               |
| Other             | 326,531              |    | 291,297               |
|                   | \$ 513,274           | \$ | 642,210               |

***Property and equipment***

Property and equipment, net consists of the following balances:

|   | December 31,<br>2013 |    | September 30,<br>2013 |
|---|----------------------|----|-----------------------|
| Land  | \$ 1,021,245         | \$ | 1,021,245             |
| Computer equipment                              | 2,237,025            |    | 2,173,266             |
| Corporate airplane                              | 3,128,504            |    | 3,128,504             |
| Furniture and office equipment                  | 1,054,347            |    | 1,062,296             |
| Manufacturing facility                          | 5,649,070            |    | 5,631,001             |
| Equipment                                       | 4,897,120            |    | 4,678,678             |
| Total   | 17,987,311           |    | 17,694,990            |
| Less: Accumulated depreciation and amortization | (10,459,727)         |    | (10,374,495)          |
|   | \$ 7,527,584         | \$ | 7,320,495             |

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Depreciation and amortization related to property and equipment was approximately \$129,000 and \$106,000 for the three months ended December 31, 2013 and 2012, respectively. The Corporate airplane is primarily utilized in support of product development and has been depreciated to its estimated salvage value.

### *Other assets*

Other assets consist of the following:

|  | December 31,<br>2013 | September 30,<br>2013 |
|--|----------------------|-----------------------|
| Intangible assets, net of accumulated amortization of \$495,037 at<br>December 31, 2013 and September 30, 2013 | \$ 105,200           | \$ 105,200            |
| Other non-current assets   | 126,781              | 116,333               |
|  | \$ 231,981           | \$ 221,533            |

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Intangible assets consist of licensing and certification rights which are amortized over a defined number of units. No impairment charges were recorded for the three months ended December 31, 2013 and 2012. Total amortization expense was approximately \$0 and \$13,000 for the three months ended December 31, 2013 and 2012, respectively. The timing of future amortization expense is not determinable because the intangible assets are being amortized over a defined number of units.

Other non-current assets consist primarily of deposits for leased facilities and inventory deliveries not expected to be applied in the next twelve months.

*Accrued expenses*

Accrued expenses consist of the following:

|                                    | December 31,<br>2013 | September 30,<br>2013 |
|------------------------------------|----------------------|-----------------------|
| Warranty                           | \$ 756,544           | \$ 701,456            |
| Salary, benefits and payroll taxes | 459,288              | 679,325               |
| Professional fees                  | 357,633              | 393,570               |
| Income taxes payable               | 243,633              | 337,993               |
| EDC program costs                  | 1,153,618            | 560,428               |
| Litigation claims                  | 481,060              | 656,865               |
| Other                              | 251,277              | 343,272               |
|                                    | \$ 3,703,053         | \$ 3,672,909          |

Other accrued expenses consist primarily of accruals for payments to consultants and sub-contractors for services completed as of December 31, 2013 and September 30, 2013.

Warranty cost and accrual information for the three months ended December 31, 2013 is highlighted below:

|  |            |
|--|------------|
| Warranty Accrual at September 30, 2013 | \$ 701,456 |
| Accrued expense                        | 116,260    |
| Warranty cost                          | (61,172)   |
| Warranty Accrual at December 31, 2013  | \$ 756,544 |

**3. Income Taxes**

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The income tax expense for the three months ended December 31, 2013 was approximately \$416,000 compared to approximately \$96,000 for the three months ended December 31, 2012.

The effective tax rate for the three months ended December 31, 2013 was 29%. The effective tax rate differs from the statutory rate for the three months ended December 31, 2013, primarily because of the Domestic Production Activities Deduction, and the federal Research and Development Tax Credit ( R&D Tax Credit ).

The effective tax rate for the three months ended December 31, 2012 was 23%. The effective tax rate differs from the statutory rate for the three months ended December 31, 2012, primarily because of the decrease in the liability recorded for uncertain tax positions resulting from the lapse of applicable statutes of limitation and the Domestic Production Activities Deduction.

