INNOVATIVE SOLUTIONS & SUPPORT INC
Form 10-K
December 20, 2013
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-K

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

For the fiscal year ended September 30, 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)

Pennsylvania	**23-2507402**
(State or other jurisdiction of incorporation)	(IRS Employer Identification No.)
720 Pennsylvania Drive, Exton, Pennsylvania	**19341**
(Address of principal executive offices)	(Zip Code)

(610) 646-9800

(Registrant s telephone number, including area code)

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

Title of each class:	**Name of each exchange on which registered**
Common Stock par value $.001 per share	The NASDAQ Stock Market, LLC

Securities registered pursuant to Section 12(g) of the Act: **None**

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes o No x

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act Yes o No x

Note: Checking the box above will not relieve any registrant required to file reports pursuant to Section 13 or section 15(d) of the Exchange Act from their obligations under those sections.

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 o No x

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§ 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes x No o

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K (§229.405) is not contained herein, and will not be contained, to the best of the registrant s knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. x

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, non-accelerated filer, and smaller reporting company, in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer o	Accelerated filer o
Non-accelerated filer o	Smaller Reporting Company x

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

The aggregate market value of the Registrant s common stock held by non-affiliates of the Registrant as of March 31, 2013 (the last business day of the registrant s most recently completed second quarter) was approximately $50.8 million. Shares of common stock held by each executive officer and director and by each person who owns 10% or more of the Registrant s outstanding common stock have been excluded since such persons may be deemed affiliates. This determination of affiliate status is not necessarily a conclusive determination for other purposes.

As of November 29, 2013, there were 16,888,086 outstanding shares of the Registrant s Common Stock

Documents Incorporated by Reference

Portions of the Registrant s Proxy Statement for the 2013 Annual Meeting of Shareholders to be filed prior to January 27, 2014 are incorporated by reference into Part III of this Report. Such Proxy Statement, except for the parts therein which have been specifically incorporated by reference, shall not be deemed filed for the purposes of this Report on Form 10-K.

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INNOVATIVE SOLUTIONS AND SUPPORT, INC.

2013 Annual Report on Form 10-K

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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:

- *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;*
- *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 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 Annual Report on Form 10-K. 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 Annual Report on Form 10-K, 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 Innovative Solutions and Support, Inc.*

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PART I

Item 1. Business

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 flight guidance and cockpit display systems for original equipment manufacturers (OEMs) and retrofit applications. 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 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, 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.

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 Flat Panel Display System (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. The Company has incorporated Electronic Flight Bag (EFB) functionality, such as charting and mapping systems, into its FPDS product line. The shift in 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. Aircraft equipped with the Company s FMS and FPDS product line (equipped with a SBAS/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 OEMs and retrofit market. Customers include various OEMs, commercial air transport carriers and corporate/general aviation companies, DoD and its commercial contractors, aircraft operators, aircraft modification centers, and foreign militaries. Occasionally, IS&S sells its products directly to DoD; however, the Company sells its products primarily to commercial customers for end use in DoD programs. Sales to defense contractors are 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 affecting spending behavior. In addition, the Budget Control Act of 2011 (the Budget Act) triggered substantial, automatic reductions in both defense and discretionary spending. The automatic across-the-board sequestration cuts are in addition to reductions already reflected in defense funding over a ten-year period. Furthermore, spending by government agencies may in the future be further reduced because of declining tax revenues associated with present economic conditions. If customers curtail or delay their spending or are forced to declare bankruptcy or liquidate their operations because of continuing adverse economic conditions, the Company s revenues and results of operations will be adversely affected. 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.

In September 2013, the FAA issued its Technical Standard Order authorization (TSO) to IS&S for its Standby Display Unit (SDU). This certification enabled IS&S to expand its product offering of the SDU to owners of various aircraft types in the United States, subject to certification of minor technical modifications to adapt it for use in a specific aircraft. This certification has led IS&S to develop an Integrated Standby Unit (ISU), which combines the Company s Air Data technology with the SDU as a standalone industry product.

In September 2013, the FAA issued its TSO to IS&S for its Digital Air Data Computer (DADC) for use on the RC-135

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aircraft, which enabled IS&S to expand its product offering of the DADC to owners of the RC-135 in the United States.

In March 2013 Delta Air Lines, Inc. (Delta) executed an agreement with IS&S for a complete Systems Integration, Dual GPS Navigation, Dual FMS, and Cockpit Avionics upgrade of Delta s MD88 and MD90 fleet for deliveries spanning 2014 to 2016.

In February 2013 Sierra Nevada Corporation awarded IS&S a contract to design, develop, manufacture, and supply an upgraded Integrated Flat Panel Display System for a number of Pilatus PC-12 type aircraft in the United States.

In May 2013, Pilatus Aircraft Limited (Pilatus) of Switzerland executed an agreement with IS&S to develop and manufacture the Utilities Management System (UMS) for the Pilatus PC-24 under a multi-year production contract. The UMS integrates multiple aircraft utility functions commonly supported by multiple individual controllers and monitors. The IS&S UMS will provide integrated control of systems from within the avionics suite and automate various normal and emergency tasks to reduce crew workload and improve safety conditions.

In December 2012 iAccess Technologies Inc. awarded IS&S a contract to design, develop, manufacture and supply an Integrated Avionics Suite System to upgrade cockpit displays for several L-100-30 and C-130 aircraft.

In October 2012, Eclipse Aerospace, Inc. (Eclipse) placed a production order with IS&S for an initial fifty ship sets of a three hundred ship set contract for the IS&S advanced avionics suite for the production model Eclipse 550. IS&S is the supplier of Primary Flight, Multi-Function Displays, and the Integrated Flight Management System® (IFMS®). The advanced avionics suite will include Dual Flight Management systems, Auto Throttles, Synthetic Vision, integrated Terrain Awareness System (TAWS), and Enhanced Vision System (EVS).

In August 2012, the FAA issued its Supplemental Type Certificate (STC) to IS&S for its FPDS on Classic B-737 aircraft. This certification enables IS&S to expand its marketing of its FPDS to owners of B-737-300/-400/-500 in the United States and internationally.

In October 2011, Eclipse selected IS&S to design and develop the advanced avionics suite for the production model Eclipse 550.

In July 2011, the National Nuclear Security Administration (NNSA) awarded IS&S a contract for the complete Systems Integration and Cockpit Avionics upgrade of their B737-400 Classic aircraft. Upon completion, this upgrade will provide NNSA full Communication Navigation Surveillance/Air Traffic Management (CNS/ATM) capabilities and similar efficiency and performance to the B737 Next Generation (NG) at the fraction of the cost of a new aircraft. This program complements the IS&S FPDS contracts for more than 400 B757/B767 aircraft with more than 230 aircraft already in revenue service. The upgrade for the B737-300/-400/-500 series aircraft and the existing B757/B767 FPDS are platforms for compliance with NextGen and Single European Sky ATM Research (SESAR) requirements, is Controller Pilot Data Link Communication (CPDLC), Link 2000, RNP, ADS-B and In-Trail capable, provides power and weight savings, and reduces fuel consumption and CO_2 emissions.

In April 2011, The Boeing Company (Boeing) awarded IS&S a contract to design and develop the Aerial Refueling Operator Control and Display Units (AROCDU) for the KC-46A Tanker Program.

In March 2011, IS&S announced it received FAA STC for its FMS and dual GPS receivers for the Eclipse Twin-Engine Jet. The IS&S FMS displays control all major systems on the aircraft and includes improvements to e-Chart, mapping and satellite weather functionality, and precision navigation. Eclipse Twin-Engine Jet operators were able to upgrade their aircraft within Integrated Flight Management System through Eclipse.

In February 2011, the FAA issued its TSO to IS&S for its Beta-3 GPS Satellite Based Augmentation System (SBAS) Receiver. This certification enabled IS&S to expand its product offering to include a GPS in its FPDS. In addition, the FAA issued a TSO in March 2011 for the IS&S Class Gamma 3 FMS and a Type 2 FAA Letter of Acceptance (LOA) that allows IS&S to provide navigation data. These certifications enabled IS&S to offer a flight management system.

In December 2010, the European Aviation Safety Agency (EASA), the European counterpart of the FAA issued its STC to IS&S for the B757 FPDS. Further, in August 2011, IS&S obtained an STC from EASA for its B767 FPDS. These certifications enabled IS&S to expand its marketing of its B757 and B767 FPDS to Europe.

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Industry

A wide range of information is critical for proper and safe operation of aircraft. With advances in technology, new types of information to assist pilots are becoming available for display in cockpits, such as satellite based weather, ground terrain maps, and ADS-B. The Company believes that aircraft cockpits will increasingly become information centers, capable of delivering additional information that is either mandated by regulation or demanded by pilots to assist in the safe and efficient operation of aircraft.

There are four general types of flight data: aircraft heading and altitude information, flight critical aircraft control data, navigation data, and maintenance and aircraft health data. Aircraft heading and altitude information includes aircraft speed, altitude, and rates of ascent and descent. Flight critical aircraft control information includes engine data such as fuel and oil quantity, and other engine measurements. Navigation data includes radio position, flight management, GPS, and alternative source information (i.e. information not originating on the aircraft, including weather depiction maps, GPS navigation, and surface terrain maps). Maintenance and aircraft health data includes on-board sensors and programs to measure parameters related to the health of a system on the aircraft. Air data calculations are based primarily on air pressure measurements derived from sensors on the aircraft. Engine data are determined by measuring various indices such as temperature, volume, revolutions per minute (RPM), and pressure within an aircraft s engines and other mechanical equipment. GPS and alternative source information are derived typically from satellites or equipment located on land and fed by satellite or radio signals to the aircraft. Maintenance and aircraft health data measures multiple parameters on various products and interface with various components to manage, measure, and report on the health, reliability and usability of a system. Pilots and maintenance technicians can presently display this information in the cockpit for reference, enhanced position awareness, and reduce support logistics of properly equipped aircraft.

Traditionally, flight data and other cockpit information were displayed on a series of separate analog mechanical instruments. In the early 1980s, Cathode Ray Tubes (CRT) and digital displays using Liquid Crystal Displays (LCD) began to replace some individual analog instruments. Presently, the industry offers high resolution color flat panels using Active Matrix Liquid Crystal Displays (AMLCD) to replace traditional analog instruments, CRT or LCD displays. IS&S expects that the ability to display more information in an efficient space and custom platform will become increasingly important if additional information, such as weather depiction maps, traffic information, surface terrain maps, datalink messaging, and surveillance displays becomes mandated by regulation or demanded by pilots. Accordingly, the Company believes flat panel displays, which can integrate and display a suite of information, will replace individual instruments CRTs and LCDs as the method for displaying information in cockpits.

In the past, equipment data, such as engine and fuel related information, were displayed on conventional analog mechanical instruments. Engine and fuel instruments provide information on engine activity, including oil and hydraulic pressures, and temperature. These instruments are clustered throughout an aircraft s cockpit. Engine and fuel instruments tend to be replaced more frequently than other instruments due to obsolescence and normal wear-and-tear. Aircraft operators continue to purchase individual conventional engine and fuel instruments as replacements, because the information displayed by these instruments is vital for safe and efficient flight. Increasingly, operators are replacing their clusters of analog mechanical instruments with integrated Engine Instrument Display Systems (EIDS) or a FPDS package.

