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 June 30, 2018

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)

PENNSYLVANIA (State or Other Jurisdiction of Incorporation or Organization)	**23-2507402** (I.R.S. Employer Identification No.)
720 Pennsylvania Drive, Exton, Pennsylvania (Address of Principal Executive Offices)	**19341** (Zip Code)

(610) 646-9800

(Registrant s Telephone Number, Including Area Code)

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

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 x No o

Indicate by check mark whether the Registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer or a smaller reporting company or an emerging growth company. See the definitions of large accelerated filer, accelerated filer, smaller reporting company and emerging growth company in Rule 12b-2 of the Exchange Act.

o Large accelerated filer	o Accelerated filer
o Non-accelerated filer (Do not check if a smaller reporting company)	x Smaller reporting company
o Emerging growth company	

If an emerging growth company, indicate by check mark if the Registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act. o

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

As of July 31, 2018, there were 16,840,599 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 June 30, 2018

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PART I FINANCIAL INFORMATION

Item 1- Financial Statements

INNOVATIVE SOLUTIONS AND SUPPORT, INC.

CONDENSED CONSOLIDATED BALANCE SHEETS

	June 30, 2018 (unaudited)		September 30, 2017	
ASSETS				
Current assets				
Cash and cash equivalents	$	20,879,412	$	24,680,301
Accounts receivable		1,780,829		2,748,597
Unbilled receivables		1,039,879		1,480,822
Inventories		4,685,652		4,179,654
Prepaid expenses and other current assets		874,375		1,092,064
Total current assets		29,260,147		34,181,438
Property and equipment, net		8,890,643		6,669,011
Other assets		184,026		187,315
Total assets	$	38,334,816	$	41,037,764
LIABILITIES AND SHAREHOLDERS EQUITY				
Current liabilities				
Accounts payable	$	1,329,859	$	1,321,251
Accrued expenses		1,899,774		1,760,037
Deferred revenue		406,748		280,354
Total current liabilities		3,636,381		3,361,642
Deferred income taxes		129,587		67,742
Total liabilities		3,765,968		3,429,384
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 June 30, 2018 and September 30, 2017	$		$	
Common stock, $.001 par value: 75,000,000 shares authorized, 18,937,050 and 18,879,580 issued at June 30, 2018 and September 30, 2017, respectively		18,937		18,880

Additional paid-in capital		51,783,779		51,583,841
Retained earnings		4,134,669		7,374,196
Treasury stock, at cost, 2,096,451 shares at June 30, 2018 and September 30, 2017		(21,368,537)		(21,368,537)
Total shareholders equity		34,568,848		37,608,380
Total liabilities and shareholders equity	$	38,334,816	$	41,037,764

The accompanying notes are an integral part of these statements.

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INNOVATIVE SOLUTIONS AND SUPPORT, INC.

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(unaudited)

	Three Months Ended June 30, 2018	Three Months Ended June 30, 2017	Nine Months Ended June 30, 2018	Nine Months Ended June 30, 2017
Sales:				
Product	$ 3,201,325	$ 4,476,717	$ 9,975,011	$ 12,566,311
Engineering development contracts	188,338	64,704	229,840	550,889
Returns and allowances				(556,009)
Total net sales	3,389,663	4,541,421	10,204,851	12,561,191
Cost of sales:				
Product	1,714,701	2,074,500	5,380,094	5,996,291
Engineering development contracts	92,279	89,640	102,502	298,332
Total cost of sales	1,806,980	2,164,140	5,482,596	6,294,623
Gross profit	1,582,683	2,377,281	4,722,255	6,266,568
Operating expenses:				
Research and development	1,028,271	1,236,184	2,983,614	3,391,181
Selling, general and administrative	1,626,640	1,682,286	5,005,941	2,025,952
Total operating expenses	2,654,911	2,918,470	7,989,555	5,417,133
Operating (loss) income	(1,072,228)	(541,189)	(3,267,300)	849,435
Interest income	15,164	7,682	36,469	27,505
Other income	16,128	15,628	53,224	4,174,953
(Loss) income before income taxes	(1,040,936)	(517,879)	(3,177,607)	5,051,893
Income tax expense (benefit)	101	(537,099)	61,920	297,220
Net (loss) income	$ (1,041,037)	$ 19,220	$ (3,239,527)	$ 4,754,673
Net(loss) income per common share:				
Basic	$ (0.06)	$ 0.00	$ (0.19)	$ 0.28
Diluted	$ (0.06)	$ 0.00	$ (0.19)	$ 0.28
Weighted average shares outstanding:				
Basic	16,816,838	16,755,082	16,800,070	16,735,533
Diluted	16,816,838	16,870,404	16,800,070	16,847,305

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 Nine Months Ended June 30 , 2018	2017
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net (loss) income	$ (3,239,527)	$ 4,754,673
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities:		
Depreciation and amortization	316,855	332,323
Share-based compensation expense:		
Stock awards	199,996	191,748
Deferred income taxes	61,845	44
(Increase) decrease in:		
Accounts receivable	967,768	2,437,823
Unbilled receivables, net	440,943	(2,362)
Inventories	(505,998)	(887,211)
Prepaid expenses and other current assets	226,070	(51,097)
Income taxes receivable/payable	(8,381)	(104,318)
Other non-current assets		(45,926)
Increase (decrease) in:		
Accounts payable, net	8,608	(482,199)
Accrued expenses	139,737	65,123
Deferred revenue	126,394	135,117
Net cash (used in) provided by operating activities	(1,265,690)	6,343,738
CASH FLOWS FROM INVESTING ACTIVITIES:		
Purchases of property and equipment	(2,535,199)	(130,058)
Net cash used in investing activities	(2,535,199)	(130,058)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Net cash provided by financing activities		
Net (decrease) increase in cash and cash equivalents	(3,800,889)	6,213,680
Cash and cash equivalents, beginning of year	24,680,301	18,767,661
Cash and cash equivalents, end of period	$ 20,879,412	$ 24,981,341
SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION		
Cash paid for income tax	$ 8,469	$ 400,000

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, develops, manufactures, sells, and services air data equipment, engine display systems, standby equipment, primary flight guidance, autothrottles and cockpit display systems for retrofit applications and original equipment manufacturers (OEMs). The Company supplies integrated Flight Management Systems (FMS), Flat Panel Display Systems (FPDS), Integrated Standby Units (ISU), advanced Global Positioning System (GPS) receivers that enable reduced carbon footprint navigation and an Autothrottle, which allows a pilot to automatically control the power setting of the engine and is designed to reduce pilot workload and enhance safety.