On January 2, 2013, the American Taxpayer Relief Act of 2012 (the Tax Relief Act ) was enacted, which retroactively reinstated and extended the R&D Tax Credit from January 1, 2012 to December 31, 2013. The current year estimated annual effective income tax rate reflects the benefit from the Federal R&D Tax Credit for only the three months ended December 31, 2013 as permitted by ASC Topic 740, because the R&D Tax Credit expired as of December 31, 2013.

At December 31, 2013, the balance of the deferred tax valuation allowance relates principally to NOLs of certain state taxing jurisdictions. The Company will continue to maintain the balance of the valuation allowance until the Company generates a sufficient level of profitability in certain jurisdictions to warrant a conclusion that it is no longer more likely than not that these net state deferred tax assets will not be realized in future periods. There is currently no assurance of such future income before taxes. The Company believes that its estimate of future taxable income is inherently uncertain, and therefore, further adjustments to the valuation allowance are possible.



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**4. Shareholders Equity and Share-based Payments**

At December 31, 2013, 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 non-vested stock awards.

Total share-based compensation expense was approximately \$234,000 and \$184,000 for the three months ended December 31, 2013 and 2012, respectively. The income tax effect recognized as a credit (charge) to additional paid-in capital related to share-based compensation arrangements was (\$147,000) and (\$10,000) for the three months ended December 31, 2013 and 2012, respectively. Compensation expense related to share-based awards is recorded as a component of general and administrative expense.

By unanimous consent of the Company's Board of Directors on January 25, 2013, the applicable option exercise price of each outstanding option to purchase common stock was reduced by \$1.50 per share pursuant to the terms of the 1998 Plan or the 2009 Plan (each as defined below), as applicable, to offset the dilutive impact of the special cash dividend paid by the Company on December 27, 2012 to common shareholders of record on December 17, 2012. As required by ASC Topic 718, the Company recorded an expense of \$22,000 related to the vested outstanding options as a result of this one-time reduction to the option exercise price in the quarter ended March 31, 2013. For non-vested options, the Company added the additional compensation cost of \$59,000 to the remaining unrecognized compensation cost for the original share options, granted under the 2009 Plan, and will expense the total amount ratably over the remaining vesting period of the options in accordance with the guidance provided by ASC Topic 718.

The Company maintains 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). The Company's shareholders approved each of these plans. The 1998 Plan expired on November 13, 2008, and there are no further shares of common stock to be awarded under the Restricted Plan.

*1998 Stock Option Plan*

The 1998 Plan authorized grants 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 the 1998 Plan. Total compensation expense under the 1998 Plan was approximately \$0 and \$10,000 for the three months ended December 31, 2013 and 2012, respectively.

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Incentive stock options granted under the 1998 Plan have exercise prices that must be at least equal to fair value of the common stock on the grant date. Nonqualified stock options granted under the 1998 Plan have exercise prices that may be 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 1998 Plan. On November 13, 2008, the 1998 Plan expired, and no additional shares were granted under the Plan after that date.

### *Restricted Plan*

The Restricted Plan for non-employee directors was approved by shareholders at the Company's February 26, 2004 Annual Meeting of Shareholders. It authorized an annual award of non-vested shares of common stock having a fair market value of \$40,000 at close of business on October 1 of each year for all eligible non-employee directors. The shares of common stock were awarded in four quarterly installments during the fiscal year provided the director was still serving on the board on the quarterly issue date. The last awards under the Restricted Plan were made in 2010, and there are no further shares to award under the Restricted Plan. However, the Company continued to make an annual grant of restricted shares to non-employee directors under the 2009 Plan.

There was no compensation expense under the Restricted Plan for the three months ended December 31, 2013 and 2012, respectively.

### *2009 Stock Option Plan*

The 2009 Plan authorizes the grant of Stock Appreciation Rights ( SARs ), Restricted Stock, Options, and other equity-based awards under the 2009 Plan (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 ).

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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 is 1,200,000, all of which may be issued pursuant to Awards of incentive stock options. In addition, the 2009 Plan provides that no more than 300,000 shares of common stock may be awarded to any employee as a performance-based Award under Section 162(m) of the Code. At December 31, 2013, there were 346,220 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 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 adjust proportionately and equitably 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 affect adversely 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 affect adversely 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.

