INTELLIGENT SYSTEMS CORP
Form 10-Q
November 14, 2013

United States

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

QUARTERLY REPORT UNDER SECTION 13 OR 15(D) OF THE SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended September 30, 2013

OR

TRANSITION REPORT UNDER SECTION 13 OR 15(D) OF THE SECURITIES EXCHANGE ACT OF 1934

For the transition period from _________ to ____________

Commission file number 1-9330

INTELLIGENT SYSTEMS CORPORATION

(Exact name of registrant as specified in its charter)

Georgia	**58-1964787**

(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
4355 Shackleford Road, Norcross, Georgia 30093	**30093**
(Address of principal executive offices)	(Zip Code)

Registrant's telephone number, including area code: **(770) 381-2900**

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

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

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

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

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

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date.

As of October 31, 2013, 8,958,028 shares of Common Stock of the issuer were outstanding.

Intelligent Systems Corporation

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Ex. 31.1 Section 302 Certification of Chief Executive Officer

Ex. 31.2 Section 302 Certification of Chief Financial Officer

Ex. 32.1 Section 906 Certification of Chief Executive Officer and Chief Financial Officer

Ex.101.INS** XBRL Instance

Ex.101.SCH** XBRL Taxonomy Extension Schema

Ex.101.CAL** XBRL Taxonomy Extension Calculation

Ex 101.DEF** XBRL Taxonomy Extension Definitions

Ex.101.LAB** XBRL Taxonomy Extension Labels

Ex.101.PRE** XBRL Taxonomy Extension Presentation

** XBRL information is furnished and not filed or a part of a registration statement or prospectus for purposes of sections 11 or 12 of the Securities Act of 1933, as amended, is deemed not filed for purposes of section 18 of the Securities Exchange Act of 1934, as amended, and otherwise is not subject to liability under these sections.

Part I Financial Information

Item 1. Financial Statements

Intelligent Systems Corporation

CONSOLIDATED BALANCE SHEETS

(in thousands, except share and per share amounts)

	September 30, 2013 *(unaudited)*	**December 31, 2012** *(audited)*
ASSETS		
Current assets:		
Cash	$ 2,839	$ 2,347
Marketable securities	343	270
Accounts receivable, net	3,173	3,038
Note and interest receivable, current portion	--	249
Inventories, net	1,059	882
Other current assets	532	340
Total current assets	7,946	7,126
Investments	1,564	1,559
Property and equipment, at cost less accumulated depreciation	1,027	1,144
Patents, net	73	107
Total assets	$ 10,610	$ 9,936
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	$ 425	$ 294
Deferred revenue, current portion	661	918
Accrued payroll	416	519
Accrued expenses	650	711
Other current liabilities	336	379
Total current liabilities	2,488	2,821
Deferred revenue, net of current portion	263	48
Other long-term liabilities	170	148
Commitments and contingencies (Note 8)		
Intelligent Systems Corporation stockholders' equity:		
Common stock, $0.01 par value, 20,000,000 shares authorized, 8,958,028 issued and outstanding at September 30, 2013 and December 31, 2012	90	90

Additional paid-in capital	21,467	21,406
Accumulated other comprehensive loss	(90)	(101)
Accumulated deficit	(12,616)	(13,758)
Total Intelligent Systems Corporation stockholders' equity	8,851	7,637
Noncontrolling interest	(1,162)	(718)
Total stockholders' equity	7,689	6,919
Total liabilities and stockholders' equity	$ 10,610	$ 9,936

The accompanying notes are an integral part of these Consolidated Financial Statements.

Intelligent Systems Corporation

CONSOLIDATED STATEMENTS OF OPERATIONS

(unaudited; in thousands, except share and per share amounts)