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

Basis of Presentation

The accompanying unaudited condensed consolidated financial statements are presented pursuant to the rules and regulations of the United States Securities and Exchange Commission (the SEC) in accordance with the disclosure requirements for the quarterly report on Form 10-Q and, therefore, do not include all of the information and footnotes required by generally accepted accounting principles in the United States (GAAP) for complete annual financial statements. In the opinion of Company management, the unaudited condensed consolidated financial statements reflect all adjustments (consisting of normal recurring adjustments) necessary to state fairly the results for the interim periods presented. The condensed consolidated balance sheet as of September 30, 2017 is derived from the audited financial statements of the Company. Operating results for the three and nine months ended June 30, 2018 are not necessarily indicative of the results that may be expected for the fiscal year ending September 30, 2018. 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, 2017.

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

Use of Estimates

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

Cash and Cash Equivalents

Highly liquid investments, purchased with an original maturity of three months or less, are classified as cash equivalents. Cash equivalents at June 30, 2018 and September 30, 2017 consist of cash on deposit and cash invested in money market funds with financial institutions.

Property and Equipment

Property and equipment are stated at cost. Depreciation is provided using an accelerated method over the estimated useful lives of the assets (the lesser of three to seven years or over the lease term), except for the manufacturing facility and the corporate airplanes, which are depreciated using the straight-line method over their estimated useful lives of thirty-nine years and ten years, respectively. 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. During the three month period ended June 30, 2018, the Company purchased an aircraft for approximately $2.4 million. This aircraft will serve as a test bed for the Company s new products and also as a sales/marketing tool for demonstrating its products to its aviation customers.

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Fair Value of Financial Instruments

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

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

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

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

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

The following table sets forth by level within the fair value hierarchy the Company s financial assets and liabilities that were accounted for at fair value on a recurring basis as of June 30, 2018 and September 30, 2017, according to the valuation techniques the Company used to determine their fair values.

	Fair Value Measurement on June 30, 2018		
	Quoted Price in Active Markets for Identical Assets (Level 1)	**Significant Other Observable Inputs (Level 2)**	**Significant Unobservable Inputs (Level 3)**
Assets			
Cash and cash equivalents:			
Money market funds	$ 20,718,490	$	$

	Fair Value Measurement on September 30, 2017		
	Quoted Price in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Assets			
Cash and cash equivalents:			
Money market funds	$ 23,897,092	$	$

Long-Lived Assets

The Company assesses the impairment of long-lived assets in accordance with Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC) Topic 360-10, *Property, Plant and Equipment.* This statement requires that long-lived assets be reviewed for impairment whenever events or changes in circumstances indicate the carrying amount of an asset may not be recoverable. In addition, long-lived assets to be disposed of should be reported at the lower of the carrying amount or fair value less cost to sell. The Company considers historical performance and future estimated results in its evaluation of potential impairment and then compares the carrying amount of the asset to estimated future cash flows expected to result from use of the asset. If the carrying amount of the asset exceeds the estimated expected undiscounted future cash flows, the Company measures the amount of the impairment by comparing the carrying amount of the asset to its fair value. The estimation of fair value is generally measured by discounting expected future cash flows. No impairment charges were recorded during the nine months ended June 30, 2018 or 2017.

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Revenue Recognition

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

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); and FASB Accounting Standards Update 2009-13, *Multiple-Deliverable Revenue Arrangements-a consensus of the FASB Emerging Issues Task Force* (ASU 2009-13); and FASB ASC Topic 605, *Revenue Recognition* (ASC Topic 605).

To the extent that an arrangement contains software components, which include functional upgrades that the Company sells 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 a sales arrangement and allocates sales to each deliverable (if more than one) based on that deliverable s fair value. 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, and 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 it would use 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 *)* under the percentage-of-completion method. 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.

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 deliverable have been met based on the provisions of ASC Topic 605. In addition, the Company also receives orders for equipment and parts, and in general, recognizes revenue upon shipment to customers.

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

Engineering Development Contracts

The Company may enter into contracts to perform specified design and EDC services related to its products. The Company recognizes revenue from these arrangements as EDC sales, 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 reasonably estimable, and the contract is long-term in nature. The Company uses the completed contract method for all other contracts. Sales and profit margins under the percentage-of-completion method are

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recorded based on the ratio of actual costs incurred to total estimated costs expected to be incurred related to the contract under the cost-to-cost method.

The percentage-of-completion method of accounting requires the Company to estimate the profit margin for each individual contract or contract segment, and to apply that profit margin on a uniform basis as sales are recorded under the contract. The estimation of profit margin 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, prototype costs, overhead costs, and capital costs. These contracts sometimes include purchase options for additional quantities and for customer change orders for additional or revised product functionality. Revenues and costs related to profitable purchase options are included in the Company s estimates only when the options are exercised, while revenues and costs related to unprofitable purchase options are included in the Company s estimates when exercise is determined to be probable. Revenues related to change orders are included in profit estimates only if they can be estimated reliably and collectability is reasonably assured. Purchase options and change orders are accounted for either as an integral part of the original contract or separately, depending upon the nature and value of the item, in the period in which any change order or purchase option becomes effective. Anticipated losses on contracts are recognized in full in the period in which losses become probable and estimable.