Total compensation expense associated with stock option awards to employees under the 2009 Plan was \$184,000, and \$124,000 for the three months ended December 31, 2013, and 2012, respectively. Total share-based compensation expense under the 2009 Plan associated with the grant of stock awards to non-employee members of the Board of Directors on a quarterly basis as compensation was \$50,000 for the three months ended December 2013 and 2012.

***Stock repurchase program***

On April 29, 2013 the Company's Board of Directors approved a new share repurchase program to acquire up to 250,000 shares of the Company's outstanding common stock until May 1, 2014. Under the new share repurchase program, the Company may 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 will depend on market conditions, and corporate and regulatory considerations. The program may be discontinued or suspended at any time. During the three months ended December 31, 2013, the Company did not make any other purchases of shares of the Company's common under the new share repurchase plan. As of December 31, 2013, the number of shares that may yet be purchased under the new share repurchased program was 250,000 shares.

During the three months ended December 31, 2012 the Company purchased 175 shares of common stock under the previous share repurchase program (which expired on February 10, 2013) at a total cost of \$696 and at an average market price of \$3.96 per share, financed with available cash.

**5. Earnings Per Share**

| [REDACTED]                            |    |            |            |
|---------------------------------------|----|------------|------------|
| Numerator:                            |    |            |            |
| Net income                            | \$ | 1,008,596  | \$ 317,589 |
| Denominator:                          |    |            |            |
| Basic weighted average shares         |    | 16,888,086 | 16,608,507 |
| Dilutive effect of share-based awards |    | 206,260    | 6          |
| Diluted weighted average shares       |    | 17,094,346 | 16,608,513 |
| Earnings per common share:            |    |            |            |
| Basic EPS                             | \$ | 0.06       | \$ 0.02    |
| Diluted EPS                           | \$ | 0.06       | \$ 0.02    |

Earnings per share ( EPS ) is 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

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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, 2013 and 2012, there were 779,834 and 651,600 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, 2013 and 2012, 84,598 and 800,645 weighted dilutive shares outstanding were excluded from the computation of diluted EPS because the effect would be anti-dilutive.

**6. Contingencies**

On September 26, 2011, Farhad Daghigh, a former employee of the Company, filed a lawsuit against the Company in the Court of Common Pleas of Chester County ( the Court ) alleging breach of contract and violation of the Pennsylvania Wage Payment and Collection Law and claiming unpaid sales commissions, prejudgment interest, and liquidated damages totaling approximately \$583,000 for the fiscal years ended 2007, 2008, 2009 and 2010, plus attorneys' fees and costs. In June 2013, following a trial without a jury, the Court found in favor of the plaintiff. In December 2013, the parties agreed to settle the matter. Under the terms of the settlement the Company is required to pay the plaintiff \$540,000 between December 2013 and the end of March 2014.

On January 17, 2007 the Company filed suit in the Court of Common Pleas for Delaware County, Pennsylvania against Strathman Associates, a former software consultant for IS&S, alleging that Strathman had improperly used IS&S trade secret and proprietary information in assisting J2 and Kollsman in developing the J2/Kollsman Air Data Computer. The case has not been resolved as of December 31, 2013.

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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. In this report, the words believe, may, will, estimate, continue, anticipate, intend, forecast, expect, plan, should, 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.*

*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 Innovative Solutions and Support, Inc.'s (the Company or IS&S) Annual Report on Form 10-K for the fiscal year ended September 30, 2013 filed with the United States Securities and Exchange Commission (the SEC) on December 20, 2013 and the following factors:*

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

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- *failure to retain/recruit key personnel;*
- *a cyber security incident;*
- *the ability to service the international market;*
- *potential future acquisitions; and*
- *other factors disclosed from time to time in the Company's filings with 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 also 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 publicly release 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, manufactures, sells, and services air data equipment, engine display systems, primary flight guidance and cockpit display systems for retrofit applications and original equipment manufacturers (OEMs). The Company supplies integrated Flight Management Systems (FMS) and advanced Global Positioning System (GPS) receivers that enable reduced carbon footprint navigation.