	Three Months Ended Sept. 30,		**Nine Months Ended Sept. 30,**	
	2013	**2012**	**2013**	**2012**
Revenue				
Products	$3,587	$3,104	$10,124	$9,879
Services	987	971	2,702	2,322
Total net revenue	4,574	4,075	12,826	12,201
Cost of revenue				
Products	1,910	1,538	5,013	4,984
Services	541	689	1,721	1,779
Total cost of revenue	2,451	2,227	6,734	6,763
Expenses				
Marketing	482	592	1,455	1,771
General and administrative	620	660	2,090	2,281
Research and development	587	550	1,863	1,831
Income (loss) from operations	434	46	684	(445)
Other income (expense)				
Interest income, net	2	4	2	8
Equity in income (loss) of affiliate company	5	(5)	5	(16)
Other income, net	16	12	49	37
Income (loss) before income taxes	457	57	740	(416)
Income taxes	--	--	42	48
Net income (loss)	457	57	698	(464)
Net loss attributable to noncontrolling interest	128	173	443	689
Net income attributable to Intelligent Systems Corporation	$585	$230	$1,141	$225
Income per share based on income attributable to Intelligent Systems Corporation:				
Basic	$0.07	$0.03	$0.13	$0.03
Diluted	$0.07	$0.03	$0.13	$0.03
Basic weighted average common shares outstanding	8,958,028	8,958,028	8,958,028	8,958,028
Diluted weighted average common shares outstanding	8,963,851	8,968,174	8,965,131	8,967,936

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (LOSS)

	Three Months Ended Sept. 30,	**Nine Months Ended Sept. 30,**

(unaudited, in thousands)	**2013**	**2012**	**2013**	**2012**
Net income (loss)	$457	$ 57	$698	$(464)
Other comprehensive income (loss):				
Foreign currency translation adjustment	(8)	26	6	7
Unrealized gain on available for sale marketable securities	22	11	5	19
Comprehensive income (loss)	$471	$ 94	$709	$(438)

The accompanying notes are an integral part of these Consolidated Financial Statements.

Intelligent Systems Corporation

CONSOLIDATED STATEMENTS OF CASH FLOWS

(unaudited, in thousands)

	Nine Months Ended Sept. 30, 2013	2012
OPERATIONS:		
Net income (loss)	$698	$(464)
Adjustments to reconcile net income (loss) to net provided by cash (used for) operating activities:		
Depreciation and amortization	343	373
Stock-based compensation expense	61	59
Non-cash interest income, net	(1)	(8)
Equity in (income) loss of affiliate company	(5)	16
Changes in operating assets and liabilities		
Accounts receivable	(135)	(318)
Inventories	(30)	(222)
Other current assets	(192)	(98)
Accounts payable	131	(76)
Deferred revenue, current portion	(257)	43
Accrued payroll	(103)	(23)
Accrued expenses	(61)	60
Other current liabilities	(43)	(102)
Other liabilities	236	(3)
Net cash provided by (used for) operating activities	642	(763)
INVESTING ACTIVITIES:		
Purchase of marketable securities	(67)	(41)
Proceeds from note and interest receivable	250	250
Purchases of property and equipment	(339)	(277)
Long-term investment	--	(300)
Net cash used for investing activities	(156)	(368)
Effects of exchange rate changes on cash	6	7
Net increase (decrease) in cash	492	(1,124)
Cash at beginning of period	2,347	3,152
Cash at end of period	$2,839	$2,028
SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION:		
Cash paid during the period for income taxes	$54	$15

NON-CASH TRANSACTION:		
Transfer of property and equipment to inventory	$147	--

The accompanying notes are an integral part of these Consolidated Financial Statements.

Intelligent Systems Corporation

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(unaudited)

1. Throughout this report, the terms “we”, “us”, “ours”, “ISC” and “Company” refer to Intelligent Systems Corporation, including its wholly-owned and majority-owned subsidiaries. As contemplated by the Securities and Exchange Commission (the “Commission”) instructions to Form 10-Q, the following footnotes have been condensed and, therefore, do not contain all disclosures required in connection with annual financial statements. Reference should be made to the Company’s year-end audited consolidated financial statements and notes thereto contained in its Annual Report on Form 10-K for the fiscal year ended December 31, 2012, as filed with the Commission. The financial information included in this report has been prepared by the Company, without audit. In the opinion of management, the financial information included in this report contains all adjustments (all of which are normal and recurring) necessary for a fair presentation of the results for the interim periods. Nevertheless, the results shown for interim periods are not necessarily indicative of results to be expected for the full year. The December 31, 2012 consolidated condensed balance sheet data was derived from audited consolidated financial statements, but does not include all disclosures required by accounting principles generally accepted in the United States.

