INNOVATIVE SOLUTIONS & SUPPORT INC
Form 10-Q
February 11, 2014
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

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

For the quarterly period ended December 31, 2013

OR

o **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the transition period from to

Commission File No. 000-31157

INNOVATIVE SOLUTIONS AND SUPPORT, INC.

(Exact name of registrant as specified in its charter)

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

(610) 646-9800

(Registrant s Telephone Number, Including Area Code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 day.

Yes x No o

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Website, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files.

Yes x No o

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

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

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes o No x

As of January 31, 2014, there were 16,894,531 shares of the Registrant s Common Stock, with par value of $.001 per share, outstanding.

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INNOVATIVE SOLUTIONS AND SUPPORT, INC.

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PART I FINANCIAL INFORMATION

Item 1 Financial Statements

INNOVATIVE SOLUTIONS AND SUPPORT, INC.

CONDENSED CONSOLIDATED BALANCE SHEETS

		December 31, 2013 (unaudited)		September 30, 2013
ASSETS				
Current Assets				
Cash and cash equivalents	$	15,827,439	$	16,386,207
Accounts receivable, net		4,759,853		4,489,434
Unbilled receivables		7,314,710		6,539,442
Inventories		4,975,541		4,377,513
Deferred income taxes		2,297,334		2,002,679
Prepaid expenses and other current assets		513,274		642,210
Total current assets		35,688,151		34,437,485
Property and equipment, net		7,527,584		7,320,495
Non-current deferred income taxes		24,447		650,998
Other assets		231,981		221,533
Total Assets	$	43,472,163	$	42,630,511
LIABILITIES AND SHAREHOLDERS EQUITY				
Current Liabilities				
Accounts payable	$	2,288,971	$	2,372,137
Accrued expenses		3,703,053		3,672,909
Deferred revenue		245,727		447,525
Total current liabilities		6,237,751		6,492,571
Non-current deferred income taxes		132,401		132,202
Other liabilities		11,579		11,491
Total Liabilities		6,381,731		6,636,264
Commitments and contingencies (See Note 6)				
Shareholders Equity				
Preferred Stock, 10,000,000 shares authorized, $.001 par value, of which 200,000 shares are authorized as Class A Convertible stock. No shares issued and outstanding at December 31, 2013 and September 30, 2013				

Common stock, $.001 par value: 75,000,000 shares authorized, 18,644,893 and 18,632,328 issued at December 31, 2013 and September 30, 2013, respectively		18,645		18,632
Additional paid-in capital		49,968,147		49,880,571
Retained earnings		7,493,230		6,484,634
Treasury stock, at cost, 1,756,807 and 1,756,807 shares at December 31, 2013 and September 30, 2013, respectively		(20,389,590)		(20,389,590)
Total Shareholders Equity		37,090,432		35,994,247
Total Liabilities and Shareholders Equity	$	43,472,163	$	42,630,511

The accompanying notes are an integral part of these statements.

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

(unaudited)

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

The accompanying notes are an integral part of these statements.

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INNOVATIVE SOLUTIONS AND SUPPORT, INC.
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(unaudited)

	For the Three Months Ended December 31, 2013	2012
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income	$ 1,008,596	$ 317,589
Adjustments to reconcile net income to net cash (used in) operating activities:		
Depreciation and amortization	129,484	119,159
Share-based compensation expense:		
Stock options	184,224	133,691
Nonvested stock awards	50,029	50,018
Tax adjustment from share-based compensation	(146,664)	(10,304)
Excess and obsolete inventory cost	25,000	
Deferred income taxes	332,096	53,869
(Increase) decrease in:		
Accounts receivable	(270,419)	(260,114)
Unbilled receivables	(775,268)	(1,412,335)
Inventories	(623,028)	333,853
Prepaid expenses and other current assets	128,936	(225,749)
Other non-current assets	(10,448)	
Increase (decrease) in:		
Accounts payable	(83,166)	(360,176)
Accrued expenses	124,502	(57,963)
Income taxes payable	(94,272)	(77,447)
Deferred revenue	(201,798)	(265,020)
Net cash used in operating activities	(222,196)	(1,660,929)
CASH FLOWS FROM INVESTING ACTIVITIES:		
Purchases of property and equipment	(336,572)	(43,231)
Net cash used in investing activities	(336,572)	(43,231)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Purchase of treasury stock		(695)
Dividend paid		(25,007,519)
Proceeds from exercise of stock options		762,759
Net cash used in financing activities		(24,245,455)
Net decrease in cash and cash equivalents	(558,768)	(25,949,615)
Cash and cash equivalents, beginning of year	16,386,207	42,977,501
Cash and cash equivalents, end of period	$ 15,827,439	$ 17,027,886
SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION		
Cash paid for income tax	$ 325,000	$ 130,000

The accompanying notes are an integral part of these statements.