As the skies and airports become more crowded, the aviation industry and its regulators are concentrating on new technologies, procedures, and regulations that allow more aircraft to operate in the skies and on the ground safely, efficiently, and with less impact on the environment. These new technologies and procedures, such as traffic avoidance, ground awareness, increased precision of navigation and vertical position, runway incursion prevention, and increased digital communication, will require innovation and intuitive methods to display situational awareness information for the pilots. The Company believes that flat panel displays provide the best solution to these requirements.

Strategy

The Company s objective is to become a leading supplier and integrator of cockpit information, and believes that its industry experience and reputation, technology and products, and business strategy provide the basis to achieve this objective. Key elements of the Company s strategy include:

- *Focusing on retrofits.* Cockpit avionics upgrades for existing aircraft is of great interest in the present economic environment. The retrofit of an aircraft with the COCKPIT/IP® FPDS is cost effective compared to the acquisition of a new aircraft and can provide the same functionality as is available in new aircraft.

- *Establishing leadership in the flat panel display market.* IS&S expects that many aircraft will be retrofitted with flat panel displays over the next several years. Given the versatility, visual appeal, and lower cost of displaying a series of instruments and other flight relevant information on a single flat panel, the Company believes that flat panel displays will increasingly replace individual analog and digital instruments, LCDs and CRTs. The Company believes the COCKPIT/IP® has significant benefits over flat panel displays currently offered by competitors, including lower cost, larger size, reduced weight, enhanced viewing angles, and a broader array of

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functions. The Company s patented and proprietary Integrity Checking Processor and Zooming features provide increased situational awareness, reliability, performance, and utility to the owner/operator. Accordingly, the Company believes that these advantages will allow IS&S to generate significant revenues from the COCKPIT/IP® product, and increase market share. In addition, demand for new aircraft, FAA mandates to upgrade older aircraft and obsolescence issues on older aircraft will contribute to this growth.

- *Continuing engineering and product development successes.* IS&S develops innovative products by combining its avionics, engineering, and design expertise with commercially available technologies, components, and products from non-aviation applications, including the personal computer and telecommunications industries. The Company s COCKPIT/IP® FPDS is an example of its ability to engineer products through the selective application of non-avionic technology. In addition, as permitted by law, IS&S applies for and registers its patents and trademarks for the technology and products it develops in the United States and various countries around the world to protect its intellectual property. Research and development (R&D) expenses were $2.6 million, $2.7 million and $5.5 million for fiscal years ended September 30, 2013, 2012 and 2011, respectively. During fiscal 2013, 2012 and 2011 revenues related to Engineering Development Contracts (EDC) accounted for 26%, 26% and 2%, respectively, of total sales. In support of these EDC programs, the Company charged $8.3 million, $4.7 million, and $0.2 million for fiscal years ended September 30, 2013, 2012 and 2011, respectively to cost of sales.

- *Maintaining leadership in air data markets.* The Company believes that it is one of the largest suppliers of air data products to the U.S. retrofit market. The pressures on the DoD procurement budget make the retrofit of aging military aircraft with newer, more advanced, and more supportable air data systems more attractive. In addition, upgrading business aircraft with higher performance engines is creating a need for more sophisticated types of air data products which the Company supplies.

- *Increasing sales to the DoD, other government agencies, defense contractors, commercial air transport and corporate/general aviation markets.* IS&S has extended its efforts to diversify sales to include all aviation end user markets, especially legacy military programs and the commercial air transport aircraft. In the commercial air transport market, the Company has addressed national carriers, regional carriers, and other fleet operators. The Company has targeted the corporate/general aviation market, both for retrofits and original equipment, and has won new and ongoing retrofit programs and two OEM programs with Eclipse and Pilatus Aircraft Limited (Pilatus). The Company continues to build a sales and marketing force to address these markets more effectively.

- *Expanding international presence.* IS&S plans to increase its international sales by adding sales and marketing personnel. The Company believes that European and other international aircraft operators and aircraft modification centers will retrofit legacy in-service aircraft with large flat panel displays. IS&S obtained approval from the EASA for installing the FPDS in Europe for the B757/B767 aircraft and expects to obtain EASA approvals for other European aircraft types.

- *Growing through acquisitions or joint ventures.* IS&S may pursue strategic acquisitions or joint ventures as a means to expand the business with enhanced technology, distribution, customer base, or products. The Company may seek to acquire developers or suppliers of complementary products, technology, information, or to acquire suppliers of similar products as a means of increasing its product offerings and market share.

Products

Current line of products includes:

Flat Panel Display Systems

Flat panel displays are AMLCD screens that can replicate the display of one or a suite of analog or digital displays on one screen. Flat panel displays can replace existing displays in legacy aircraft. AMLCDs are used also for security monitoring on-board aircraft and as tactical workstations on military aircraft. The flat panel product line presents numerous advantages for presentation of engine performance data. During fiscal years 2013, 2012 and 2011, revenues related to FPDS accounted for 88%, 87% and 79%, respectively, of total sales.

The Company s FPDS can replace conventional analog and digital displays and can display additional information which is not commonly displayed in the cockpit with conventional analog and digital displays. The COCKPIT/IP® is capable of

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displaying nearly all types of air data, engine and fuel data, altitude, heading and navigational data, maintenance and aircraft health data, and alternative source information. As technology and information delivery systems develop further, additional information will be displayed in the cockpit, such as surface terrain maps and data link messaging. IS&S designed the COCKPIT/IP® to be capable of displaying information from a variety of sources, including its Reduced Vertical Separation Minimum (RVSM) air data system, engine and fuel instrumentation, and third-party data and information products.

The Company s new ISU can be installed in a variety of fixed wing aircraft and helicopters. The ISU measures, processes, and displays altitude, attitude, airspeed, slip/skid, and navigation display information into an intuitive and concise single instrument display. The ISU incorporates an integral Inertial Measurement Unit (IMU) and includes an air data module to measure static and total pressure for independent display of altitude, airspeed, and Mach number. The unit has an optional battery module that provides one hour of operation of the unit during emergency conditions or complete electrical system failures.

From time to time, customers may order one or more FPDSs customized to their particular requirements. Typically, the Company charges for added development cost. This source of revenue is characterized as EDC on the consolidated statement of operations. Consistent with this approach, engineering costs incurred in customizing the FPDSs are included in cost of sales.

Air Data Systems and Components

The Company s air data products calculate and display various measures such as aircraft speed, altitude, and rate of ascent and descent. These air data products utilize advanced sensors to gather air pressure data and customized algorithms to interpret data, thus allowing the system to calculate altitude more accurately. During fiscal 2013, 2012, and 2011, sales of air data systems and components accounted for 12%, 13%, and 21%, respectively, of total revenues.

IS&S sells individual components as well as partial and complete air data systems. The components and systems include:

- digital air data computers, which calculate various air data parameters such as altitude, airspeed, vertical speed, angle of attack and other information derived from the measure of air pressure;

- integrated air data computers and display units, which calculate and convey air data information;

- altitude displays, which convey aircraft altitude measurements;

- airspeed displays, which convey various types of airspeed measurements including vertical airspeed and rates of ascent and descent; and

- altitude alerters, which allow the pilot to select a desired cruising altitude, and which provide warnings to pilots when an unacceptable deviation occurs.

IS&S develops, manufactures and markets engine and fuel displays. These solid-state multifunction displays convey information with respect to fuel and oil levels, and engine activity, such as oil and hydraulic pressure and temperature. They include individual and multiple displays installed throughout the cockpit. The displays can be used in conjunction with the Company s engine and fuel data equipment or that of other manufacturers.

Engine and fuel displays are vital to safe flight. In addition, accurate conveyance of engine and fuel information is critical for monitoring engine stress and parts maintenance. Engine and fuel displays tend to be replaced more frequently than other displays, and have been slow to incorporate new technology since their introduction because of their low cost, standard design and universal use.

IS&S believes that its air data engine and fuel displays are extremely reliable, have been designed to be programmable, and are adaptable easily without major modification to most modern aircraft. These products have been installed on B727, B737, C-130H, DC-9, DC-10, P-3, F-16, and A-10 aircraft.

Customers

The Company s customers include the United States government (including DoD, the Department of Interior (DOI) and the Department of Homeland Security (DHS), American Airlines, Inc. (AAI), Boeing, BAE Systems, Eclipse, FedEx Corporation (FedEx), Icelandair, L-3 Communications, Lockheed Martin Corporation, Pilatus, Sierra Nevada Corporation,

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and the Department of National Defense (Canada), among others. In fiscal 2013 the two largest customers, Eclipse Aerospace and American Airlines, accounted for 24%, and 14% of total revenue, respectively. In fiscal year 2012 the three largest customers, Eclipse Aerospace, Inc., FedEx, and NNSA, accounted for 20%, 14% and 13% of total revenue, respectively. In fiscal year 2011 the two largest customers, Eclipse and FedEx, accounted for 20% and 15% of total revenue, respectively.

On November 29, 2011, AMR Corporation, the parent company of AAI and certain of its U.S. based subsidiaries filed voluntary petitions for Chapter 11 reorganization in the U.S. Bankruptcy Court for the Southern District of New York. The Company s revenues from AAI accounted for 14%, 5% and 8% of total revenue for the fiscal years 2013, 2012 and 2011, respectively. As at September 30, 2013, orders from AAI were an immaterial percentage of the Company s backlog. AAI continued to purchase products from the Company in the ordinary course of business after November 29, 2011. (See Note 14 - Commitments and Contingencies in Notes to Consolidated Financial Statements attached).

Retrofit Market

Historically, a majority of the Company s sales have come from the retrofit market, which, IS&S has pursued because of its continued growth in response to the need to support the world s aging fleet of aircraft. The design and airframe structure of an aircraft generally exceeds the technology and technical capabilities of the original cockpit instruments and avionics. The Company has developed products that address this market niche that enables owners and operators to upgrade their aircraft by retrofitting them with IS&S products at a competitive cost, with equipment that provides them with cockpit displays with capabilities and technology equivalent to new aircraft that are currently being sold.

Updating an aircraft s electronics equipment has become common as new technology makes obsolete existing instruments while an aircraft remains structurally and mechanically sound. Retrofitting an aircraft is a substantially less expensive alternative than purchasing a new aircraft. IS&S expects its main customers in the retrofit market will continue to be:

- the DoD and defense contractors,
- aircraft operator, and
- aircraft modification centers.

Department of Defense and Defense Contractors. The Company sells its products directly to the DoD and to domestic and international defense contractors for end use on military aircraft retrofit programs. DoD programs generally take one of two forms: a subcontract with a prime government contractor, such as Boeing, Lockheed Martin, or L-3 Communications; or a direct contract with the appropriate government agency, such as the U.S. Air Force. The government s desire for cost-effective retrofit of its aircraft has led it to purchase commercial off-the-shelf equipment rather than to develop specially designed products, which are usually more costly and take longer to implement. These contracts tend to be on arms length commercial terms, although some termination and other provisions of government contracts are typically applicable to these contracts, as described under Government Regulation below. Each government agency or general contractor retains the right to terminate

a contract at any time at its convenience. Upon such alteration or termination, IS&S is entitled typically to an equitable adjustment to the contract price so that it would be compensated for already delivered items, and reimbursement for allowable costs incurred.