The Company reviews estimates of profit margins for contracts on a quarterly basis. Assuming the initial estimates of revenue 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 contracts. Changes in these underlying estimates due to revisions in revenues and cost estimates or the exercise of contract options may result in profit margins being recognized unevenly over a contract as 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 (loss contracts), if any, resulting from changes in estimates are included in results of operations and disclosed in the notes to the consolidated financial statements of the Company.

Customer Service Revenue

The Company enters into sales arrangements with customers for the repair or upgrade of its various products that are not under warranty. The Company s customer service revenue and cost of sales for the three and nine months ended June 30, 2018 and 2017 respectively are as follows:

	For the Three Months Ended June 30,		**For the Nine Months Ended June 30,**	
	2018	**2017**	**2018**	**2017**
Customer Service Sales	$ 1,000,436	$ 827,046	$ 3,224,743	$ 2,228,934
Customer Service Cost of Sales	463,513	367,697	1,465,091	1,001,046
Gross Profit	$ 536,923	$ 459,349	$ 1,759,652	$ 1,227,888

Income Taxes

Income taxes are recorded in accordance with ASC Topic 740, *Income Taxes* (ASC Topic 740), which utilizes a balance sheet approach to provide for income taxes. Under this method, the Company recognizes deferred tax assets and liabilities for temporary differences between the financial reporting basis and the tax basis of the Company s assets, liabilities, and expected benefits of utilizing net operating losses (NOL) and tax credit carry-forwards. The impact on deferred taxes of changes in tax rates and laws, if any, are applied to the years during which temporary differences are expected to be settled, and are reflected in the consolidated financial statements in the period of enactment. At the end of each interim and year-end reporting period, the Company prepares an estimate of the annual effective income tax rate and applies that annual effective income tax rate to ordinary year-to-date pre-tax income for the interim period. Specific tax items discrete to a particular quarter are recorded in income tax expense for that quarter. The estimated annual effective tax rate used in providing for income taxes on a year-to-date basis may change in subsequent periods.

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

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both prudent and feasible. The Company s current balance of the deferred tax valuation allowance is recorded against all of its federal and state deferred tax assets. The Company will continue to assess all available evidence during future periods to evaluate any changes to the realization of its deferred tax assets. If the Company were to determine that it would be able to realize additional federal or state deferred tax assets in the future, it would make an adjustment to the valuation allowance which would reduce the provision for income taxes.

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

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

Engineering Development

The Company invests a large percentage of its sales on engineering development, both research and development (R&D) and EDC. At June 30, 2018, approximately 27% of the Company s employees were engineers engaged in various engineering development projects. Total engineering development expense is comprised of both internally funded R&D and product development and design charges related to specific customer contracts. Engineering development expense consists primarily of payroll-related expenses of employees engaged in EDC projects, engineering related product materials and equipment, and subcontracting costs. R&D charges incurred for product design, product enhancements, and future product development are expensed as incurred. Product development and design charges related to specific customer contracts are charged to cost of sales-EDC based on the method of contract accounting (either percentage-of-completion or completed contract) applicable to such contracts.

Treasury Stock

We account for treasury stock purchased under the cost method and include treasury stock as a component of stockholder s equity. Treasury stock purchased with intent to retire (whether or not the retirement is actually accomplished) is charged to common stock.

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 a financial statement 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 and nine months ended June 30, 2018 and 2017, respectively, comprehensive income consisted of net income only, and there were no items of other comprehensive income for any of the periods presented.

Share-Based Compensation

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

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Warranty

The Company offers warranties on some products of various lengths, however the standard warranty is twenty-four months. At the time of shipment, the Company establishes a reserve for estimated costs of warranties based on its best estimate of the amounts necessary to settle future and existing claims using historical data on products sold as of the balance sheet date. The length of the warranty period, the product s failure rates, and the customer s usage affect warranty cost. If actual warranty costs differ from the Company s estimated amounts, future results of operations could be affected adversely. Warranty cost is recorded as cost of sales, and the reserve balance recorded as an accrued expense. While the Company maintains product quality programs and processes, its warranty obligation is affected by product failure rates and the related corrective costs. If actual product failure rates and/or corrective costs differ from the estimates, the Company revises the estimated warranty liability accordingly.

Self-Insurance Reserves

Since January 1, 2014, the Company has self-insured a significant portion of its employee medical insurance. The Company maintains a stop-loss insurance policy that limits its losses both on a per employee basis and an aggregate basis. Liabilities associated with the risks that are retained by the Company are estimated based upon actuarial assumptions such as historical claims experience, demographic factors and other actuarial assumptions. The Company estimated the total medical claims incurred but not reported and the Company believes that it has adequate reserves for these claims at June 30, 2018 and September 30, 2017. However, the actual value of such claims could be significantly affected if future occurrences and claims differ from these assumptions. At June 30, 2018 and September 30, 2017, the estimated liability for medical claims incurred but not reported was approximately $58,000 and $53,000 respectively. The Company has recorded the excess of funded premiums over estimated claims incurred but not reported of approximately $72,000 and $249,000 as a current asset in the accompanying condensed consolidated balance sheets as of June 30, 2018 and September 30, 2017, respectively.

Concentrations

Major Customers and Products

For the three months ended June 30, 2018, three customers, Pilatus Aircraft Ltd (Pilatus), L3 Technologies (L3) and United States Department of Defense (DoD), accounted for 26%, 15% and 12% of net sales. During the nine months ended June 30, 2018, one customer, Pilatus, accounted for 17% of net sales.