2. *Stock-based Compensation* – At September 30, 2013, we had two stock–based compensation plans in effect. We record compensation cost related to unvested stock option awards by recognizing the unamortized grant date fair value on a straight line basis over the service periods of each award. We have estimated forfeiture rates based on our historical experience. Stock option compensation expense is recognized as a component of general and administrative expenses in the accompanying Consolidated Financial Statements. We recorded $21,000 and $20,000 of stock-based compensation expense in the three months ended September 30, 2013 and 2012, respectively and $61,000 and $59,000 for the nine months ended September 30, 2013 and 2012, respectively. The estimated fair value of options granted is calculated using the Black-Scholes option pricing model with assumptions as previously disclosed in our 2012 Form 10-K.

As of September 30, 2013, there is $70,000 of unrecognized compensation cost related to stock options. During the nine month period ended September 30, 2013, an aggregate of 17,000 options were granted to four independent members of our board pursuant to the 2011 Non-Employee Director Stock Option Plan. All options were granted at fair market value on the date of grant. No options were exercised during the three and nine month periods ended September 30, 2013. A total of 92,000 unexercised options expired during the nine month period ended September 30, 2013.

The following table summarizes stock options as of September 30, 2013:

	# of Shares	Wgt Avg Exercise Price	Wgt Avg Remaining Contractual Life in Years	Aggregate Intrinsic Value
Outstanding at September 30, 2013	270,500	$ 1.75	6.9	$ 16,740
Vested at September 30, 2013	170,000	$ 1.87	6.1	$ 13,680

The aggregate intrinsic value in the table above represents the total pre-tax intrinsic value (the difference between the Company's closing stock price on the last trading day of the third quarter of 2013 and the exercise price, multiplied by the number of in-the-money options) that would have been received by the option holders had all option holders exercised their options on September 30, 2013. The amount of aggregate intrinsic value will change based on the fair market value of the company's stock.

3. *Fair Value of Financial Instruments* - The carrying value of cash, marketable securities, accounts receivable, accounts payable and certain other financial instruments (such as short-term borrowings, accrued expenses, and other current liabilities) included in the accompanying consolidated balance sheets approximates their fair value principally due to the short-term maturity of these instruments. The carrying value of the non-interest bearing note receivable approximates its fair value and has been discounted at a rate of 4% which approximates rates offered in the market for notes receivable with similar terms and conditions.

Financial instruments that potentially subject us to concentrations of credit risk consist principally of cash, marketable securities, trade accounts and note receivable. Our available cash is held in accounts managed by third-party financial institutions. Cash may exceed the Federal Deposit Insurance Corporation, or FDIC, insurance limits. While we monitor cash balances on a regular basis and adjust the balances as appropriate, these balances could be impacted if the underlying financial institutions fail. To date, we have experienced no loss or lack of access to our cash; however, we can provide no assurances that access to our cash will not be impacted by adverse conditions in the financial markets.

4. *Fair Value Measurements* - In determining fair value, the Company uses quoted market prices in active markets. GAAP establishes a fair value measurement framework, provides a single definition of fair value, and requires expanded disclosure summarizing fair value measurements. GAAP emphasizes that fair value is a market-based measurement, not an entity specific measurement. Therefore, a fair value measurement should be determined based on the assumptions that market participants would use in pricing an asset or liability.

GAAP establishes a hierarchy for inputs used in measuring fair value that maximizes the use of observable inputs and minimizes the use of unobservable inputs by requiring that the most observable input be used when available. Observable inputs are based on data obtained from sources independent of the company that market participants would use in pricing the asset or liability. Unobservable inputs are inputs that reflect the company's assumptions about the estimates market participants would use in pricing the asset or liability developed based on the best information available in the circumstances.

The hierarchy is measured in three levels based on the reliability of inputs:

• Level 1

Valuations based on quoted prices in active markets for identical assets or liabilities that we have the ability to access. Valuation adjustments and block discounts are not applied to Level 1 instruments.

• Level 2

Valuations based on quoted prices in less active, dealer or broker markets. Fair values are primarily obtained from third party pricing services for identical or comparable assets or liabilities.

• Level 3

Valuations derived from other valuation methodologies, including pricing models, discounted cash flow models and similar techniques, and not based on market, exchange, dealer, or broker-traded transactions. Level 3 valuations incorporate certain assumptions and projections that are not observable in the market and significant professional judgment is needed in determining the fair value assigned to such assets or liabilities.