Aircraft Operators. The Company also sells its products to aircraft operators, including commercial airlines, cargo carriers, and business and general aviation aircraft owners or suppliers, primarily for retrofitting of aircraft owned or operated by these customers. The Company s commercial fleet customers include or have included, among others, American Airlines, ABX Air, FedEx and Icelandair. IS&S sells these customers a range of products from FPDS to air data systems.

Aircraft Modification Centers. Aircraft modification centers, which repair and retrofit private aircraft, represent the primary retrofit market for private and corporate jets. IS&S has established relationships with a number of aircraft modification centers throughout the United States. These modification centers act as distribution outlets for the Company s products.

OEM Market

The Company has been selected to provide the cockpit avionics suite for the Eclipse new E550 production aircraft. During the years 2006 through late 2008, the Company provided cockpit displays in support of Eclipse Aviation Inc. (Aviation) production of approximately 150 aircraft until late 2008 when Aviation filed for bankruptcy. Eclipse purchased the assets of Aviation in 2009. In 2011 Eclipse announced the planned production in 2013 of the E550 aircraft and selected IS&S as the

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system integrator. During the past four years, IS&S has been providing, through Eclipse, enhanced capability through retrofits to numerous owners of the Aviation produced aircraft.

In May 2013, Pilatus of Switzerland announced that it had selected IS&S to develop and manufacture the Utilities Management System (UMS) for the recently announced Pilatus PC-24 under a multi-year production contract. The UMS integrates multiple aircraft utility functions commonly supported by multiple individual controllers and monitors. The UMS will provide integrated control of systems from within the avionics suite and automate various normal and emergency tasks to reduce crew workload and improve safety conditions. This open architecture system will allow Pilatus to design and/or refine control and monitoring algorithms internally.

IS&S also markets its products to other original equipment manufacturers including Boeing and Lockheed Martin.

Backlog

	September 30	
$000 s	**2013**	**2012**
Backlog, beginning of period	$ 19,712	$ 27,505
Plus: bookings during period, net	102,955	16,785
Less: revenue recognized during period	(31,567)	(24,578)
Backlog, end of period	$ 91,100	$ 19,712

Backlog represents the value of contracts and purchase orders received, less the revenue recognized to date on those contracts and purchase orders. The year over year increase of $71.4 million was the result of booking $103.0 million in new business, (approximately $60 million from Delta) offset by $31.6 million of recognized revenue. Air Data product backlog as of September 30, 2013 increased by $2.7 million from September 30, 2012, and FPDS backlog as of September 30, 2013 increased by $68.7 million from September 30, 2012, primarily because of the contract awarded by Delta to retrofit their MD-88/90 fleet cockpit. Backlog excludes potential future sole-source production orders from products currently in development under the Company s EDC programs, including the Eclipse 550, the Pilatus PC-24, and the KC-46A, all of which the Company expects to enter into extended production phases upon completion of development. Although the Company believes that the orders included in backlog are firm, most of the backlog involves orders that can be modified or terminated by the customer. As of September 30, 2013, approximately 64% of the Company s backlog was expected to be filled beyond fiscal 2014.

Engineering Development

The Company invests a large percentage of its sales on engineering development, both R&D and EDC. At September 30, 2013, approximately 43% 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.

Sales and Marketing

IS&S focuses its sales efforts on passenger and cargo carrying aircraft operators, general aviation operators, aircraft modification centers, the DoD, DoD contractors, and OEMs. Periodically, the Company evaluates its sales and marketing efforts with respect to these focus areas and, where appropriate, makes use of third-party sales representatives who receive compensation through commissions based on performance.

The Company s ability to provide prompt and effective repair and upgrade service is critical to its marketing efforts. The customer service program offers a 24-hour customer hotline. The Company services its customers utilizing either field service engineers or its in-house repair and upgrade facility. The Company can lend spare units to customers during periods when it is repairing or overhauling their equipment. The Company s in-house turnaround times for both repairs and upgrades

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average less than 30 days. IS&S provides customers with a standard two-year warranty on new products. The Company offers customers extended warranties of varying lengths beyond the two years for additional fees.

The majority of the Company s sales, personnel and assets are within the United States. In fiscal year 2013, 2012 and 2011 net sales outside the United States amounted to $4.8 million, $4.4 million and $4.0 million, respectively.

Government Regulation

FAA regulations govern the manufacture and installation of the Company s products in aircraft owned and operated in the United States, and the IS&S facility is FAA certified. The most significant product and installation regulations are TSO and STC, which establish the minimum product performance standards.

Generally, sales of IS&S products to European or other non-U.S. owners of aircraft require approval of EASA, or other relevant governmental agencies. EASA certification requirements for the manufacture and installation of the Company s products in European owned aircraft mirror FAA regulations. The EASA process for granting European certifications is similar to that of the FAA.

In addition to product related regulations, IS&S is subject to U.S. Government procurement regulations with respect to the sale of the Company s products to government entities or government contractors. These regulations establish requirements which contractors must meet to do business with or on behalf of government entities. The government agency or general contractor retains the right to terminate a contract at any time at its convenience. Upon such alteration or termination, IS&S is generally entitled to an equitable adjustment to the contract price so that the Company receives the purchase price for products or services already delivered, and reimbursement for allowable costs incurred and for termination related costs.

Manufacturing, Assembly and Materials Acquisition

The Company s manufacturing activities consist primarily of assembling and testing components and subassemblies, and integrating them into finished systems. IS&S believes this approach allows it to achieve relatively flexible manufacturing capacity and to minimize expenses. Typically, the Company purchases components for products from third-party suppliers and assembles them in a clean room environment. Many of the components purchased are standard products, although certain parts are made to the Company s specifications.

When appropriate, IS&S enters into long-term supply agreements and uses its relationships with long-term suppliers to improve product quality and availability, and to reduce delivery times and product costs. In addition, the Company identifies alternative suppliers for important component parts. Generally, the introduction of component parts from new suppliers in existing products requires FAA certification of the entire finished product if the newly sourced component varies significantly from the original drawings and specifications. IS&S has not experienced significant delays in delivery of products caused by the inability to obtain either component parts or FAA approval of products incorporating new component parts.

Quality Assurance

Product quality is of vital importance to the Company s customers and IS&S. The Company is ISO 9001 and AS9100C certified. These standards represent an international consensus on effective management practices with the goal of ensuring that a company can deliver its products and related services consistently in a manner that meets or exceeds customer quality requirements. IS&S s certification to these standards allows the Company to represent to customers that it maintains high quality industry standards in the education of its employees, and in the design and manufacture of its products. In addition, the Company s products undergo extensive quality control testing prior to being delivered to customers. IS&S maintains detailed records of test results and its quality control processes.

Competition

The market for the Company s products is highly competitive, and the Company competes in several niches in which a number of manufacturers specialize. Competitors vary in size and resources, and substantially all of the Company s competitors are much larger than IS&S and have substantially greater resources. With respect to air data systems and related products, the Company s principal competitors include Honeywell International Inc. (Honeywell), Rockwell Collins, Inc., Thales Communications, Inc. (Thales), and Garmin Ltd. (Garmin). With respect to flat panel displays, principal competitors currently include Honeywell, Rockwell Collins, Inc., L-3 Communications, Garmin and GE Aviation Systems (GEAS). However, as the flat panel display industry evolves and the demand for flat panel displays increase, IS&S may face future competition in this area from other suppliers.

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The Company believes that the principal competitive factors in its markets are cost, development cycle time, responsiveness to customer preferences, product quality, technology, and reliability. IS&S believes that its significant and long-standing customer relationships reflect the Company s ability to compete favorably with respect to these factors.

Intellectual Property and Proprietary Rights

IS&S relies on patents to protect its proprietary technology. As of September 30, 2013, the Company holds 24 U.S. patents and has 5 U.S. patent applications pending relating to its technology. In addition, IS&S holds 25 international patents and has 25 international patent applications pending. Certain of these patents and patent applications cover technology relating to air data measurement systems while others cover technology relating to flat panel display systems and other aspects of the COCKPIT/IP® solution. While IS&S believes these patents have significant value in protecting its technology, it believes that the innovative skill, technical expertise, and know-how of the Company s personnel in applying the technology reflected in its patents would be difficult, costly, and time consuming to reproduce.

While IS&S is not aware of any pending lawsuits against the Company alleging patent infringement or the violation of other intellectual property rights, it cannot be certain such infringement claims will not be asserted against the Company in the future.

Employees

As of September 30, 2013, IS&S had 141 employees. The Company s future success depends on its ability to attract, train and retain highly qualified personnel. IS&S plans to hire additional personnel, in particular engineers, during the next twelve months. Competition for such qualified personnel is intense, and the Company may not be able to attract, train, and retain highly qualified personnel in the future. The Company is not unionized.

Executive Officers of the Registrant

The following is a list of the Company s executive officers, their ages and their positions:

Name	Age	Position
Geoffrey S. M. Hedrick	71	Chairman of the Board and Chief Executive Officer
Shahram Askarpour	56	President
Ronald C. Albrecht	68	Chief Financial Officer

Geoffrey S. M. Hedrick was the Chief Executive Officer from the time he founded the Company in February 1988 through June 4, 2007, and was reappointed as Chief Executive Officer on September 8, 2008. He has been Chairman of the Board since 1997. Prior to founding IS&S, Mr. Hedrick served as President and Chief Executive Officer of Smiths Industries North American Aerospace Companies. He founded Harowe Systems, Inc. in 1971, which was subsequently acquired by Smiths Industries. Mr. Hedrick has over 40 years of experience in the avionics

industry, and he holds a number of patents in the electronics, optoelectric, electromagnetic, aerospace, and contamination control fields.

Shahram Askarpour has been President since April 2012. Dr. Askarpour joined the Company as a Director of Engineering in 2003, was promoted to Vice President of Engineering in 2005 and was promoted to President on April 2, 2012. Dr. Askarpour has more than 30 years of aerospace industry experience in managerial and technical positions. Prior to joining IS&S he was employed by Smiths Aerospace (a division of Smiths Group PLC), Instrumentation Technology and Marconi Avionics. He holds a number of key patents in the aviation field. Dr. Askarpour received his engineering education in the United Kingdom, and received an undergraduate degree in Electrical Engineering from Middlesex University, a post graduate Certificate of Advanced Study in Systems Engineering, and a PhD in Automatic Control from Brunel University. He was awarded the title of Associate Research Fellow for three consecutive years by Brunel University, and has published numerous papers in leading international, peer reviewed journals. In addition, he has completed management courses at Carnegie Mellon University and finance courses at the Wharton Business School.