For the three months ended June 30, 2017, two customers, Kanematsu Aerospace (Kanematsu) and Sierra Nevada Corporation (Sierra Nevada), accounted for 30% and 15% of net sales, respectively. During the nine months ended June 30, 2017, three customers, Sierra Nevada, DHL Aviation Services (DHL) and Kanematsu accounted for 20%, 13% and 11% of net sales, respectively.

Major Suppliers

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

For the three and nine month periods ended June 30, 2018, the Company had three suppliers and two suppliers, respectively, that were individually responsible for greater than 10% of the Company s total inventory related purchases.

For the three and nine months ended June 30, 2017, the Company had zero and two suppliers, respectively, that were individually responsible for greater than 10% of the Company s total inventory related purchases.

Concentration of Credit Risk

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

Basis of Presentation

Certain prior year financial statement amounts have been reclassified to conform to the current year presentation.

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Recent Accounting Pronouncements

In March 2016, the FASB issued ASU 2016-09, Improvements to Employer Share-Based Payment Accounting, which simplifies the tax treatment of stock shortfalls and windfalls. Previous guidance required excess tax benefits (windfalls) to be recorded in equity. Tax deficiencies (shortfalls) were recorded in equity to the extent of previous windfalls then to the income statement. The new guidance simplifies this treatment by having all windfalls and shortfalls recorded through the income statement. This guidance became effective for us beginning on October 1, 2017. Adoption of this standard did not have a material effect upon the consolidated financial statements.

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

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

In July 2015, the FASB issued Accounting Standards Update (ASU) No. 2015-11, Simplifying the Measurement of Inventory. ASU 2015-11 simplifies the subsequent measurement of inventory by requiring inventory to be measured at the lower of cost and net realizable value. ASU 2015-11 applies only to inventories for which cost is determined by methods other than last-in first-out and the retail inventory method. ASU 2015-11 is effective for public companies for annual reporting periods beginning after December 15, 2016, and interim periods within those fiscal years. We adopted ASU 2015-11 effective October 1, 2017 and the implementation had no material impact on the consolidated financial statements.

In August 2014, the FASB issued ASU No. 2014-15, Presentation of Financial Statements - Going Concern (Subtopic 205-40) (ASU 2014-15). The objective of ASU 2014-15 is to define management s responsibility to evaluate whether there is substantial doubt about an organization s ability to continue as a going concern and provide related disclosures. Previously, GAAP did not provide guidance to evaluate whether there was substantial doubt regarding an organization s ability to continue as a going concern. This ASU provides guidance to an organization s management, with principles and definitions to reduce diversity in the timing and content of financial statement disclosures commonly provided by organizations. This standard was adopted by the Company at September 30, 2017, and the adoption of this ASU did not have a material impact on the consolidated financial statements.

In May 2014, the FASB issued ASU No. 2014-09, Revenue from Contracts with Customers, which provides a single, comprehensive revenue recognition model for all contracts with customers, and contains principles to determine the measurement of revenue and timing of when it is recognized. The model will supersede most existing revenue recognition guidance, and also requires enhanced revenue-related disclosures. The

FASB has also issued several related ASUs which provide additional implementation guidance and clarify the requirements of the model. Adoption of the new rules could affect the timing of revenue recognition for certain transactions. The guidance permits two implementation approaches, one requiring retrospective application of the new standard with restatement of prior years and one requiring retrospective application of the new standard with the cumulative effect of applying the new standard as of the date of initial application recognized and disclosure of results under old standards. Based on the nature of the Company s business, the adoption of ASU No. 2014-09, or any of the subsequent related ASU s, is not expected to impact financial reporting with respect to the majority of its revenue streams. The Company is currently in the process of evaluating current accounting policies to identify potential differences for each of its revenue streams, and there is the potential for some changes to revenue recognition practices for multiple-element arrangements. We anticipate using the modified retrospective method of adoption when the Company adopts this standard in fiscal year 2019.

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

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2. Supplemental Balance Sheet Disclosures

Unbilled Receivables

Unbilled receivables principally represent sales recorded under the percentage-of-completion method of accounting that have not been billed to customers in accordance with applicable contract terms. Unbilled receivables, net of progress payments were $1.0 million at June 30, 2018 and $1.5 million at September 30, 2017.

Significant changes in estimates related to accounting for long-term contracts under the percentage-of-completion method may have a material effect on the Company s results of operations in the period in which the revised estimates are made. There were no cumulative catch-up adjustments resulting from changes in estimates for the three and nine months ended June 30, 2018. Cumulative catch-up adjustments resulting from changes in estimates decreased operating income by $45,000 for the three months ended June 30, 2017 and increased operating income by $76,000 for the nine months ended June 30, 2017.

Inventories

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

	June 30, 2018	September 30, 2017
Raw materials	$ 3,223,960	$ 2,920,209
Work-in-process	965,039	794,756
Finished goods	496,653	464,689
	$ 4,685,652	$ 4,179,654

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Prepaid expenses and other current assets

Prepaid expenses and other current assets consist of the following:

	June 30, 2018	September 30, 2017
Prepaid insurance	$ 254,333	$ 402,300
Income tax refund receivable	268,890	260,509
Other	351,152	429,255
	$ 874,375	$ 1,092,064

Property and equipment

Property and equipment, net consists of the following:

	June 30, 2018	September 30, 2017
Land	$ 1,021,245	$ 1,021,245
Computer equipment	2,315,949	2,247,866
Corporate airplanes	5,601,039	3,194,571
Furniture and office equipment	1,051,637	1,051,637
Manufacturing facility	5,733,313	5,733,313
Equipment	5,568,422	5,507,774
	21,291,605	18,756,406
Less: accumulated depreciation and amortization	(12,400,962)	(12,087,395)
	$ 8,890,643	$ 6,669,011

Depreciation and amortization related to property and equipment was approximately $105,000 and $111,000 for the three months ended June 30, 2018 and 2017, respectively. The corporate airplanes are utilized primarily in support of product development. The Pilatus PC-12 airplane, one of the Company s two corporate airplanes, has been depreciated to its estimated salvage value.