In instances where the determination of the fair value measurement is based on inputs from different levels of the fair value hierarchy, the level in the fair value hierarchy within which the entire fair value measurement falls is based on the lowest level input that is significant to the fair value measurement in its entirety.

Our available-for-sale investments are classified within level 1 of the valuation hierarchy.

The fair value of equity method and cost method investments has not been determined as it was impracticable to do so due to the fact that the investee companies are relatively small, early stage private companies for which there is no comparable valuation data available without unreasonable time and expense.

5. *Inventories* – The value of inventories at September 30, 2013 and December 31, 2012 is as follows:

(in thousands)	**September 30, 2013**	**December 31, 2012**
Raw materials	$ 958	$ 795
Finished goods	101	87
Total inventories	$ 1,059	$ 882

6. *Concentration of Revenue* – The following table indicates the percentage of consolidated revenue represented by each customer for any period in which such customer represented more than 10% of consolidated revenue.

	Three Months Ended Sept. 30,		**Nine Months Ended Sept. 30,**	
(unaudited)	**2013**	**2012**	**2013**	**2012**
ChemFree Customer A	16.0%	29.0%	22.0%	29.0%
ChemFree Customer B	--	10.0%	--	10.0%
ChemFree Customer C	28.0%	11.5%	18.0%	12.9%

7. *Short-term Borrowings* – On June 29, 2012, we renewed our working capital line of credit with our bank. The revolving line of credit bears interest at the higher of the prime rate plus one and one half percent (1.5%) and 6.0% (6.0% at September 30, 2013); is secured by all assets of the company and our principal subsidiaries; is guaranteed by our subsidiaries; and expires June 30, 2014. We may borrow an aggregate of 80 percent of qualified accounts receivable of our consolidated subsidiaries plus 10 percent of inventory, up to a maximum of $1,250,000. At September 30, 2013, our borrowing base calculation resulted in availability of the maximum of $1,250,000, of which we had drawn down $0. The terms of the loan contain typical covenants not to sell or transfer material assets, to create liens against assets, to merge with another entity, to change corporate structure or the nature of our business, to declare or pay dividends, or to redeem shares of common stock. The loan agreement also contains covenants not to change the chief executive and chief financial officers of the company or to make loans to or invest in new minority-owned companies, without first obtaining the consent of our bank in each case. Furthermore, the terms of the loan include a covenant requiring the company to maintain a minimum tangible net worth as defined in the loan agreement at the end of each calendar quarter during the loan term. As of September 30, 2013, we were in compliance with the loan covenants.

8. *Commitment and Contingencies* – Please refer to Note 8 to our Consolidated Financial Statements included in our 2012 Form 10-K for a description of our commitments and contingencies.

Legal Matters – On April 2, 2013, ChemFree received a letter from Clearwater Environmental Services (“CES”) regarding a claim for additional sales commission that CES alleges is owed to it pursuant to a sales agreement between CES and ChemFree that expired October 31, 2012. On April 8, 2013, ChemFree sent a letter in reply to CES disputing its claim. The company believes that all amounts due to CES have been paid in full in accordance with the terms of the sales agreement and intends to vigorously defend against this claim. ChemFree has initiated arbitration proceedings as required under the contract. While management believes it will prevail in the matter, there can be no assurance of the outcome of the dispute.

In the ordinary course of business, from time to time we may be involved in various pending or threatened legal actions. The litigation process is inherently uncertain and it is possible that the resolution of such matters might have a material adverse effect upon our financial condition and/or results of operations.

9. *Industry Segments* – Segment information is presented consistent with the basis described in our 2012 Form 10-K. The following table contains segment information for continuing operations for the three and nine months ended September 30, 2013 and 2012.