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Innovative Solutions and Support Inc.
Notes to Condensed Consolidated Financial Statements

(unaudited)

1. Summary of Significant Accounting Policies

Description of the Company

Innovative Solutions and Support, Inc. (the Company or IS&S) was incorporated in Pennsylvania on February 12, 1988. The Company operates in one business segment as a systems integrator that designs, manufactures, sells, and services air data equipment, engine display systems, primary flight guidance and cockpit display systems for retrofit applications and original equipment manufacturers (OEMs). The Company supplies integrated Flight Management Systems (FMS) and advanced Global Positioning System (GPS) receivers that enable reduced carbon footprint navigation. The Company also continues to position itself as a system integrator, which provides the Company with the potential to generate more substantive orders over a broader product base. The strategy, as both a manufacturer and integrator, is designed to leverage the latest technologies developed for the computer and telecommunications industries into advanced and cost-effective solutions for the general aviation, commercial air transport, the United States Department of Defense (DoD)/governmental, and foreign military markets. This approach, combined with the Company s industry experience, is designed to enable IS&S to develop high-quality products and systems, to reduce product time to market, and to achieve cost advantages over products offered by its competitors. Customers include commercial air transport carriers and corporate/general/aviation companies, the DoD and its commercial contractors, aircraft operators, aircraft modification centers, foreign militaries, and various OEMs.

Basis of Presentation

The accompanying unaudited condensed consolidated financial statements are presented pursuant to the rules and regulations of the United States Securities and Exchange Commission (the SEC) in accordance with the disclosure requirements for the quarterly report on Form 10-Q and, therefore, do not include all of the information and footnotes required by generally accepted accounting principles in the United States (GAAP) for complete annual financial statements. In the opinion of Company management, the unaudited condensed consolidated financial statements reflect all adjustments (consisting of normal recurring adjustments) necessary to state fairly the results for the interim periods presented. The condensed consolidated balance sheet as of September 30, 2013 is derived from audited financial statements. Operating results for the three months ended December 31, 2013, are not necessarily indicative of the results that may be expected for the fiscal year ending September 30, 2014. These unaudited condensed consolidated financial statements should be read in conjunction with the audited consolidated financial statements and notes of the Company included in the Company s Annual Report on Form 10-K for the fiscal year ended September 30, 2013.

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

Use of Estimates

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

Cash and Cash Equivalents

Highly liquid investments purchased with an original maturity of three months or less are classified as cash equivalents. Cash equivalents at December 31, 2013 and September 30, 2013 consist of funds invested in money market funds with financial institutions.

Property and Equipment

Property and equipment are stated at cost. Depreciation is provided using an accelerated method over estimated useful lives of the assets (the lesser of three to seven years or over the lease term), except for the corporate airplane and manufacturing facility, which are depreciated using the straight-line method over estimated useful lives of ten years and thirty-nine years, respectively. During fiscal 2014, no depreciation was provided for the airplane since it had been depreciated to its estimated salvage value. Major additions and improvements are capitalized, while maintenance and repairs that do not improve or extend the life of assets are charged to expense as incurred.

Long-Lived Assets

The Company assesses the impairment of long-lived assets in accordance with Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC) Topic 360-10, *Property, Plant and Equipment* (ASC Topic 360-10). This statement requires that long-lived assets be reviewed for impairment whenever events or changes in circumstances indicate the carrying amount

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of an asset may not be recoverable. In addition, long-lived assets to be disposed of must be reported at the lower of the carrying amount or fair value less cost to sell. The Company considers historical performance and future estimated results in its evaluation of potential impairment and then compares the carrying amount of the asset to estimated future cash flows expected to result from use of the asset. If the carrying amount of the asset exceeds the estimated expected undiscounted future cash flows, the Company measures the amount of the impairment by comparing the carrying amount of the asset to its fair value. The estimation of fair value is generally measured by discounting expected future cash flows. No impairment charges were recorded during the three months ended December 31, 2013 or 2012.