Depreciation and amortization related to property and equipment was approximately $314,000 and $330,000 for the nine months ended June 30, 2018 and 2017, respectively.

Other assets

Other assets consist of the following:

	June 30, 2018	September 30, 2017
Intangible assets, net of accumulated amortization of $531,637 at June 30, 2018 and September 30, 2017, respectively	$ 68,600	$ 68,600
Other non-current assets	115,426	118,715
	$ 184,026	$ 187,315

Intangible assets consist of licensing and certification rights which are amortized over a defined number of units. No impairment charges were recorded in the nine months ended June 30, 2018 and 2017.

Amortization expense was approximately $0 and $200 for the three months ended June 30, 2018 and 2017, respectively.

Amortization expense was approximately $0 and $2,600 for the nine months ended June 30, 2018 and 2017, respectively. The timing of future amortization expense is not determinable because the intangible assets are being amortized over a defined number of units.

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Accrued expenses

Accrued expenses consist of the following:

	June 30, 2018	September 30, 2017
Warranty	$ 893,914	$ 1,013,461
Salary, benefits and payroll taxes	387,783	258,688
Professional fees	145,677	219,331
Reduction in workforce / Severance	259,348	
Other	213,052	268,557
	$ 1,899,774	$ 1,760,037

During the period ended June 30, 2018, the Company incurred $259,348 in severance and other costs associated with a reduction in workforce.

Warranty cost and accrual information for the three and nine months ended June 30, 2018 is highlighted below:

	Three Months Ending June 30, 2018	Nine Months Ending June 30, 2018
Warranty accrual, beginning of period	$ 930,458	$ 1,013,461
Accrued expense	1,368	9,070
Warranty cost	(37,912)	(128,617)
Warranty accrual, end of period	$ 893,914	$ 893,914

3. Income Taxes

During the three and nine month periods ended June 30, 2018, income taxes were impacted relative to the prior year period by the Tax Cuts and Jobs Act (the Act), which was enacted into law on December 22, 2017. Income tax effects resulting from changes in tax laws are accounted for by the Company in accordance with the authoritative guidance, which requires that these tax effects be recognized in the period in which the law is enacted and the effects are recorded as a component of the provision for income taxes from continuing operations.

The Act includes significant changes to the U.S. corporate income tax system which reduces the U.S. federal corporate tax rate from 35.0% to 21.0% as of January 1, 2018. The decrease in the U.S. federal corporate tax rate from 35.0% to 21.0% results in a blended statutory tax rate of 24.5% for the fiscal year ending September 30, 2018. The Act also eliminates for NOLs the previous carryback period of two years and permits an indefinite carryforward period.

The income tax expense for the three months ended June 30, 2018 was approximately $0 as compared to an income tax benefit of $0.5 million for the three months ended June 30, 2017.

The effective tax rate for the three months ended June 30, 2018 was approximately 0% and differs from the statutory tax rate mostly due to an increase in the valuation allowance of approximately $2.5 million. The majority of this change is a result of the tax benefit related to pre-tax losses not being currently realizable in future periods.

The effective tax rate benefit for the three months ended June 30, 2017 was 103.7%. The effective tax rate benefit for the three months ended June 30, 2017 differs from the statutory tax rate primarily due to the change in the anticipated profitability in the period partially offset by the reduction in the utilization of certain R&D tax credits in the period resulting in an increase in the valuation allowance of approximately $0.5 million.

The income tax expense for the nine months ended June 30, 2018 was $0.1 million as compared to an income tax expense of $0.3 million for the nine months ended June 30, 2017.

The effective tax rate for the nine months ended June 30, 2018 was (1.9%) and differs from the statutory tax rate mostly due to an increase in the valuation allowance of approximately $4.8 million. The majority of this change is a result of the tax benefit related to pre-tax losses not being currently realizable in future periods.

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The effective tax rate for the nine months ended June 30, 2017 was 5.9%. The effective tax rate for the nine months ended June 30, 2017 differs from the statutory rate primarily due to a change in the valuation allowance of approximately $1.4 million included in the estimated annual effective tax rate that is attributable to the anticipated profitability in the period. The majority of this change is a result of the bad debt reserve reversal being deductible for tax purposes and the utilization of certain R&D tax credits in the period.

4. Shareholders Equity and Share-based Payments

At June 30, 2018, the Company s Amended and Restated Articles of Incorporation provides the Company authority to issue 75,000,000 shares of common stock and 10,000,000 shares of preferred stock.

Share-based compensation

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

Total share-based compensation expense was $0 for each of the three and nine month periods ended June 30, 2018 and 2017. The income tax effect recognized as a credit to additional paid-in capital related to share-based compensation arrangements was $0 for each of the three and nine month periods ended June 30, 2018 and 2017.

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

1998 Stock Option Plan

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

Total compensation expense associated with stock option awards to employees under the 1998 Plan was $0 for the three and nine month periods ended June 30, 2018 and 2017.

2009 Stock-Based Incentive Compensation Plan

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

Subject to an adjustment necessary upon a stock dividend, recapitalization, forward split or reverse split, reorganization, merger, consolidation, spin-off, combination, repurchase or share exchange, extraordinary or unusual cash distribution, or other similar corporate transaction or event, the maximum number of shares of common stock available for Awards under the 2009 Plan shall be 1,200,000, all of which may be issued pursuant to Awards of incentive stock options. In addition, the Plan provides that no more than 300,000 shares of common stock per year may be awarded to any employee as a performance-based Award under Section 162(m) of the Code. At June 30, 2018 there were 202,128 shares of common stock available for awards under the plan.