Ronald C. Albrecht has been Chief Financial Officer since August 2010. Prior to joining the Company, Mr. Albrecht served in a number of executive positions, both operational and financial, with Smiths Aerospace (UK). Smiths Aerospace was acquired by GEAS in 2007. Most recently, Mr. Albrecht served as Vice President and General Manager of Smiths Aerospace Electro Mechanical Business from 2003 to 2007 and, subsequently, of GEAS Electro Mechanical Business from 2007 to

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2010. Prior to his operational roles, he served as Chief Financial Officer of Smiths Aerospace, based in London, and has substantial mergers & acquisition and strategic planning experience. Mr. Albrecht received a B.A. in Government and Economics from Dartmouth College and a M.B.A. in Finance from Stanford University. He is a Certified Public Accountant (California/Inactive).

Other

The public may read and copy any materials filed by IS&S with the SEC at the SEC s public reference room located at 100 F Street, N.E., Washington, D.C. 20549. The public may obtain information about the operation of the SEC s public reference rooms by calling the SEC at 1-800-SEC-0330. The SEC also maintains a website at http://www.sec.gov that contains reports, proxy and information statements and other information about issuers that file electronically with the SEC.

IS&S maintains its corporate website at http://www.innovative-ss.com and makes available, free of charge, on that website (under the Investor Relations tab) the Company s annual reports on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K and amendments to those as reasonably practicable after it electronically files such material with, or furnishes it to, the SEC. The information on the Company s web site is not incorporated as part of this Annual Report on Form 10-K.

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Item 1A. Risk Factors

Each reader should carefully consider the risks, uncertainties and other factors described below, in addition to the other information set forth in this report, because they could materially and adversely affect the Company s business, operating results, financial condition, cash flows, prospects, and the value of an investment in IS&S common stock.

Risks Related to IS&S Business

Reductions in government expenditures could adversely affect IS&S business.

The Budget Act of 2011 triggered substantial, automatic reductions in both defense and discretionary spending. The automatic across-the-board sequestration cuts are in addition to reductions already reflected in the defense funding over a ten-year period and could have significant consequences to the Company s business and industry. While the full impact of sequestration is undetermined, the impact of any resulting reductions in defense appropriations, and/or reductions in U.S. defense spending could result in delays in procurement of products and services due to lack of funding, and negatively affect the IS&S s revenues, financial condition and results of operations.

The ongoing global recession and concern regarding credit availability could adversely affect IS&S.

The ongoing global recession and continued concern regarding credit availability, including failures of financial institutions, has initiated unprecedented government intervention in the U.S., Europe and other regions of the world. If these concerns continue or worsen, risks to IS&S include:

- declines in revenues and profitability from reduced orders, payment delays or other factors caused by the economic problems of customers;
- reprioritization of government spending away from defense programs in which IS&S participates;
- reduced access to credit sources; and
- disruptions in supplies associated with any financial constraints faced by vendors.

A portion of IS&S sales has been, and is expected to continue to be, defense contractors or government agencies in connection with government aircraft retrofit or original equipment manufacturing contracts. Sales to government contractors and government agencies could decline as a result of DoD spending cuts and general budgetary constraints which may become more severe as the federal budget deficit remains high.

The loss of a key customer or a significant deterioration in the financial condition of a key customer could have a material adverse effect on the Company s results of operations.

The Company s revenue is concentrated with a limited number of customers. During fiscal year 2013 IS&S derived 64% of revenue from the top 5 five customers. IS&S expects a relatively small number of customers to account for a majority of its revenues for the foreseeable future. As a result of the concentrated customer base, a loss of one or more of these customers or a dispute or litigation with one of these key customers could affect adversely its revenue and results of operations. In addition, the Company monitors and evaluates the credit status of its customers and attempts to adjust sales terms as appropriate. Despite these efforts, a significant deterioration in the financial condition or bankruptcy filing of a key customer could affect adversely the Company s business, results of operations, and financial condition.

On November 29, 2011, AMR Corporation, the parent company of AAI and certain of its other U.S. based subsidiaries, filed voluntary petitions for Chapter 11 reorganization in the U.S. Bankruptcy Court for the Southern District of New York. The Company s revenues from AAI accounted for 14%, 5% and 8% total revenue for the fiscal years 2013, 2012 and 2011, respectively. (See Note 14 - Commitments and Contingencies in Notes to Consolidated Financial Statements attached).

Growth of the Company s customer base could be limited by delays or difficulties in completing development and introduction of planned products or product enhancements. If IS&S fails to enhance existing products, or to develop and achieve market acceptance for flat panel displays, flight management systems and other new products that meet customer requirements, its business will be adversely affected.

IS&S currently spends a large portion of its R&D efforts in developing and marketing the FPDS, FMS, and complementary products. The Company s ability to grow and diversify its operations through introduction and sale of new products is dependent upon the continued success in product development and engineering activities, its sales and

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marketing efforts, and regulatory approvals to sell such products. Sales growth will depend in part on market acceptance of and demand for the FPDS, FMS, and future products. IS&S cannot be certain that it will be able to develop, introduce or market its FPDS, FMS, or other new products or product enhancements in a timely or cost-effective manner, or that any new products will receive market acceptance or necessary regulatory approval.

In seeking new customers, the Company may have difficulty in displacing the products of incumbent competitors. IS&S cannot be assured that potential customers will accept its products or that existing customers will not abandon them.

The Company s revenue and operating results may vary significantly from quarter to quarter, which may cause its stock price to decline.

The Company s revenue and operating results may vary significantly from quarter to quarter because of a number of factors, including:

- demand for products and/or delivery schedule changes by its customers;
- capital expenditure budgets of aircraft owners and operators, and appropriation cycles of the U.S. government;
- changes in the use of the Company s products, including air data system, flat panel displays, and flight management systems;
- delays in introducing or obtaining government approval for new products;
- new product introductions by competitors;
- changes in IS&S pricing policies or pricing policies of competitors; and
- costs related to possible acquisition of technologies or businesses.

IS&S plans to structure its sales and marketing operations and to fund levels of product development in proportion to its total sales. As a result, a delay in generating revenues could cause significant variations in its operating results from quarter to quarter.

Contracts can be terminated by customers at any time and, therefore, may not result in sales.

The Company s retrofit projects are generally pursuant to either a direct contract with a customer or a subcontract with a general contractor to a customer (including government agencies). Each contract, including contracts with government agencies, includes various terms and conditions that impose certain requirements on IS&S, including the ability of the government agency or general contractor to alter the price, quantity or delivery schedule of the products. Additionally, each government agency or general contractor retains the right to terminate the contract at any time at its convenience. Upon alteration or termination of these contracts, IS&S is entitled typically to an equitable adjustment to the contract price so that it would be compensated for delivered items and allowable costs incurred. Accordingly, because these contracts can be terminated, the Company cannot be assured that its backlog will result in sales.

The Company enters into fixed-price contracts or service arrangements to perform specified design and EDC services related to its products that could subject IS&S to losses in the event the Company incurs cost overruns on its projects.

During fiscal 2013, approximately 26% percent of the Company s total sales were from fixed-price EDC arrangements with customers to perform specified design and EDC services related to its products. These arrangements allow IS&S to benefit by recovering some of the cost of its engineering development group, but it carries the risk of potential cost overruns. If the Company s initial cost estimates are incorrect, it can potentially incur large one time charges and losses on these contracts. These EDC arrangements can expose the Company, potentially, to losses because the customer may compel IS&S to complete a project or, in the event of a termination for default, pay the incremental cost of its replacement by another provider. Because some of these projects involve new technologies and applications, and can last for more than a year, unforeseen events such as technological difficulties, fluctuations in the price of raw materials, problems with subcontractors, and cost overruns can result in the contractual price becoming less favorable or even unprofitable to IS&S over time. Furthermore, if the Company does not meet project deadlines or if its products do not meet customer specifications, it may need to renegotiate contracts on less favorable terms, be forced to pay penalties or liquidated damages, or suffer losses if the customer exercises its right to terminate. The Company s results of operations are dependent on its ability to maximize earnings from the EDC service arrangements. Lower earnings caused by cost overruns could have a negative impact on the Company s financial condition, operating results, and cash flows.

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IS&S depends on key personnel to manage its business effectively, and an inability to retain its key employees could adversely impact the Company s ability to compete.

The Company s success depends on the efforts, abilities, and expertise of its senior management and other key personnel. There can be no assurance IS&S will be able to retain such employees, the loss of some of whom could damage its ability to execute its business strategy. The Company intends to continue hiring key management, engineering, and sales and marketing personnel. In spite of a U.S. unemployment rate of approximately 7.5% during 2013, competition for skilled personnel is intense, and IS&S may not be able to attract or retain additional qualified personnel.

The Company s future success will depend in part on its ability to implement and improve its operational, administrative and financial systems and controls and to manage, train and expand its employee base. IS&S cannot be assured that, after giving effect to its cost containment initiatives, that current and planned personnel levels, systems, procedures, and controls will be adequate to support the current and future customer base. In such a circumstance, the Company may not be able to exploit existing and potential market opportunities. Any delays or difficulties encountered could impair the Company s ability to attract new customers or maintain its relationships with existing customers.

IS&S relies on third party suppliers for components of its products, and any interruption in the supply of these components could hinder its ability to deliver products on a timely basis.

The Company s manufacturing process consists primarily of assembling components purchased from its supply chain. The suppliers may not continue to be available to IS&S. If the Company is unable to maintain relationships with key third party suppliers, the development and distribution of its products could be delayed until equivalent components can be obtained and integrated into the products. In addition, substitution of certain components from other manufacturers may require product redesign, FAA or other approval, which could delay the Company s ability to ship products.

The Company s competition includes other manufacturers of air data systems and flight information displays against whom it may not be able to compete successfully.

The markets for the Company s products are intensely competitive and subject to rapid technological change. Competitors include Honeywell, Rockwell Collins, Inc., Thales, GEAS, and L-3 Communications. All these competitors have substantially greater financial, technical and human resources than does IS&S. In addition, these competitors have much greater experience in and resources for marketing their products. As a result, these competitors may be able to respond more quickly to new or emerging technologies and customer preferences, or to devote greater resources to development, promotion and sale of their products than IS&S can. The Company s competitors may have greater name recognition and more extensive customer bases. Such competition could result in price reductions, fewer customer orders, reduced gross margins, and loss of market share.

The Company s success depends on its ability to protect its proprietary rights against potential risk of infringement. If IS&S is unable to protect and enforce its intellectual property rights, it may be unable to compete effectively.

The Company s success and ability to compete will depend in part on its ability to obtain and maintain patent or other protection for its technology and products, both in the United States and internationally. In addition, IS&S must operate without infringing the proprietary rights of others.

IS&S currently holds 24 U.S. patents and has 5 U.S. patent applications pending. In addition, the Company holds 25 international patents and has 25 international patent applications pending. IS&S cannot be certain that patents will be issued on any of its present or future applications. In addition, existing patents or future patents may not adequately protect the Company s technology if they are not broad enough and are successfully challenged, or if other entities are able to develop competing methods without violating its patents. If IS&S is not successful in protecting its intellectual property, competitors could begin to offer products that incorporate the Company s technology. Patent protection involves complex legal and factual questions, and, therefore, is highly uncertain. Litigation relating to intellectual property is often very time consuming and expensive. If a successful claim of patent infringement were made against IS&S, and if the Company were unable to develop non-infringing technology, or to license the infringed or similar technology on a timely and cost-effective basis, the Company might not be able to produce and sell some of its products. Further, IS&S has incurred and may continue to incur significant legal and other costs in defense of its intellectual property.