Revenue Recognition

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

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

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

Multiple Element Arrangements -

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

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

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

Single Element Arrangements

Products -

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

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

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

Engineering Development Contracts

The Company may enter into contracts to perform specified design and EDC services related to its products. The Company recognizes revenue from these arrangements as EDC revenue, following the guidance included in ASC Topic 605-35, and considers the nature of these contracts (including term, size of contract, and level of effort) when determining the appropriate accounting treatment for a particular contract. Certain of these contracts are accounted for under the percentage-of-completion method of accounting when the Company determines that progress toward completion is reasonable and reliably estimable, and the contract is long-term in nature. The Company uses the completed contract method for all others contracts. Sales and profit margins under the percentage-of-completion method are recorded based on the ratio of actual costs incurred to total estimated costs expected to be incurred related to the contract under the cost-to-cost method (for development effort).

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

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

The Company typically reviews estimates of profit margins for contracts on a quarterly basis. If the initial estimates of sales and costs under a contract are accurate, the percentage-of-completion method results in the profit margin being recorded evenly as revenue is recognized under the contract. Changes in these underlying estimates because of revisions in sales and cost estimates or to the exercise of contract options may result in profit margins being recognized unevenly over a contract because such changes are accounted for on a cumulative basis in the period estimates are revised. Significant changes in estimates related to accounting for long-term contracts may have a material effect on the Company s results of operations in the period in which the revised estimate is made. Cumulative catch-up adjustments resulting from changes in estimates are disclosed in the notes to consolidated financial statements.

Income Taxes

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

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

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future operations generate losses, further adjustments to the valuation allowance are possible. There is currently no assurance of such future income before income taxes.

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

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

Engineering Development

The Company invests a large percentage of its sales in engineering development, both research and development (R&D) and EDC. At December 31, 2013, approximately 40% of the Company s employees were engineers engaged in various engineering development projects. IS&S invests a large percentage of its sales in EDC and R&D projects to allow its customers to benefit from the latest technological advancements. Total engineering development expense is comprised of both design and EDC related to specific customer contracts and R&D. EDC expense consists primarily of payroll-related expenses of employees engaged in EDC projects, engineering related product materials and equipment, and subcontracting costs. R&D charges incurred for product design, product enhancements, and future product development are expensed as incurred. EDC and design charges related to specific customer arrangements are charged to cost of sales-EDC based on the method of contract accounting (either percentage of completion or completed contract) applicable to such contracts.

Comprehensive Income

Pursuant to FASB ASC Topic 220, *Comprehensive Income* (ASC Topic 220), the Company is required to classify items of other comprehensive income by their nature in the balance sheet and display the accumulated balance of other comprehensive income separately from retained earnings and additional paid-in capital in the equity section of its condensed consolidated balance sheets. For the three months ending December 31, 2013 and 2012, comprehensive income consisted of net income only. There were no items of other comprehensive income or accumulated other comprehensive income balances in the equity accounts for any of the periods presented.

Fair Value of Financial Instruments

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

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

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

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

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

The following table sets forth by level within the fair value hierarchy the Company s financial assets and liabilities that were accounted for at fair value on a recurring basis as of December 31, 2013 and September 30, 2013, according to the valuation techniques the Company used to determine their fair values.

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

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

Stock-Based Compensation

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

Warranty

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

Concentrations

Major Customers and Products

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

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

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

Major Suppliers

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

For the three months ended December 31, 2013, the Company had one supplier which accounted for greater than 10% of the Company s total inventory related purchases. For the three months ended December 31, 2012, the Company had one supplier which accounted for greater than 10% of the Company s total inventory related purchases.

Concentration of Credit Risk

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

The Company has no reserve for doubtful accounts as of December 31, 2013 and September 30, 2013 because of the favorable history of collections and a specific analysis of amounts outstanding.

Recent Accounting Pronouncements

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

2. Supplemental Balance Sheet Disclosures

Unbilled Receivables

Unbilled receivables principally represent sales recorded under the percentage-of-completion method of accounting that have not been billed to customers in accordance with applicable contract terms. Unbilled receivables, net of customer payments, were $7.3 million and $6.5 million at December 31, 2013 and September 30, 2013, respectively.

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

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Inventories

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

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

Prepaid expenses and other current assets

Prepaid expenses and other current assets consist of the following:

	December 31, 2013	September 30, 2013
Prepaid insurance	$ 186,743	$ 350,913
Other	326,531	291,297
	$ 513,274	$ 642,210

Property and equipment

Property and equipment, net consists of the following balances:

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

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

Other assets

Other assets consist of the following:

	December 31, 2013	September 30, 2013
Intangible assets, net of accumulated amortization of $495,037 at December 31, 2013 and September 30, 2013	$ 105,200	$ 105,200