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

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adjustments in the terms and conditions of any Awards, including any performance goals, in recognition of unusual or nonrecurring events affecting the Company or any subsidiary, or in response to changes in applicable laws, regulations or accounting principles, provided that no adjustment may be made that would adversely affect the status of any Award that is intended to be a performance-based Award under Section 162(m) of the Code, unless otherwise determined by the Compensation Committee.

Total compensation expense related to Options issued to employees under the 2009 Plan was $0 for each of the three and nine month periods ended June 30, 2018 and 2017. The expense under the 2009 Plan related to shares issued to non-employee members of the Company s Board of Directors as compensation was approximately $0 for each of the three month periods ended June 30, 2018 and 2017. Directors compensation was approximately $200,000 and $192,000 for each of the nine month periods ended June 30, 2018 and 2017. Total compensation expense associated with the 2009 Plan was approximately $0 for each of the three month periods ended June 30, 2018 and 2017; and approximately $200,000 and $192,000 for each of the nine month periods ended June 30, 2018 and 2017, respectively.

Restricted Stock Units

During fiscal 2016, the Company s Board of Directors (the Board) approved grants of RSUs to the non-employee directors on the Board as compensation for their services during calendar year 2016. Under the terms of the awards, at the conclusion of the vesting period on January 2, 2017, the grants of RSUs were settled in shares of the Company s common stock at a rate of one share of stock for each unit. Directors that did not serve for the entirety of calendar year 2016 received a pro rata portion of such award for time served. As of June 30, 2018, there were no unvested restricted stock units outstanding under the 2009 Plan.

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5. Earnings Per Share

	Three Months Ended June 30,				Nine Months Ended June 30,			
	2018		2017		2018		2017	
Numerator:								
Net loss	$	(1,041,037)	$	19,220	$	(3,239,527)	$	4,754,673
Denominator:								
Basic weighted average shares		16,816,838		16,755,082		16,800,070		16,735,533
Dilutive effect of share-based awards				115,322				111,772
Diluted weighted average shares		16,816,838		16,870,404		16,800,070		16,847,305
Earnings per common share:								
Basic EPS	$	(0.06)	$	0.00	$	(0.19)	$	0.28
Diluted EPS	$	(0.06)	$	0.00	$	(0.19)	$	0.28

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

The number of incremental shares from the assumed exercise of stock options is calculated by using the treasury stock method. As of June 30, 2018 and 2017, there were 556,834 and 586,834 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 June 30, 2018 and 2017, respectively, 306,834 and 336,834 diluted weighted-average shares outstanding were excluded from the computation of diluted EPS because the effect would be anti-dilutive.

For the nine months ended June 30, 2018 and 2017, respectively, 322,612 and 337,090 diluted weighted-average shares outstanding were excluded from the computation of diluted EPS because the effect would be anti-dilutive.

Net income and EPS in the nine months ended June 30, 2017 were positively impacted by approximately $4.1 million of other income related to the Company s settlement agreement with Delta Air Lines, Inc. (See Note 6 to condensed consolidated financial statements).

6. Contingencies

On February 23, 2017 the Company entered into a settlement agreement with Delta. Under the terms of the settlement, Delta paid the Company $7.75 million resulting in the reversal of the $3.6 million reserve for the collection of the unbilled receivable in the fiscal year ended September 30, 2017.

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

CAUTIONARY STATEMENT REGARDING FORWARD-LOOKING STATEMENTS

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

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

- *market acceptance of the Company s flat panel display systems, NextGen Flight Deck, ThrustSense Integrated PT6 Autothrottle (patent pending) and COCKPIT/IP® or other planned products or product enhancements;*
- *continued market acceptance of the Company s air data systems and products;*
- *the competitive environment and new product offerings from competitors;*
- *difficulties in developing and producing the Company s NextGen Flight Deck, ThrustSense Integrated PT6 Autothrottle (patent pending), COCKPIT/IP® Flat Panel Display System or other planned products or product enhancements;*
- *the deferral or termination of programs or contracts for convenience by customers;*
- *the availability of government funding;*
- *the impact of general economic trends on the Company s business;*
- *the ability to gain regulatory approval of products in a timely manner;*
- *delays in receiving components from third party suppliers;*
- *the bankruptcy or insolvency of one or more key customers;*

- *protection of intellectual property rights;*
- *failure to retain/recruit key personnel;*
- *a cyber security incident;*
- *the ability to service the international market;*
- *risks related to our self-insurance program;*
- *potential future acquisitions;*
- *changes in law, including changes to corporate tax laws in the United States and the availability of certain tax credits; and*
- *other factors disclosed from time to time in the Company s filings with the United States Securities and Exchange Commission (the SEC).*

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

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

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

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Company Overview

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

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

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

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

More recently, the Company has developed and received certification on its NextGen Flight Deck featuring its ThrustSense Integrated PT6 Autothrottle (ThrustSense Autothrottle) for retrofit in the Pilatus PC-12. The NextGen Flight Deck features Primary Flight and Multi-Function Displays, ISUs as well as an Integrated FMS and Electronic Flight Bag System. The innovative avionics suite includes dual flight management systems, autothrottles, synthetic vision and enhanced vision. The NextGen enhanced avionics suite is available for integration into other business aircraft with Non-FADEC and FADEC engines.

The ThrustSense Autothrottle is innovative in that it is the first autothrottle developed for a turbo prop that allows a pilot to automatically control the power setting of the engine. The autothrottle computes and controls appropriate power levels reducing overall pilot workload. The system computes thrust, holds selected speed/torque, and implements appropriate speed and engine limit protection. When engaged by the pilot, the autothrottle system adjusts the throttles automatically to achieve and hold the selected airspeed guarded by a torque/temperature limit mode. The autothrottle system takes full advantage of the integrated cockpit utilizing Weight and Balance information for optimal control settings and enabling safety functions like a Turbulence control mode.