	Three Months Ended Sept. 30,		**Nine Months Ended Sept. 30,**	
(unaudited, in thousands)	**2013**	**2012**	**2013**	**2012**
Information Technology				
Revenue	$1,088	$1,001	$3,106	$2,412
Operating loss	(182)	(352)	(885)	(1,576)
Industrial Products				
Revenue	3,486	3,074	9,720	9,789
Operating income	882	696	2,622	2,215
Consolidated Segments				
Revenue	4,574	4,075	12,826	12,201
Operating income	700	344	1,737	639
Corporate expenses	(266)	(298)	(1,053)	(1,084)
Consolidated operating income (loss)	$434	$46	$684	$(445)

(unaudited, in thousands)	**Three Months Ended Sept. 30, 2013**	**2012**	**Nine Months Ended Sept. 30, 2013**	**2012**
Depreciation and Amortization				
Information Technology	$70	$60	$152	$123
Industrial Products	53	78	185	241
Consolidated segments	123	138	337	364
Corporate	--	3	6	9
Consolidated depreciation and amortization	$123	$141	$343	$373
Capital Expenditures				
Information Technology	$(1)	$73	$98	$144
Industrial Products	36	88	237	129
Consolidated segments	35	161	335	273
Corporate	1	4	4	4
Consolidated capital expenditures	$36	$165	$339	$277

(unaudited, in thousands)	**September 30, 2013**	**December 31, 2012**
Identifiable Assets		
Information Technology	$ 1,710	$ 1,712
Industrial Products	6,905	6,250
Consolidated segments	8,615	7,962
Corporate	1,995	1,974
Consolidated assets	$ 10,610	$ 9,936

10. *Income Taxes* – We have recognized tax benefits from all tax positions we have taken, and there has been no adjustment to any carry forwards (net operating loss or research and development credits) in the past two years. As of September 30, 2013 and December 31, 2012, we have recorded a liability of $170,000 and $148,000, respectively, in connection with unrecognized tax benefits related to uncertain tax positions. The liability includes $35,000 and $28,000 of interest and penalties, as of September 30, 2013 and December 31, 2012 respectively. As of September 30, 2013, management expects some incremental, but not significant, changes in the balance of unrecognized tax benefits over the next twelve months.

Our policy is to recognize accrued interest related to uncertain tax positions in interest expense and related penalties, if applicable, in general and administrative expense. During the nine months ended September 30, 2013, we recognized $5,000 in interest expense and $2,000 in penalties related to uncertain tax positions. During the nine months ended September 30, 2012, we recognized $2,000 in interest expense and $3,000 in penalties related to uncertain tax positions.

We file a consolidated U.S. federal income tax return for all subsidiaries in which our ownership equals or exceeds 80%, as well as individual subsidiary returns in various states and foreign jurisdictions. With few exceptions we are no longer subject to U.S. federal, state and local or foreign income tax examinations by taxing authorities for years before 2009.

11. *Recent Accounting Pronouncements* – We have considered all recently issued accounting pronouncements and do not believe the adoption of such pronouncements will have a material impact on our Consolidated Financial Statements.

12. *Subsequent Events* – We evaluated subsequent events through the date when these financial statements were issued. We are not aware of any significant events that occurred subsequent to the balance sheet date but prior to the filing of this report that would have a material impact on our Consolidated Financial Statements.

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

In addition to historical information, this Form 10-Q may contain forward-looking statements relating to ISC. All statements, trend analyses and other information relative to markets for our products and trends in revenue, gross margins and anticipated expense levels, as well as other statements including words such as “anticipate”, “believe”, “plan”, “estimate”, “expect”, and “intend”, and other similar expressions, constitute forward-looking statements. Prospective investors are cautioned that any such forward-looking statements are not guarantees of future performance and involve risks and uncertainties including those factors described below under “Factors That May Affect Future Operations”, and that actual results may differ materially from those contemplated by such forward-looking statements. Except to the extent required by law, ISC undertakes no obligation to update or revise forward-looking statements to reflect changed assumptions, the occurrence of unanticipated events or changes in future operating results.

For purposes of this discussion and analysis, we are assuming and relying upon the reader’s familiarity with the information contained in Item 6. Management’s Discussion and Analysis of Financial Condition and Results of Operations, in the Form 10-K for the year ended December 31, 2012 as filed with the Securities and Exchange Commission.