Increasingly, the Company is positioning itself as a system integrator, which capability provides the Company with the potential to generate more substantive orders over a broader product base. The Company has demonstrated an ability to incorporate added electronic flight bag functionality such as charting and mapping systems into its Flat Panel Display Systems (FPDS) product line. The strategy, as both a manufacturer and integrator, is 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, the United States Department of Defense (DoD)/governmental, and foreign military markets. This approach, combined with the Company's industry experience, enables IS&S to develop high-quality products and systems, to reduce substantially 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 Department of Defense and its commercial contractors, aircraft operators, aircraft modification centers, foreign militaries, and various OEMs.

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, referred to as FPDS, that incorporates proprietary technology, low cost, reduced power consumption, decreased weight, and increased functionality. The Company believes the FPDS 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. IS&S believes that the transition to FPDS as part of airplane retrofit requirements will continue. The shift in regulatory and technological environment has resulted in the increase in the number of Wide Area Augmentation System (WAAS) approach qualified airports. Aircraft equipped with the Company's FMS and FPDS products (equipped with a WAAS 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.

IS&S sells to both the retrofit market and OEMs. Customers include the DoD and its commercial contractors, aircraft operators, aircraft modification centers, foreign militaries, and various OEMs. 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 made on commercial terms, although some of the termination and other provisions of government contracts are applicable to these contracts. IS&S sells its products to agencies of the United States and foreign governments, aircraft operators, aircraft modification centers, and original equipment manufacturers. Customers have been and may continue to be affected by the present uncertain economic conditions 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. In addition, spending by government agencies may in the future be reduced because of ongoing budget constraints. If customers curtail or delay their spending or are forced to declare bankruptcy or liquidate their operations due to adverse economic conditions, IS&S revenues and results of operations will be adversely affected. However, the Company believes that, in an adverse economic environment, customer who may have otherwise elected to purchase newly manufactured aircraft will be interested instead in retrofitting existing aircraft as a cost effective alternative, which will create 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, supplies, and outside service costs related to production management, purchasing, material control, and quality control. Cost of sales includes warranty costs.

Cost of sales related to engineering development contracts ( EDC ) is comprised of engineering labor, consulting services, and other cost associated with specific design and development projects. These costs are incurred pursuant to contractual arrangements and are typically accounted for as contract costs within cost of sales with the payment from customers under such contracts accounted for as EDC sales 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 and 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 will expense associated R&D costs as they are incurred.

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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, 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, revenue and expenses, and related disclosure of contingent assets and liabilities. On an on-going 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 year ended September 30, 2013 contains a discussion of these critical accounting policies. There have been no significant changes in the Company's critical accounting policies since September 30, 2013. See also Note 1 to the unaudited condensed consolidated financial statements for the three month period ending December 31, 2013 as set forth herein.

**RESULTS OF OPERATIONS FOR THE THREE MONTHS ENDED  
DECEMBER 31, 2013 AND 2012**

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

|                                     |       |       |
|-------------------------------------|-------|-------|
| <b>Net sales:</b>                   |       |       |
| Engineering development contracts   | 30.3  | 27.5  |
| Product                             | 34.2% | 33.1% |
| Total cost of sales                 | 66.0% | 53.5% |
| Gross profit                        | 34.0% | 46.5% |
| <b>Operating expenses:</b>          |       |       |
| Selling, general and administrative | 15.7  | 27.6  |

|              |     |     |
|--------------|-----|-----|
|              |     |     |
|              |     |     |
|              |     |     |
|              |     |     |
| Other income | 0.1 | 0.2 |
|              |     |     |
|              |     |     |
|              |     |     |

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**Three Months Ended December 31, 2013 Compared to the Three Months Ended December 31, 2012**

*Net sales.* Net sales increased \$4.6 million, or 70%, to \$11.1 million, for the three months ended December 31, 2013 from \$6.5 million in the three months ended December 31, 2012. For the three months ended December 31, 2013, product sales increased \$3.0 million and EDC sales increased \$1.6 million from the same period in the prior year. Product sales increased from the same period in the prior year primarily because of increased shipments of displays for retrofit programs to the DoD, military subcontractors, and a commercial transport customer. The increase in EDC sales was primarily the result of revenues from increased activity on EDC projects awarded in the prior year. For the three months ended December 31, 2013 and 2012, the Company recognized equal amounts of revenue and cost of \$2.9 million and \$0.5 million, respectively, related to certain contracts for which, at the time of recognition, either zero margins were expected, or a zero margin approach to applying the percentage of completion method were used in accordance with the guidance of the Financial Accounting Standards Board ( FASB ) Accounting Standards Codification ( ASC ) Topic 605-35 *Construction-Type and Production-Type Contracts* (ASC Topic 605-35 ).