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

Customers have been and may continue to be affected by the uncertain economic conditions that currently exist both in the United States and abroad. Such conditions may cause customers to curtail or delay their spending on both new and existing aircraft. Factors that can impact general economic conditions and the level of spending by customers include, but are not limited to, general levels of consumer spending, increases in fuel and energy costs, conditions in the real estate and mortgage markets, labor and healthcare costs, access to credit, consumer confidence, and other macroeconomic factors that affect spending behavior. Furthermore, spending by government agencies may be reduced in the future if tax revenues decline, including as a result of recently enacted tax reform legislation in the United States. If customers curtail or delay their spending or are forced to declare bankruptcy or liquidate their operations because of adverse economic conditions, the Company s revenues and results of operations would be affected adversely. However, the Company believes that, in an uncertain economic environment, customers that may have otherwise elected to purchase newly manufactured aircraft may be interested instead in retrofitting existing aircraft as a cost-effective alternative, thereby creating a market opportunity for IS&S. Cost of sales related to product sales is comprised of material components and third-party avionics purchased from suppliers, direct labor, and overhead costs. Many of the components are standard, although certain parts are manufactured to meet IS&S specifications. The overhead portion of cost of sales is comprised primarily of salaries and benefits, building occupancy costs, supplies, and outside service costs related to production, purchasing, material control, and quality control. Cost of sales includes warranty costs.

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

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

During the nine month period ended June 30, 2018, the Company reduced its overall headcount. The reductions affected most of the departments in the Company with the majority of the reductions coming from the operations department. The Company expects to see a significant reduction in its overall payroll and related benefit expense in the fourth quarter of fiscal 2018 as a result of these actions.

Critical Accounting Policies and Estimates

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

The Company believes that its critical accounting policies affect its more significant estimates and judgments used in the preparation of its consolidated financial statements. The Annual Report on Form 10-K for the fiscal year ended September 30, 2017 contains a discussion of these critical accounting policies. There have been no significant changes in the Company s critical accounting policies since September 30, 2017. See also Note 1 to the unaudited condensed consolidated financial statements for the three and nine months period ending June 30, 2018 as set forth herein.

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RESULTS OF OPERATIONS FOR THE THREE AND NINE MONTHS ENDED JUNE 30, 2018 AND 2017

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

	Three Months Ended June 30, 2018	Three Months Ended June 30, 2017	Nine Months Ended June 30, 2018	Nine Months Ended June 30, 2017
Net sales:				
Product	94.4%	98.6%	97.7%	95.6%
Engineering development contracts	5.6%	1.4%	2.3%	4.4%
Total net sales	100.0%	100.0%	100.0%	100.0%
Cost of sales:				
Product	50.6%	45.7%	52.7%	47.7%
Engineering development contracts	2.7%	2.0%	1.0%	2.4%
Total cost of sales	53.3%	47.7%	53.7%	50.1%
Gross profit	46.7%	52.3%	46.3%	49.9%
Operating expenses:				
Research and development	30.3%	27.2%	29.2%	27.0%
Selling, general and administrative	48.0%	37.0%	49.1%	16.1%
Total operating expenses	78.3%	64.3%	78.3%	43.1%
Operating (loss) income	(31.6)%	(11.9)%	(32.0)%	6.8%
Interest income	0.4%	0.2%	0.4%	0.2%
Other income	0.5%	0.3%	0.5%	33.2%
(Loss) income before income taxes	(30.7)%	(11.4)%	(31.1)%	40.2%
Income tax expense (benefit)	0.0%	(11.8)%	0.6%	2.4%
Net (loss) income	(30.7)%	0.4%	(31.7)%	37.8%

Three Months Ended June 30, 2018 Compared to the Three Months Ended June 30, 2017

Net sales. Net sales were $3.4 million for the three months ended June 30, 2018 compared to $4.5 million for the three months ended June 30, 2017, a decrease of 24.4%. Net product sales decreased $1.3 million in the three months ended June 30, 2018 compared to the three months ended June 30, 2017, and EDC sales increased $0.1 million from the same period in the prior year. Product sales for the three months ended June 30, 2018 decreased from the same period in the prior year primarily because of decreased shipments of engine and fuel instrumentation for retrofit programs to foreign military customers. The increase in EDC sales in the current year period was primarily the result of new customer design and EDC programs.

Cost of sales. Cost of sales decreased $0.4 million, or 18.2%, to $1.8 million, or 52.9% of net sales, in the three months ended June 30, 2018, compared to $2.2 million, or 48.9% of net sales, in the three months ended June 30, 2017. The decrease in cost of sales was primarily the result of a decrease in product sales volume for the three months ended June 30, 2018 compared to the three months ended June 30, 2017. The Company s overall gross margin was 47.1% and 51.1% for the three months ended June 30, 2018 and 2017, respectively. This decrease in overall gross margin primarily reflects a lower product gross margin primarily the result of reduced coverage of fixed costs due to lower sales volume.

Research and development. R&D expense decreased $0.2 million, or 16.7%, to $1.0 million, or 29.4% of net sales, in the three months ended June 30, 2018 from $1.2 million, or 26.7% of net sales, in the three months ended June 30, 2017. The decrease in R&D expense in the quarter reflected a reduced payroll and related benefit expense.

Selling, general, and administrative. Selling, general and administrative expense decreased by $0.1 million to $1.6 million in the three months ended June 30, 2018 from an expense of $1.7 million in the three months ended June 30, 2017. The decrease in selling, general, and administrative expense in the three months was primarily the result of a decrease in sales commissions of $0.1 million. As a percentage of net sales, selling, general and administrative expenses increased to 48.0% of net sales in the three months ended June 30, 2018 from 37.8% of net sales in the three months ended June 30, 2017.