A cyber security incident could have a negative impact.

A cyber-attack that bypasses the Company s information technology (IT) security systems causing an IT security breach,

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may lead to a material disruption of its IT business systems and/or the loss of business information resulting in an adverse business impact. Risks may include:

- negative impact on future results due to the theft, destruction, loss, misappropriation, or release of confidential data or intellectual property;

- operational or business delays resulting from the disruption of IT systems and subsequent clean-up and mitigation activities; and

- negative publicity resulting in reputation or brand damage with customers, partners or industry peers.

Tax changes could affect the Company s effective tax rate and future profitability.

The Company s future results could be affected negatively by changes in the effective tax rate as a result of changes in the overall profitability and changes to statutory tax rates in the United States, changes in tax legislation, and the results of audits and examination of previously filed tax returns.

IS&S may not be able to identify or complete acquisitions, or it may consummate an acquisition that adversely affects the Company s operating results.

One of the Company s strategies may be to acquire businesses or technologies that complement its existing operations. IS&S has limited experience in acquiring businesses or technologies. There can be no assurance IS&S will be able to acquire or profitably manage acquisitions or successfully integrate them into its operations. Furthermore, certain risks are inherent in pursuing acquisitions, such as the demands of management s time and attention and combining disparate company cultures and facilities. Acquisitions may have an adverse effect on the Company s operating results, particularly in quarters immediately following the consummation of such transactions, as the Company integrates operations of acquired businesses into its operations. Once integrated, acquisitions may not perform as expected or be accretive to the Company s results of operations.

Risks Related to the Company s Industry

If IS&S is unable to respond to rapid technological change, its products could become obsolete and its reputation could suffer.

Future generations of flat panel displays, air data systems, engine and fuel displays, and flight management systems which embody new technologies or new industry standards could render the Company s products obsolete. The market for aviation products is subject to rapid technological change, new product introductions, changes in customer preferences, and evolving industry standards and government regulations. The Company s future success will depend on its ability to:

- embrace rapidly changing technologies;

- adapt the Company s products to evolving industry standards and government regulations; and

- develop and introduce timely, high quality, cost effective new products, and product enhancements to address the increasingly sophisticated needs of its customers.

If IS&S fails to modify or improve its products in response to evolving industry standards and government regulations, its products could rapidly become obsolete.

The Company s products are currently subject to direct regulation by the FAA, and other equivalent organizations. The Company s products, as they relate to aircraft applications, must be approved by the FAA, EASA or other equivalent organizations before they can be installed in an aircraft. To be certified, IS&S must demonstrate that its products are accurate and able to maintain certain levels of repeatability over time. Although certification requirements of the FAA and EASA are substantially similar, no formal reciprocity exists between the two regulators. Accordingly, even though the Company s products are FAA approved, it may need to obtain approval from EASA or other appropriate organizations to have them certified for installation outside the United States.

Significant delay in receiving certification for newly developed products or enhancements to the Company s products, or the loss of certification for its existing products, could result in lost sales or delays in sales. Furthermore, new regulations or

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product standards, and changes to existing product standards could require IS&S to change its products and underlying technology. IS&S cannot ensure that it will receive regulatory approval on a timely basis or at all.

Inasmuch as the Company s products utilize sophisticated technology and are deployed in complex aircraft cockpit environments, problems with these products may arise that could harm the Company s reputation for quality assurance and, consequently, its business prospects.

The Company s products use complex system designs and components that may contain errors, omissions, or defects, particularly when the Company incorporates new technologies into its products or when it releases new versions or enhancements of its existing products. Despite the Company s quality assurance process, errors, omissions or defects could occur in its current products, in new products, or in new versions or enhancements of existing products. IS&S may be required to redesign or recall those products or pay damages. Such an event could result in the following:

- delay or loss of revenues;
- cancellation of customer contracts;
- diversion of development resources;
- damage to the Company s reputation;
- increased service and warranty costs; or
- litigation costs.

Although IS&S carries product liability insurance, this insurance may not be adequate to cover its losses in the event of a large product liability claim. In addition, IS&S may not be able to maintain such insurance in the future.

The Company has limited experience in marketing and distributing its products internationally.

IS&S plans to derive an increasing amount of its revenues from sales outside the United States, particularly in Europe. Risks inherent in doing business internationally include:

- differing regulatory requirements;
- legal uncertainty regarding liability;
- tariffs, trade barriers, and other regulatory barriers;
- political and economic instability;
- changes in diplomatic and trade relationships;
- potentially adverse tax consequences;
- the impact of recessions in economies outside the United States; and
- variances and unexpected changes in local laws and regulations.

Currently, all of the Company s international sales are denominated in U.S. dollars. An increase in the dollar s value compared to other currencies could render its products less competitive in the international markets. In the future, IS&S may be required to conduct sales in the foreign country s local currency, thus exposing the Company to fluctuations and volatility in exchange rates that could adversely affect its operating results.

Item 1B. Unresolved Staff Comments.

None

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Item 2. Properties.

In fiscal 2001, IS&S purchased 7.5 acres of land in the Eagleview Corporate Park in Exton, Pennsylvania. Shortly thereafter, the Company constructed a 45,000 square foot design, manufacturing and office facility on this site. Land development approval allows for expansion of up to 20,400 square feet. Such expansion would provide for a 65,400 square foot facility which is adequate to meet the needs of the Company for the foreseeable future.

Item 3. Legal Proceedings.

In the ordinary course of business, the Company is subject to various legal proceedings and claims. IS&S does not believe any such matters that are currently pending will have a material effect on the Company s 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 (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 awarding him damages for breach of contract, violation of the Pennsylvania Wage Payment and Collection Law, prejudgment interest, and plaintiff s reasonable attorneys fees. The Company has appealed the decision. Pending the outcome of the appeal, the Company has recorded an estimated total liability of $657,000 (which includes the plaintiff s estimated attorney s fees) for the fiscal year ended September 30, 2013.

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 the date hereof.

Item 4. Mine Safety Disclosures.

Not applicable.

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Part II

Item 5. Market for the Registrant s Common Equity, Related Stockholder Matters, and Issuer Repurchases of Equity Securities.

The Company s common stock has been traded on the NASDAQ Stock Market, LLC under the symbol ISSC since its initial public offering on August 4, 2000. The following table lists the high and low per share sale prices for the common stock for the periods indicated:

	Fiscal Year 2013		Fiscal Year 2012	
Period	**High**	**Low**	**High**	**Low**
First Quarter	$ 5.41	$ 3.20	$ 4.80	$ 3.20
Second Quarter	4.93	3.36	4.51	3.50
Third Quarter	9.25	4.56	4.75	3.02
Fourth Quarter	8.41	6.38	4.50	3.20

On November 29, 2013, there were 17 holders of record of the shares of outstanding common stock. This total does not reflect beneficial shareholders who hold their stock in nominee or street name through brokerage firms.

On December 7, 2012 the Company s Board of Directors declared a special cash dividend in the amount of $1.50 per share, payable on or about December 27, 2012 to shareholders of record as of the close of business on December 17, 2012. The total dividend payment was approximately $25 million. The Company did not pay dividends in fiscal 2012 or fiscal 2011. The declaration and payment of any dividend in the future will be at the discretion of the Company s Board of Directors.

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 year ended September 30, 2013, the Company did not make any other purchases of shares of the Company s common under the new share repurchase plan. As at September 30, 2013, the number of shares that may yet be purchased under the new share repurchased program was 250,000 shares.

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The graph below shows the cumulative shareholder return on $100 invested at the market close on September 30, 2008 through and including September 30, 2013, the last trading day before the end of the Company s most recently completed fiscal year, with the cumulative total return over the same time period of the same amount invested in the NASDAQ Composite Index, the Russell 2000 Index, and the Dow Jones US Aerospace & Defense Index.

	9/08	9/09	9/10	9/11	9/12	9/13
Innovative Solutions and Support, Inc.	**100.00**	**91.93**	**89.72**	**88.62**	**73.03**	**210.11**
NASDAQ Composite	**100.00**	**103.76**	**116.52**	**120.44**	**157.60**	**195.67**
Russell 2000	**100.00**	**90.45**	**102.53**	**98.91**	**130.47**	**169.68**
Dow Jones US Aerospace & Defense	**100.00**	**93.80**	**106.41**	**107.87**	**128.92**	**187.93**

* $100 invested on 9/30/08 in stock or index including reinvestment of dividends.

Fiscal year ending September 30.

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Item 6. Selected Consolidated Financial Data.

The following tables present portions of the Company s consolidated financial statements. The following selected consolidated financial data set forth below should be read together with Management s Discussion and Analysis of Financial Condition and Results of Operations and the consolidated financial statements and related notes to the consolidated financial statements appearing elsewhere herein. The selected statement of operations data for the fiscal years ended September 30, 2013, 2012 and 2011 and the balance sheet data as at September 30, 2013 and 2012 are derived from the Company s audited consolidated financial statements included elsewhere in this Annual Report on Form 10-K. The selected statements of operations data for the fiscal years ended September 30, 2010 and 2009 and the balance sheet data as at September 30, 2011, 2010 and 2009 are extracted from the Company s audited consolidated financial statements that are not included in this Annual Report on Form 10-K.

	Fiscal year ended September 30,				
	2013	**2012**	**2011**	**2010**	**2009**
Statement of Operations Data:					
Net Sales	$ 31,567,307	$ 24,578,198	$ 25,737,652	$ 25,257,323	$ 36,734,150
Cost of sales	18,942,737	14,067,933	11,945,184	11,520,029	17,895,984
Gross profit	12,624,570	10,510,265	13,792,468	13,737,294	18,838,166
Research and development	2,578,034	2,693,554	5,500,924	5,234,240	5,313,007
Selling, general and administrative	8,119,071	7,400,199	7,683,637	8,099,587	8,647,506
Total operating expenses	10,697,105	10,093,753	13,184,561	13,333,827	13,960,513
Operating income	1,927,465	416,512	607,907	403,467	4,877,653
Interest income, net	41,174	100,414	142,433	185,815	315,765
Other income	38,120	65,005	150,010	50,000	50,099
Income before income taxes	2,006,759	581,931	900,350	639,282	5,243,517
Income tax expense (benefit), net	119,842	(2,397,063)	183,760	(109,094)	234,856
Net income	$ 1,886,917	$ 2,978,994	$ 716,590	$ 748,376	$ 5,008,661
Net income per common share:					
Basic	$ 0.11	$ 0.18	$ 0.04	$ 0.04	$ 0.30
Diluted	$ 0.11	$ 0.18	$ 0.04	$ 0.04	$ 0.30
Cash dividends declared per common share	$ 1.50	$	$	$	$
Weighted average shares outstanding:					
Basic	16,753,068	16,641,895	16,782,223	16,751,528	16,745,379
Diluted	16,855,854	16,641,900	16,824,621	16,777,886	16,760,500

	As of September 30,				
	2013	**2012**	**2011**	**2010**	**2009**
Balance Sheet Data:					
Cash and cash equivalents	$ 16,386,207	$ 42,977,501	$ 42,625,854	$ 40,916,346	$ 35,565,694
Working capital	27,944,914	49,087,538	47,332,110	46,311,056	44,624,477
Total assets	42,630,511	62,597,231	58,257,604	57,590,522	57,536,012
Debt and capital lease obligations, less current portion				15,560	26,991
Total shareholders equity	35,994,247	57,080,403	54,260,787	53,468,037	52,398,742

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Item 7. Management s Discussion and Analysis of Financial Condition and Results of Operations.