*Cost of sales.* Cost of sales increased \$3.8 million or 110%, to \$7.3 million, or 66% of net sales, in the three months ended December 31, 2013 from \$3.5 million, or 53% of net sales in the three months ended December 31, 2012. The increase in cost of sales resulted primarily from the change in sales mix to a higher proportion of EDC sales and the increase in product sales volume for the three months ended December 31, 2013 compared to the three months ended December 31, 2012. In addition, EDC margins include the negative impact of cumulative catch-up adjustments of \$183,000 resulting from changes in estimated cost to complete on certain EDC programs for the three months ended December 31, 2013. The Company's overall gross margin decreased to 34% from 47% because of the higher proportion of lower margin EDC sales and the negative effect of the cumulative catch-up adjustment for certain EDC projects in the three months ended December 31, 2013.

*Research and development.* R&D expense decreased \$0.2 million, or 26%, to \$0.6 million, or 5.6% of net sales, in the three months ended December 31, 2013 from \$0.9 million, or 13.0% of net sales, in the three months ended December 31, 2012. The decrease in R&D expense in the quarter reflected a higher percentage of engineering resources devoted to support EDC projects.

*Selling, general, and administrative.* Selling, general and administrative expense decreased \$0.1 million, or 3%, to \$1.7 million, or 15.7% of net sales, in the three months ended December 31, 2013 from \$1.8 million, or 27.6% of net sales, in the three months ended December 31, 2012. The decrease in selling, general, and administrative expense in the quarter was primarily the result of lower professional fees and the partial reversal of the non-recurring expense recorded in the prior year, related to the settlement of a previously disclosed legal matter during the quarter. (See Note 6 Contingencies in Notes to Consolidated Financial Statements attached).

*Interest income.* Interest income was \$10,000 in the three months ended December 31, 2013 compared to \$18,000 in the three months ended December 31, 2012. The decrease in interest income was primarily the result of lower cash balances in the three months ended December 31, 2013 compared to the prior year period in which the Company paid a \$25 million special cash dividend to shareholders.

*Other income.* Other miscellaneous income decreased marginally by \$6,000 in the three months ended December 31, 2013 compared to the same period in the prior year.

*Income tax expense.* The income tax expense for the three months ended December 31, 2013 was \$416,000 compared to \$96,000 for the three months ended December 31, 2012.

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The effective tax rate for the three months ended December 31, 2013 was 29%. The effective tax rate differs from the statutory rate for the three months ended December 31, 2013, primarily because of the Domestic Production Activities Deduction and the federal Research and Development Tax Credit ( R&D Tax Credit ).

The effective tax rate for the three months ended December 31, 2012 was 23%. The effective tax rate differs from the statutory rate for the three months ended December 31, 2012, primarily because of the decrease in the liability recorded for uncertain tax positions due to the lapse of applicable statutes of limitation and the Domestic Production Activities Deduction.

On January 2, 2013, the American Taxpayer Relief Act of 2012 (the Tax Relief Act ) was enacted, which retroactively reinstated and extended the R&D Tax Credit from January 1, 2012 to December 31, 2013. The current year estimated annual effective income tax rate reflects the benefit from the Federal R&D Tax Credit for only the three months ended December 31, 2013 as permitted by ASC Topic 740, because the R&D Tax Credit expired as of December 31, 2013.