Interest income. Interest income increased to $15,000 in the three months ended June 30, 2018 from $8,000 in the three months ended June 30, 2017, mainly a result of higher interest rates in the current year period compared to the same period in the prior year.

Other income. Other income was $16,000 in each of the three month periods ended June 30, 2018 and 2017 and is mainly composed of royalties earned in each such period.

Income tax expense. The income tax expense for the three months ended June 30, 2018 was approximately $0 as compared to an income tax benefit of $0.5 million for the three months ended June 30, 2017. The effective tax rate for the three months ended June 30, 2018 was 0% and differs from the statutory tax rate mostly due to an increase in the valuation allowance of approximately $2.5 million. The majority of this change is a result of the tax benefit related to pre-tax losses not being currently realizable in future periods. The Act permits an indefinite carryforward period for NOLs.

The effective tax rate benefit for the three months ended June 30, 2017 was 103.7%. The effective tax rate benefit for the three months ended June 30, 2017 differs from the statutory tax rate primarily due to the change in the anticipated profitability in the period partially offset by the reduction in the utilization of certain R&D tax credits in the period resulting in an increase in the valuation allowance of approximately $0.5 million.

Net loss. The Company reported a net loss for the three months ended June 30, 2018 of $1.0 million compared to net income of $0.02 million for the three months ended June 30, 2017. On a diluted basis, the loss per share was $0.06 for the three months ended June 30, 2018 compared to net income per share of $0.00 for the three months ended June 30, 2017.

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Nine months ended June 30, 2018 Compared to the Nine months ended June 30, 2017

Net sales. Net sales were $10.2 million for the nine months ended June 30, 2018 compared to $12.6 million for the nine months ended June 30, 2017, a decrease of 19.0%. Net product sales decreased $2.0 million in the nine months ended June 30, 2018 compared to the nine months ended June 30, 2017, and EDC sales decreased $0.4 million from the same period in the prior year. Product sales for the nine months ended June 30, 2018 decreased from the same period in the prior year primarily because of decreased shipments of displays for retrofit programs to the DoD and military subcontractors. The decrease in EDC sales in the current year period was the result of the completion of EDC projects awarded in prior years and they have not been replaced by new EDC projects.

Cost of sales. Cost of sales decreased $0.8 million, or 12.7%, to $5.5 million, or 53.9% of net sales, in the nine months ended June 30, 2018, compared to $6.3 million, or 50.0% of net sales, in the nine months ended June 30, 2017. The decrease in cost of sales was primarily the result of a decrease in product sales volume for the nine months ended June 30, 2018 compared to the nine months ended June 30, 2017. The Company s overall gross margin was 46.1% and 50.0% for the nine months ended June 30, 2018 and 2017, respectively. This decrease in overall gross margin primarily reflects a lower product gross margin primarily the result of reduced coverage of fixed costs due to lower sales volume.

Research and development. R&D expense decreased $0.4 million, or 11.8%, to $3.0 million, or 29.4% of net sales, in the nine months ended June 30, 2018 from $3.4 million, or 27.0% of net sales, in the nine months ended June 30, 2017. The decrease in R&D expense in the nine months reflected a reduced payroll and related benefit expense.

Selling, general, and administrative. Selling, general and administrative expense increased by $3.0 million to $5.0 million in the nine months ended June 30, 2018 from $2.0 million in the nine months ended June 30, 2017. The increase in selling, general, and administrative expense in the nine months ended June 30, 2018 was primarily the result of the reversal in the prior year period of the $3.6 million reserve of the Delta unbilled receivable due to the February 23, 2017 settlement with Delta. As a percentage of net sales, selling, general and administrative expenses increased to 49.0% of net sales in the nine months ended June 30, 2018 from 15.9% of net sales in the nine months ended June 30, 2017.

Interest income. Interest income increased to $36,000 in the nine months ended June 30, 2018 from $28,000 in the nine months ended June 30, 2017, mainly a result of higher interest rates in this period compared to the same period in the prior year.

Other income. Other income was $53,000 in the nine months ended June 30, 2018 and $4.2 million for the nine months ended June 30, 2017. Other income for the nine months ended June 30, 2018 is mainly composed of royalties earned. For the nine months ended June 30, 2017, the Delta settlement payment to the Company of $7.75 million is reflected in the financial statements as payment of the $3.6 million unbilled receivable previously reserved which has been reversed in the period ended June 30, 2017 in selling, general and administrative expenses. The remainder of the settlement payment, approximately $4.1 million, is reflected as other income in the nine months ended June 30, 2017.

Income tax expense. The income tax expense for the nine months ended June 30, 2018 was $0.1 million as compared to an income tax expense of $0.3 million for the nine months ended June 30, 2017.

The effective tax rate for the nine months ended June 30, 2018 was (1.9%) and differs from the statutory tax rate mostly due to an increase in the valuation allowance of approximately $4.8 million. The majority of this change is a result of the tax benefit related to pre-tax losses not being currently realizable in future periods. The Act permits an indefinite carryforward period for NOLs.

The effective tax rate for the nine months ended June 30, 2017 was 5.9%. The effective tax rate for the nine months ended June 30, 2017 differs from the statutory rate primarily due to a reduction in the valuation allowance of approximately $1.4 million included in the estimated annual effective tax rate that is attributable to the anticipated profitability in the prior year. The majority of this change is a result of the bad debt reserve reversal being deductible for tax purposes and the utilization of certain R&D tax credits in the period.

Net loss. The Company reported a net loss for the nine months ended June 30, 2018 of $3.2 million compared to net income of $4.8 million for the nine months ended June 30, 2017. On a diluted basis, the loss per share was $0.19 for the nine months ended June 30, 2018 compared to income per share of $0.28 for the nine months ended June 30, 2017.

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Liquidity and Capital Resources

The following table highlights key financial measurements of the Company:

	June 30, 2018	September 30, 2017