The following discussion and analysis should be read in conjunction with Selected Consolidated Financial Data and the consolidated financial statements and related notes included in this report.

Overview

Innovative Solutions and Support, Inc. (the Company, or IS&S) was incorporated in Pennsylvania on February 12, 1988. The Company operates in one business segment as a systems integrator that designs, develops, manufactures, sells, and services flight guidance and cockpit display systems for original equipment manufacturers (OEMs) and retrofit applications. 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 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, 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.

The Company sells to both the retrofit market and OEMs. Customers include commercial air transport carriers and corporate/general aviation companies, 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.

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 typically accounted for 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, and other general corporate expenses.

IS&S sells its products to agencies of the United States and foreign governments, aircraft operators, aircraft modification centers, and original equipment manufacturers. The Company s 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 the Company s customers to curtail or delay spending on both new and existing aircraft. Factors that can impact general economic conditions and the level of spending by IS&S 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 factors which can affect spending behavior. In addition, the Budget Act triggered substantial, automatic reductions in both defense and discretionary spending. The automatic across-the-board sequestration cuts are in addition to reductions already reflected in defense funding over a ten-year period. Furthermore, future spending by government agencies may be further reduced because of declining tax revenues associated with the present economic environment. If the Company s customers curtail or delay their spending, or are forced to declare bankruptcy or liquidate their operations because of adverse economic conditions, IS&S s revenues and results of operations

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will be negatively affected. 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 an opportunity for IS&S.

On November 29, 2011, AMR Corporation, the parent company of American Airlines, Inc. (AAI) and certain of its other U.S. based subsidiaries filed voluntary petitions for Chapter 11 reorganization in the U.S. Bankruptcy Court for the Southern District of New York. AAI continued to purchase and pay for products from the Company in the ordinary course of business after November 29, 2011. The Company s revenues from AAI accounted for 14%, 5% and 8% of total revenue for the fiscal years 2013, 2012 and 2011, respectively. As at September 30, 2013, orders from AAI were an immaterial percentage of the Company s backlog. (See Note 14 - Commitments and Contingencies in Notes to Consolidated Financial Statements attached).

The Company experienced increases in personnel costs in fiscal year 2013 primarily in the R&D and production departments, and reductions in personnel costs in each of fiscal years 2012 and 2011, primarily through resignation and retirements of employees who were not replaced, and a planned reduction in workforce. The reductions affected most departments in the Company.

Results of Operations

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

	Twelve Months Ending September 30,		
	2013	**2012**	**2011**
Net sales:			
Product	74.3%	74.4%	97.8%
Engineering development contracts	25.7%	25.6%	2.2%
Total net sales	100.0%	100.0%	100.0%
Cost of sales:			
Product	33.6%	38.2%	45.8%
Engineering development contracts	26.4%	19.0%	0.6%
Total cost of sales	60.0%	57.2%	46.4%
Gross profit	40.0%	42.8%	53.6%
Operating expenses:			
Research and development	8.2%	11.0%	21.4%
Selling, general and administrative	25.7%	30.1%	29.9%
Total operating expenses	33.9%	41.1%	51.3%
Operating income	6.1%	1.7%	2.3%
Interest income	0.1%	0.4%	0.6%
Interest (expense)	0.0%	(0.1)%	(0.1)%
Other income	0.1%	0.3%	0.6%

Income before income taxes	6.3%	2.3%	3.4%
Income tax expense (benefit)	0.4%	(9.8)%	0.7%
Net income	5.9%	12.1%	2.7%

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Fiscal Year Ended September 30, 2013 Compared to Fiscal Year Ended September 30, 2012

Net sales. Net sales increased $7.0 million, or 28.4%, to $31.6 million for fiscal 2013 from $24.6 million for fiscal 2012. For fiscal 2013, product sales increased $5.2 million and EDC sales increased $1.8 million from fiscal 2012. The increase in product sales was primarily the result of higher shipments to customers for their upgrade and retrofit programs, while the increase in EDC sales resulted from increased activity on several EDC programs and from new EDC programs awarded during the year. For fiscal 2013 and 2012, the Company recognized revenue of $4.8 million and $2.4 million, respectively, related to certain contracts for which, at the time of recognition, either zero margins are expected to be earned or a zero margin approach to applying the percentage of completion method is used in accordance with the guidance of 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 $4.9 million, or 34.7%, to $18.9 million, or 60.0% of net sales, for fiscal 2013 from $14.0 million, or 57.2% of net sales, for fiscal 2012. The increase in cost of sales resulted primarily from the change in sales mix and the increase in product sales volume in fiscal 2013 as compared to fiscal 2012. In addition, EDC margins include the negative impact of cumulative catch-up adjustments of $444,000 and $0, resulting from changes in estimated cost to complete on certain EDC programs for fiscal 2013 and 2012, respectively. An increased proportion of higher margin revenues generated from product sales was offset by the impact of an increase in zero margin or negative margin EDC revenues resulting in a lower gross profit percentage of 40.0% for the year ended September 30, 2013 compared to 42.8% for the year ended September 30, 2012.

Research and development. R&D expense decreased $0.1 million, or 4.3%, to $2.6 million or 8.2% of net sales for fiscal 2013, from $2.7 million or 11.0% of net sales for fiscal 2012. The decrease in R&D expense for the year ended September 30, 2013 resulted from an increase in EDC revenues which required the Company to allocate more engineering resources to support new EDC programs compared to the prior fiscal year.

Selling, general, and administrative. Selling, general and administrative expenses increased $0.7 million, or 9.7%, to $8.1 million, or 25.7% of net sales, for fiscal 2013 from $7.4 million or 30.1% of net sales, for fiscal 2012. The increase in selling, general, and administrative expense for the year ended September 30, 2013 was caused by the non-recurring expense of $657,000 recorded for a previously disclosed legal matter. (See Note 14 Contingencies in Notes to Consolidated Financial Statements attached). The decrease as a percentage of net sales for the year ended September 30, 2013, compared to the prior year ended September 30, 2012, is attributable primarily to the increase in net sales.

Interest income, net . Net interest income decreased by $59,000 to $41,000, or 0.1% of net sales, for fiscal 2013 from $100,000, or 0.4% of net sales, for fiscal 2012. The decrease in interest income was primarily the result of lower cash balances in the last nine months compared to the same prior year period as a result of the special cash dividend paid to shareholders in late December 2012.

Other income. Other miscellaneous income decreased marginally by $27,000 in fiscal 2013 compared to fiscal 2012.

Income taxes. The income tax expense for fiscal year ended September 30, 2013 was $0.1 million compared to an income tax benefit of $2.4 million for the fiscal year ended September 30, 2012. The tax expense for the fiscal year ended September 30, 2013 was attributable to the pretax income offset in part by Federal Research and Development Tax Credits (Federal R&D Tax Credit) recorded. On January 1, 2013,

Congress enacted the American Taxpayer Relief Act of 2012 which retroactively reinstated and extended the Federal R&D Tax Credit from January 1, 2012 to December 31, 2013. The current year income tax provision reflects the benefit of the retroactive application of the Federal R&D Tax Credit for nine months from the prior fiscal year plus a full year benefit for the current fiscal year in accordance with FASB ASC Topic 740 *Income Taxes* (ASC Topic 740).

The effective tax rate for the year ended September 30, 2013 was 6.0%. The effective tax rate differs from the statutory rate for the year ended September 30, 2013 primarily because of the favorable impact of the Federal R&D Tax Credit for the fiscal year as discussed above. The effective tax benefit rate for the year ended September 30, 2012 was (411.9%). The effective tax benefit rate differs from the statutory rate for the year ended September 30, 2012 primarily because of the reversal of valuation allowances of $2.4 million related to federal net deferred tax assets in accordance with ASC Topic 740, due to the recent history of income before income taxes, together with projections of profitability in future years.

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The current balance of the deferred income tax valuation allowance relates principally to net operating losses (NOL) of certain state taxing jurisdictions. The Company believes that its estimate of future taxable income is inherently uncertain, and if its current or future operations generate losses, further adjustments to the valuation allowance are possible. There is currently no assurance of such future income before income taxes.

Net income. As a result of the factors described above, the Company s net income for fiscal 2013 was $1.9 million compared to net income of $3.0 million for fiscal 2012. Net income for fiscal 2012 includes the tax benefit of $2.4 million related to the reversal of valuation allowances related to federal net deferred tax assets discussed above. On a fully diluted basis, the net income per share was $0.11 for fiscal 2013, compared to $0.18 for fiscal 2012.

Fiscal Year Ended September 30, 2012 Compared to Fiscal Year Ended September 30, 2011

Net sales. Net sales decreased $1.2 million, or 4.5%, to $24.5 million for fiscal 2012 from $25.7 million for fiscal 2011. For fiscal 2012, product sales decreased $6.9 million and EDC sales increased $5.7 million from fiscal 2011. The decrease in product sales was primarily the result of decreased shipments to customers who slowed or delayed their respective retrofit programs, while the increase in EDC sales resulted from new customer design and EDC programs. For fiscal 2012 and 2011, the Company recognized equal amounts of revenue and cost of $2.4 million and $0, respectively, related to certain contracts for which, at the time of recognition, either zero margins are expected to be earned or a zero margin approach to applying the percentage of completion method is used in accordance with the guidance of ASC Topic 605-35, *Construction-Type and Production-Type Contracts* , which substantially explains the lower gross profit percentage on EDC revenues for the year ended September 30, 2012 when compared to the year ended September 30, 2011.

Cost of sales. Cost of sales increased $2.1 million, or 17.8%, to $14.0 million, or 57.2% of net sales for fiscal 2012 from $11.9 million, or 46.4% of net sales for fiscal 2011. The increase resulted primarily from the change in sales mix and the decrease in product sales volume in fiscal 2012 as compared to fiscal 2011. As a result of the decreased sales volume, product cost of sales for the year ended September 30, 2012 was lower as a percentage of total net sales at 38.2% compared to 45.8% for the year ended September 30, 2011. The combination of decreased net sales and change in product mix resulted in a lower gross profit percentage compared to the same period in the prior year.

Research and development. R&D expense decreased $2.8 million, or 51.0%, to $2.7 million or 11.0% of net sales for fiscal 2012, from $5.5 million or 21.4% of net sales for fiscal 2011. The decrease in R&D expense for the year ended September 30, 2012 was primarily the result of the change in mix whereby a higher number of engineering hours were devoted to working on new customer design and EDC programs instead of internal R&D.