At December 31, 2013, the balance of the deferred tax valuation allowance relates principally to NOLs of certain state taxing jurisdictions. The Company will continue to maintain the balance of the valuation allowance until the Company generates a sufficient level of profitability in certain jurisdictions to warrant a conclusion that it is no longer more likely than not that these net state deferred tax assets will not be realized in future periods. There is currently no assurance of such future income before taxes. The Company

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believes that its estimate of future taxable income is inherently uncertain, and therefore further adjustments to the valuation allowance are possible.

*Net income.* As a result of the factors described above, the Company reported net income for the three months ended December 31, 2013 of \$1.0 million compared to \$0.3 million for the three months ended December 31, 2012. On a fully diluted basis, the income per share of \$0.06 for the three months ended December 31, 2013 compared to \$0.02 for the three months ended December 31, 2012.

**Liquidity and Capital Resources**

The following table highlights key financial measurements of the Company:

|  | December 31,<br>2013 | September 30,<br>2013 |
|--|----------------------|-----------------------|
| Cash and cash equivalents                        | \$ 15,827,439        | \$ 16,386,207         |
| Accounts receivable, net                         | 4,759,853            | 4,489,434             |
| Current assets                                   | 35,688,151           | 34,437,485            |
| Current liabilities                              | 6,237,751            | 6,492,571             |
| Deferred revenue                                 | 245,727              | 447,525               |
| Total debt and other non-current liabilities (1) | 143,980              | 143,693               |
| Quick ratio (2)                                  | 3.30                 | 3.22                  |
| Current ratio (3)                                | 5.72                 | 5.30                  |

|   | Three Months Ending December 31,<br>2013 | 2012           |
|---|--|----------------|
| Cash flow activities:                               |  |                |
| Net cash (used in) provided by operating activities | \$ (222,196)                             | \$ (1,660,929) |
| Net cash (used in) investing activities             | (336,572)                                | (43,231)       |
| Net cash (used in) financing activities             |  | (24,245,455)   |

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- (1) Excludes deferred revenue
- (2) Calculated as: Cash and Cash Equivalents and Accounts Receivable, net divided by Current Liabilities
- (3) Calculated as: Current Assets divided by Current Liabilities

The Company's principal source of liquidity has been from cash flows generated from current year operations and the ability to access cash accumulated from prior year 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 return value to its shareholders.

***Operating activities***

The Company used cash in operating activities of \$0.2 million for the three months ended December 31, 2013 compared to a use of cash of \$1.7 million for the three months ended December 31, 2012. The cash used in operating activities during the three months ended December 31, 2013 funded a \$0.8 million increase in unbilled receivables which represent principally sales recorded under the percentage-of-completion method of accounting that have not been billed to customers in accordance with applicable contract terms of EDCs. The Company expects that the cash invested in funding the EDCs will be recovered from customers in accordance with contract terms.

***Investing activities***

For the three months ended December 31, 2013 and 2012, the Company spent \$337,000 and \$43,000, respectively, primarily for the purchase of production and laboratory test equipment. The Company plans to continue investing in capital expenditures at modestly higher levels than it has in prior years.

***Financing activities***

There were no cash flows related to financing activities for the three months ended December 2013.

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For the three months ended December 31, 2012, the Company received \$0.8 million from the exercise of options to acquire shares of common stock and repurchased 175 shares of common stock during the same period. On December 7, 2012, the Company's Board of Directors declared a special cash dividend in the amount of \$1.50 per share which was paid to shareholders on December 27, 2012. The aggregate amount of the dividend payment was approximately \$25 million.

**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 to increase 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. Further, IS&S may need to develop and introduce new or enhanced products, to respond to competitive pressures, to invest in or acquire businesses or technologies, or to respond to unanticipated requirements or developments. If additional funds are raised through the issuance of equity securities, dilution to existing shareholders may result. If insufficient funds are available, the Company may not be able to introduce new products or to compete effectively.

**Backlog**

As of December 31, 2013 and September 30, 2013, backlog was \$86.7 million and \$91.1 million, respectively. Backlog represents the value of contracts and purchase orders received, less the revenue recognized to date on those contracts and purchase orders. The decrease during the quarter of \$4.4 million, or 4.8%, was the result of \$6.7 million in new business, offset by \$11.1 million of revenue recognized for the three months ended December 31, 2013. As of December 31, 2013, approximately 73% of the Company's backlog is not expected to be filled within fiscal year 2014.