Selling, general, and administrative. Selling, general and administrative expenses decreased $0.3 million, or 3.7%, to $7.4 million, or 30.1% of net sales for fiscal 2012 from $7.7 million or 29.9% of net sales for fiscal 2011. The slight decrease in selling, general, and administrative expense for the year ended September 30, 2012 was primarily the result of a reduced number of personnel compared to the prior year period and cost containment efforts. The increase as a percentage of net sales for the year ended September 30, 2012, compared to the prior year ended September 30, 2011, was attributable primarily to the decrease in net sales.

Interest income, net. Net interest income decreased by $42,000 to $100,000 or 0.4% of net sales for fiscal 2012 from $142,000 or 0.6% of net sales for fiscal 2011. The decrease in interest income was primarily because of lower interest rates during fiscal 2012 compared to fiscal 2011.

Other income. Other income decreased marginally by $0.1 million in fiscal 2012 when compared to fiscal 2011 from proceeds of miscellaneous income items.

Income taxes. The income tax benefit for fiscal year ended September 30, 2012 was $2.4 million compared to an income tax expense of $0.2 million for the fiscal year ended September 30, 2011. The tax benefit was attributable primarily to the reversal of valuation allowances of $2.4 million for the fiscal year ended September 30, 2012 related to federal net deferred tax assets in accordance with ASC Topic 740 because of the recent history of income before income taxes, together with projections of profitability in fiscal 2013 and future years.

The effective tax benefit rate for the year ended September 30, 2012 was (411.9%). The effective tax benefit rate differs from the statutory rate for the year ended September 30, 2012 primarily because of the reversal of valuation allowances of $2.4 million for the fiscal year ended September 30, 2012 related to federal net deferred tax assets in accordance with ASC Topic 740.

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The effective tax rate for the year ended September 30, 2011 was 20.4%. The effective tax rate differs from the statutory rate for the year ended September 30, 2011 primarily due to the utilization of R&D tax credits.

The Company had maintained a full valuation allowance against its deferred tax assets in prior years due to uncertainty as to the extent and timing of profitability in future periods. At September 30, 2012, the Company considered all available evidence, including the recent history of pre-tax income, together with projections of profitability in future periods. As a result of this analysis, the Company determined that the positive evidence at September 30, 2012 was sufficient to conclude that it was appropriate to reverse the valuation allowance previously recorded against its net federal deferred tax assets at September 30, 2012.

Net income. As a result of the factors described above, the Company s net income for fiscal 2012 was $3.0 million for fiscal 2012 compared to net income of $0.7 million for fiscal 2011. On a fully diluted basis, the net income per share was $0.18 for fiscal 2012, compared to $0.04 for fiscal 2011.

Liquidity and Capital Resources

The following table highlights key financial measurements of the Company:

	September 30, 2013	September 30, 2012
Cash and cash equivalents	$ 16,386,207	$ 42,977,501
Accounts receivable, net	$ 4,489,434	$ 3,978,512
Current assets	$ 34,437,485	$ 54,377,366
Current liabilities	$ 6,492,571	$ 5,289,828
Deferred revenue	$ 447,525	$ 1,426,552
Total debt and other non-current liabilities (1)	$ 143,693	$ 227,000
Quick ratio (2)	3.22	8.88
Current ratio (3)	5.30	10.28

	Twelve Months Ended September 30,		
	2013	2012	2011
Cash flow activites:			
Net cash (used in) provided by operating activites	$ (2,152,317)	$ 1,380,831	$ 2,276,166
Net cash used in investing activites	(586,801)	(217,533)	(255,454)
Net cash used in financing activites	(23,852,176)	(811,651)	(311,204)

(1) Excludes deferred revenue; includes current portion of capitalized lease obligations

(2) Calculated as: the sum of cash and cash equivalents plus 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 cash flows from current year operations and cash accumulated from prior years operations. Cash is used principally to finance inventory, accounts receivable, unbilled receivables, and payroll.

Operating Activities

The Company used $2.2 million cash in operating activities during fiscal 2013 compared to operating activities providing cash of $1.4 million during fiscal 2012. The cash used in operating activities for the year ended September 30, 2013 resulted primarily from an increase in unbilled receivables of $4.9 million, partially offset by cash provided from increases in accounts payable and accrued expenses of $2.0 million for the fiscal year 2013. Unbilled receivables 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 on engineering development projects. The Company should recover the cash invested in funding the EDC programs from customers as it completes project milestones.

During fiscal 2012, the Company generated $1.4 million in cash from operating activities. Cash generated from operations was attributable primarily to increases in accounts payable, accrued expenses and deferred revenues resulting from advance billings to customers as scheduled by the respective EDC programs. These were offset partially by increases in inventory and

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unbilled receivables, which funded materials, inventory and third party service providers to fulfill the Company s obligations under the EDC programs.

The Company generated $2.3 million in cash flow from operating activities during fiscal 2011. A focus on inventory reduction contributed to the positive cash flow, and was offset by increases in accounts receivable and decreases in accounts payable and accrued expenses. Increase in accounts receivable at the end of 2011 was due to higher sales to customers on normal credit terms at the end of the year compared to sales to customers on advance payment terms at the end of 2010.

Investing Activities

Cash used in investing activities was $0.6 million, $0.2 million and $0.3 million for fiscal years 2013, 2012 and 2011 respectively, and consisted of spending for production equipment 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

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. For the fiscal year ended September 30, 2013, the Company received $1.2 million from the exercise of options to acquire shares of common stock. The Company used $696 to purchase 175 shares of the Company s common stock under the share repurchase program on the first day of fiscal 2013.

Cash used in financing activities was $0.8 million for fiscal year 2012 and was used primarily for the repurchase of 211,722 shares of the Company s common stock. Cash used in financing activities was $0.3 million for fiscal year 2011 and consisted primarily of the repurchase of 62,400 shares of the Company s common stock.

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.

Contractual Obligations

The Company s contractual obligations as of September 30, 2013 mature as follows:

	Payments Due by Period				
Contractual Obligations	**Total**	**Less than 1 Year**	**1-3 Years**	**4-5 Years**	**After 5 Years**
Operating leases	$ 23,953	$ 14,259	$ 9,694	$	$
Purchase obligations (1)	3,787,568	3,584,068	187,952	15,548	
Other liabilities	11,491		11,491		
	$ 3,823,012	$ 3,598,327	$ 209,137	$ 15,548	$

(1) A purchase obligation is defined as an agreement to purchase goods or services that is enforceable and legally binding on the Company and that specifies all significant terms, including: fixed or minimum quantities to be purchased; fixed, minimum or variable price provisions; and the approximate timing of the transaction. These amounts are primarily comprised of open purchase order commitments entered in the ordinary course of business with vendors and subcontractors pertaining to fulfillment of the Company s current order backlog.

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Off-Balance Sheet Arrangements

The Company has no off-balance sheet arrangements.

Inflation

IS&S does not believe inflation had a material effect on its financial position or results of operations during the past three years. However, it cannot predict future effects of inflation.

Critical Accounting Policies

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America (GAAP) requires management to make estimates and assumptions that affect reported amounts of assets and liabilities, disclosure of contingent assets and liabilities at the date of the financial statements and the reported amount of revenues and expenses during the reporting period. The Company s most critical accounting policies are revenue recognition, income taxes, inventory valuation, share based compensation and warranty reserves.

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, and 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 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 (ASU) 2009-14, *Revenue Arrangements That Include Software Elements* (ASU 2009-14), 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 typically 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 FASB ASU 2009-13, *Multiple-Deliverable Revenue Arrangements a consensus of the FASB Emerging Issues Task Force* (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 s determines the best estimate of selling price by applying the same pricing policies and methodologies that would be used to determine the price to sell the deliverable on a standalone basis.

To the extent that an arrangement contains defined design and EDC activities as an identified deliverable in addition to products (resulting in a multiple element arrangement), the Company recognizes as EDC sales amounts earned during the design and development phase of the contract following the guidance included in ASC Topic 605-35. To the extent that multiple element arrangements include product sales, the Company recognizes revenue once revenue recognition criteria for the product deliverable 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 operations.

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Single Element Arrangements

Products

To the extent that a single element arrangement provides for product sales and repairs, the Company recognizes revenue when revenue recognition criteria for the product deliverable have been met based on the provisions of ASC Topic 605. In addition, the Company receives orders for equipment and parts. 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 recognized as sales on a straight-line basis over the warranty period.

Engineering development contract services

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 earnings 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 ASC Topic 605-35.

The Company reviews estimates of profit margins for contracts typically on a quarterly basis. Assuming 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 due to revisions in sales 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 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

Income taxes are recorded in accordance with 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 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.

Deferred tax assets are reduced by valuation allowances if, based on the consideration of all available evidence, it is more

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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 Company believes that its estimate of future taxable income is inherently uncertain, and if its current or future operations generate losses, further adjustments to the valuation allowance would be possible. The current balance of the deferred tax valuation allowance relates principally to NOL of certain state taxing jurisdictions. 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.

Inventory valuation

The Company values inventory at the lower of cost (first-in, first-out) or market. Inventories are written down for estimated obsolescence equal to the difference between inventory cost and estimated net realizable value based on a combination of historical usage and assumptions based on expected usage related to estimated future customer and market demands. The Company s method of valuing inventory contains uncertainties because the calculation requires management to consider inventory aging, to make assumptions regarding expected usage, and to apply judgments on forecasted future demand, market conditions, and technological obsolescence. If actual future demand or market conditions are less favorable than those projected by management, additional inventory write-down may be required.

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 or non-employee director is required to provide service in exchange for the award.

Accordingly, adoption of ASC Topic 505-50 s and ASC Topic 718 s fair value method results in recording compensation costs under the Company s stock based compensation plans. The Company determined the fair value of its stock option awards at the date of grant using the Black-Scholes option pricing model. Option pricing models and generally accepted valuation techniques require management to make assumptions and to apply judgment to determine the fair value of its awards. These assumptions and judgments include estimating future volatility of the Company s stock price, expected dividend yield, future employee turnover rates, and future employee stock option exercise behaviors. Changes in these assumptions can materially affect fair value estimates. The Company does not believe that a reasonable likelihood exists that there will be a material change in future estimates or assumptions used to determine stock-based compensation expense. However, if actual results are not consistent with the Company s estimates or assumptions, the Company would have to adjust its estimates. Such

adjustments could have a material impact on the Company s financial position.

Warranty reserves

The Company offers warranties on some products of various lengths. At the time of shipment, and when sold separately, the Company establishes a reserve estimated for 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 adversely affected. Warranty cost is recorded as cost of sales and the reserve balance recorded as an accrued expense. While the Company maintains product quality programs and processes, its warranty obligation is affected by product failure rates and the related corrective costs. If actual product failure rates and/or corrective costs differ from the estimates, the Company revises estimated warranty liability.

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New 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 during the fourth quarter of fiscal year ending September 20, 2013 did not have a material impact on the Company s consolidated financial statements.

In May 2011 the FASB issued ASU 2011-04, *Fair Value Measurement (Topic 820), Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs* (ASU 2011-04). ASU 2011-04 amends the fair value measurement and disclosure guidance to converge GAAP and International Financial Reporting Standards (IFRS) requirements for measuring amounts at fair value as well as disclosures about these measurements. ASU 2011-04 was to be adopted prospectively and was effective for the interim and annual periods beginning after December 15, 2011. The adoption of ASU 2011-04 did not have a material impact on the Company s consolidated financial statements.

In June 2011, the FASB issued ASU No. 2011-05, *Comprehensive Income (Topic 220): Presentation of Comprehensive Income* (ASU 2011-05) which requires that all non-owner changes in stockholders equity be presented either in a single continuous statement of comprehensive income or in two separate but consecutive statements. In the two-statement approach, the first statement would present total net income and its components followed consecutively by a second statement that would present total other comprehensive income, the components of other comprehensive income, and the total of comprehensive income. ASU 2011-05 is to be adopted retrospectively and is effective for annual periods beginning after December 2011. The adoption of ASU 2011-05 did not have an impact on the Company s consolidated financial position, results of operations, or cash flows, because the guidance only changes the presentation of financial information. In February 2013, the FASB issued ASU 2013-02 requiring the effective date for implementation of the deferred elements of ASU 2011-05 to be effective for reporting periods beginning after December 15, 2012, with early adoption permitted.

Business Segments

The Company operates in one business segment as a systems integrator that designs, manufactures, sells, and services flight guidance and cockpit display systems for OEMs and retrofit applications. Customers include commercial air transport carriers and corporate/general aviation companies, DoD and its commercial contractors, aircraft operators, aircraft modification centers, foreign militaries, and various OEMs. The Company currently derives the majority of its revenues from the sale of this equipment and related EDC services. Almost all of the Company s sales, operating results and identifiable assets are in the United States. In fiscal year 2013, 2012, and 2011 net sales outside the United States amounted to $4.8 million, $4.4 million and $4.0 million, respectively.

Item 7A. 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 funds, which bear interest at a variable rate. The Company does not participate in interest rate hedging. The Company does not believe that there is any material market risk exposure with respect to derivative or other financial instruments that would require disclosure under this item.

Item 8. Financial statements and supplementary data.

The financial statements of Innovative Solutions and Support, Inc. listed in the index appearing under Item 8 herein are filed as part of this Report.

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Innovative Solutions and Support, Inc.

INDEX TO CONSOLIDATED FINANCIAL STATEMENTS

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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Shareholders of

Innovative Solutions and Support, Inc.

Exton, Pennsylvania

We have audited the accompanying consolidated balance sheets of Innovative Solutions and Support, Inc. and subsidiaries (the Company) as of September 30, 2013 and 2012, and the related consolidated statements of operations, cash flows, and shareholders equity for each of the three years in the period ended September 30, 2013. These consolidated financial statements are the responsibility of the Company s management. Our responsibility is to express an opinion on the financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, such consolidated financial statements present fairly, in all material respects, the financial position of the Company as of September 30, 2013 and 2012, and the results of its operations and its cash flows for each of the three years in the period ended September 30, 2013, in conformity with accounting principles generally accepted in the United States of America.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the Company s internal control over financial reporting as of September 30, 2013, based on the criteria established in *Internal Control Integrated Framework* (1992) issued by the Committee of Sponsoring Organizations of the Treadway Commission and our report dated December 20, 2013 expressed an unqualified opinion on the Company s internal control over financial reporting.

/s/ *DELOITTE & TOUCHE LLP*
Philadelphia, Pennsylvania
December 20, 2013

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INNOVATIVE SOLUTIONS AND SUPPORT, INC.

CONSOLIDATED BALANCE SHEETS

	September 30, 2013	September 30, 2012
ASSETS		
Current assets		
Cash and cash equivalents	$ 16,386,207	$ 42,977,501
Accounts receivable, net	4,489,434	3,978,512
Unbilled receivables	6,539,442	1,595,436
Inventories	4,377,513	3,801,547
Deferred income taxes	2,002,679	1,588,162
Prepaid expenses and other current assets	642,210	436,208
Total current assets	34,437,485	54,377,366
Property and equipment, net	7,320,495	7,214,378
Non-current deferred income taxes	650,998	846,887
Other assets	221,533	158,600
Total assets	$ 42,630,511	$ 62,597,231
LIABILITIES AND SHAREHOLDERS EQUITY		
Current liabilities		
Accounts payable	$ 2,372,137	$ 1,139,464
Accrued expenses	3,672,909	2,723,812
Deferred revenue	447,525	1,426,552
Total current liabilities	6,492,571	5,289,828
Non-current deferred income taxes	132,202	128,998
Other liabilities	11,491	98,002
Total liabilities	6,636,264	5,516,828
Commitments and contingencies (See Note 14)		
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 September 30, 2013 and 2012		
Common stock, $.001 par value: 75,000,000 shares authorized, 18,632,328 and 18,329,314 issued at September 30, 2013 and 2012, respectively	18,632	18,329
Additional paid-in capital	49,880,571	47,845,732
Retained earnings	6,484,634	29,605,236

Treasury stock, at cost, 1,756,807 and 1,756,632 shares at September 30, 2013 and 2012, respectively		(20,389,590)		(20,388,894)
Total shareholders equity		35,994,247		57,080,403
Total liabilities and shareholders equity	$	42,630,511	$	62,597,231

The accompanying notes are an integral part of these statements.

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INNOVATIVE SOLUTIONS AND SUPPORT, INC.

CONSOLIDATED STATEMENTS OF OPERATIONS

	For the Fiscal Year Ended September 30,		
	2013	**2012**	**2011**
Net sales:			
Product	$ 23,459,034	$ 18,289,963	$ 25,174,846
Engineering development contracts	8,108,273	6,288,235	562,806
Total net sales	31,567,307	24,578,198	25,737,652
Cost of sales:			
Product	10,601,057	9,389,904	11,790,885
Engineering development contracts	8,341,680	4,678,029	154,299
Total cost of sales	18,942,737	14,067,933	11,945,184
Gross profit	12,624,570	10,510,265	13,792,468
Operating expenses:			
Research and development	2,578,034	2,693,554	5,500,924
Selling, general and administrative	8,119,071	7,400,199	7,683,637
Total operating expenses	10,697,105	10,093,753	13,184,561
Operating income	1,927,465	416,512	607,907
Interest income	41,174	101,012	143,942
Interest (expense)		(598)	(1,509)
Other income	38,120	65,005	150,010
Income before income taxes	2,006,759	581,931	900,350
Income tax (benefit) expense	119,842	(2,397,063)	183,760
Net income	$ 1,886,917	$ 2,978,994	$ 716,590
Net income per common share:			
Basic	$ 0.11	$ 0.18	$ 0.04
Diluted	$ 0.11	$ 0.18	$ 0.04
Cash dividend per share	$ 1.50	$	$
Weighted average shares outstanding:			
Basic	16,753,068	16,641,895	16,782,223
Diluted	16,855,854	16,641,900	16,824,621

The accompanying notes are an integral part of these statements.

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INNOVATIVE SOLUTIONS AND SUPPORT, INC.

CONSOLIDATED STATEMENTS OF SHAREHOLDERS EQUITY

	Common Stock	Additional Paid-In Capital	Retained Earnings	Treasury Stock	Total
Balance, September 30, 2010	$ 18,245	$ 46,831,646	$ 25,909,652	$ (19,291,506)	$ 53,468,037
Share-based compensation		177,399			177,399
Issuance of stock to directors	42	197,645			197,687
Purchase of treasury stock				(298,926)	(298,926)
Net Income			716,590		716,590
Balance, September 30, 2011	$ 18,287	$ 47,206,690	$ 26,626,242	$ (19,590,432)	$ 54,260,787
Share-based compensation		439,085			439,085
Issuance of stock to directors	42	199,957			199,999
Purchase of treasury stock				(798,462)	(798,462)
Net income			2,978,994		2,978,994
Balance, September 30, 2012	$ 18,329	$ 47,845,732	$ 29,605,236	$ (20,388,894)	$ 57,080,403
Share-based compensation		678,840			678,840
Exercise of stock options	255	1,156,039			1,156,294
Issuance of stock to directors	48	199,960			200,008
Purchase of treasury stock				(696)	(696)
Dividends			(25,007,519)		(25,007,519)
Net income			1,886,917		1,886,917
Balance, September 30, 2013	$ 18,632	$ 49,880,571	$ 6,484,634	$ (20,389,590)	$ 35,994,247

The accompanying notes are an integral part of these statements.

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INNOVATIVE SOLUTIONS AND SUPPORT, INC.

CONSOLIDATED STATEMENTS OF CASH FLOWS

	For the Fiscal Year Ended September 30,		
	2013	**2012**	**2011**
CASH FLOWS FROM OPERATING ACTIVITIES:			
Net income	$ 1,886,917	$ 2,978,994	$ 716,590
Adjustments to reconcile net income to net cash (used) provided by operating activities:			
Depreciation and amortization	545,620	529,325	672,196
Share-based compensation expense:			
Stock options	712,395	444,507	170,586
Stock awards	200,008	199,998	199,712
Tax adjustment from share-based compensation:	(33,301)	(5,422)	6,813
Provision for (recovery of) loss on accounts receivable		(1,373)	17,225
(Gain) loss on disposal of property and equipment	(11,536)		2,413
Excess and obsolete inventory cost	48,450	113,456	471,496
Deferred income taxes	(215,424)	(2,434,379)	751
(Increase) decrease in:			
Accounts receivable	(510,922)	(853,025)	(611,363)
Unbilled receivables	(4,944,006)	(1,210,796)	35,789
Inventories	(624,416)	(406,408)	676,301
Prepaid expenses and other current assets	(206,002)	54,788	42,277
Other non-current assets	(116,333)		(121,237)
Increase (decrease) in:			
Accounts payable	1,232,673	695,948	(100,362)
Accrued expenses	744,085	192,101	(188,354)
Income taxes payable	118,502	(110,805)	219,324
Deferred revenue	(979,027)	1,193,922	66,009
Net cash (used in) provided by operating activities	(2,152,317)	1,380,831	2,276,166
CASH FLOWS FROM INVESTING ACTIVITIES:			
Purchases of property and equipment	(605,301)	(217,533)	(255,454)
Proceeds from the sale of property and equipment	18,500		
Net cash (used in) investing activities	(586,801)	(217,533)	(255,454)
CASH FLOWS FROM FINANCING ACTIVITIES:			
Proceed from exercise of stock options	1,156,039		
Purchase of treasury stock	(696)	(798,462)	(298,926)
Dividend paid	(25,007,519)		
Repayment of capitalized lease obligations		(13,189)	(12,278)
Net cash (used in) financing activities	(23,852,176)	(811,651)	(311,204)
Net increase in cash and cash equivalents	(26,591,294)	351,647	1,709,508
Cash and cash equivalents, beginning of year	42,977,501	42,625,854	40,916,346
Cash and cash equivalents, end of year	$		