Backlog activity for the three months ended December 31, 2013 (in thousands):

| Balance at<br>September 30,<br>2013 | Bookings<br>(net of De-bookings) | Recognized<br>in Revenue | Balance at<br>December 31,<br>2013 |
|-------------------------------------|----------------------------------|--------------------------|------------------------------------|
| \$ 91,100                           | \$ 6,729                         | \$ 11,106                | \$ 86,724                          |

**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 variable rates. Accordingly, the Company does not participate in interest rate hedging, 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, 2013, were constant and no actions were taken to alter the existing interest rate sensitivity, a hypothetical 1% increase in variable interest rates would have affected interest income by approximately \$36,000, with a resulting impact on cash flows of approximately \$36,000 for the three months ended December 31, 2013.

**Item 4. Controls and Procedures**

(a) An evaluation was performed under the supervision and with the participation of the Company's management, including its Chief Executive Officer ( CEO ) and Chief Financial Officer ( CFO ) of the effectiveness of the Company's disclosure controls and procedures, as such term is defined under Rule 13a-15e under the Exchange Act as of December 31, 2013. Based on that evaluation, the Company's management, including the CEO and CFO, concluded that the Company's disclosure controls and procedures are effective to provide reasonable assurance that information required to be disclosed by the Company in reports that it files or submits under the Exchange Act, is recorded, processed, summarized and reported as specified in SEC's rules and forms and that such information is accumulated and communicated to the Company's

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management, including the CEO and CFO, or persons performing similar functions, as appropriate to allow timely decisions regarding required disclosure.

(b) 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 have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

**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. The Company does not believe any such matters that are currently pending will have a material adverse effect on the results of operations or financial position.

On September 26, 2011, Farhad Daghigh, a former employee of the Company, filed a lawsuit against the Company in the Court of Common Pleas of Chester County alleging breach of contract and violation of the Pennsylvania Wage Payment and Collection Law and claiming unpaid sales commissions, prejudgment interest, and liquidated damages totaling approximately \$583,000 for the fiscal years ended 2007, 2008, 2009 and 2010, plus attorneys' fees and costs. In June 2013, following a trial without a jury, the Court found in favor of the plaintiff. In December 2013, the parties agreed to settle the matter. Under the terms of the settlement, the Company is required to pay the plaintiff \$540,000 between December 2013 and the end of March 2014.

On January 17, 2007 the Company filed suit in the Court of Common Pleas for Delaware County, Pennsylvania against Strathman Associates, a former software consultant for IS&S, alleging that Strathman had improperly used IS&S trade secret and proprietary information in assisting J2 and Kollsman in developing the J2/Kollsman Air Data Computer. This matter has not been resolved as of December 31, 2013.

**Item 1A. Risk Factors**

There are no material changes to the risk factors described under Item 1A of our Form 10-K for the year ended September 30, 2013.

**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

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**Item 6. Exhibits**

(a) Exhibits

- 31.1 Certification of Chief Executive Officer Pursuant to Rule 13a-14(a) **(1)**
- 31.2 Certification of Chief Financial Officer Pursuant to Rule 13a-14(a) **(1)**
- 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 **(3)**
- 101.SCH XBRL Taxonomy Extension Scheme Document **(3)**
- 101.CAL XBRL Taxonomy Extension Calculation Linkbase Document **(3)**
- 101.DEF XBRL Taxonomy Extension Definition Linkbase Document **(3)**
- 101.LAB XBRL Taxonomy Extension Label Linkbase Document **(3)**
- 101.PRE XBRL Taxonomy Extension Presentation Linkbase Document **(3)**

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(1) Filed herewith

(2) Furnished herewith

(3) Pursuant to Regulation S T, these interactive data files are deemed not filed or incorporated in any registration statement or prospectus for purposes of Sections 11 or 12 of the Securities Act of 1933 or Section 18 of the Securities Exchange Act of 1934 and otherwise are not subject to liability under those sections.



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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 11, 2014

By:

/s/ RONALD C. ALBRECHT  
RONALD C. ALBRECHT  
CHIEF FINANCIAL OFFICER