We derive our product revenue from sales and leases of equipment and supplies in our Industrial Products sector and from sales of software licenses in our Information Technology Products and Services sector. Our service revenue consists of fees for consulting, customization, training, processing services, maintenance and support for software products in our Information Technology Products and Services sector. Our revenue fluctuates from period to period and our results are not necessarily indicative of the results to be expected in future periods. Period-to-period comparisons may not be meaningful and it is difficult to predict the level of consolidated revenue on a quarterly or annual basis for a number of reasons, including the following:

A change in revenue level at one of our subsidiaries may impact consolidated revenue or be offset by an opposing change at another subsidiary.

Software license revenue in a given period may consist of a relatively small number of contracts and contract values can vary considerably depending on the software product and scope of the license sold. Consequently, even minor delays in delivery under a software contract (which may be out of our control) could have a significant and unpredictable impact on the consolidated revenue that we recognize in a given quarterly or annual period.

Customers may decide to postpone a planned implementation of our software for any number of reasons, which may be unrelated to our software or contract performance, but which may affect the amount, timing and characterization of our deferred and/or recognized revenue.

We have frequently recognized consolidated operating losses on a quarterly and annual basis and are likely to do so in the future from time to time. Our ChemFree subsidiary generates an operating profit and positive cash flow on a quarterly and annual basis. Our CoreCard subsidiary is not consistently profitable, due in part to significant research and development expense that is invested in its product offerings and the deferral of initial contract revenue recognition until licensed software and associated services are delivered to its customers. Depending upon the size and number of software licenses recognized in a particular period and the level of expenses incurred to support existing customers and development and sales activities, CoreCard may report operating profits on an irregular basis as it builds a larger customer base. A significant portion of CoreCard's expense is related to personnel, including a workforce of approximately 200 employees located in India. In addition, CoreCard is now offering card processing services as an alternative for customers who prefer to outsource this function instead of licensing our software and running the application in-house. We expect to incur losses in the near future for the processing business because contract revenue is spread out over multi-year contracts while we are currently investing in the infrastructure, resources and internal controls and compliance processes to support this new line of business. For these and other reasons, our operating results may vary from quarter to quarter and at the present time are generally not predictable with a reasonable degree of certainty.

From time to time, we derive income from sales of holdings in affiliate and other minority-owned companies or we may record a charge if we believe the value of a non-consolidated company is impaired. We also recognize on a quarterly basis our pro rata share of the income or losses of an affiliate company accounted for by the equity method. The timing and amount of the gain or loss recognized as a result of a sale or the amount of equity in the income or losses of the affiliate are not under our control and are not necessarily indicative of future results, either on a quarterly or annual basis.

In recent years, most of our cash has been generated by our ChemFree operations and, on an irregular basis, from sales of our investments or subsidiaries. We have used a significant amount of the cash received from these transactions and operations to support the domestic and international operations associated with our CoreCard subsidiary and the corporate office.

Results of Operations

The following discussion should be read in conjunction with the Consolidated Financial Statements and the notes to Consolidated Financial Statements presented in this quarterly report.

Revenue – Total revenue from continuing operations in the three month period ended September 30, 2013 was $4,574,000 compared to $4,0750,000 in the third quarter of 2012. For the nine month period ended September 30, 2013, total revenue was $12,826,000, compared to $12,201,000 in the same period in 2012.

Revenue from *products*, which includes sales and leases of equipment and supplies in our Industrial Products segment as well as software license fees in our Information Technology segment, was $3,587,000 in the three month period ended September 30, 2013, a 16 percent increase compared to the three month period ended September 30, 2012. Product revenue was $10,124,000 in the nine month period ended September 30, 2013, an increase of 2 percent compared to the nine month period ended September 30, 2012. In the three month period ended September 30, 2013, our ChemFree subsidiary reported year-over-year growth in total product revenue of approximately 11 percent, led by increased domestic sales of its SmartWasher® parts washer machines which were impacted positively by an unusually large one-time order in 2013. As expected, lease revenue declined in both the third quarter and year-to-date period in 2013 due to the non-renewal of a lease contract effective July 1, 2013 when the customer decided to purchase the installed lease machines rather than continue with a lease program. Future lease revenue and profit contribution is expected to reflect this lower level of leased equipment. Software license revenue from our Information Technology segment increased in both the three and nine month periods ended September 30, 2013 compared to the same periods in 2012 due to more license fees for initial contracts and tier upgrades.

Service revenue from the Information Technology segment was $987,000 and $2,702,000 in the three and nine months ended September 30, 2013, respectively, an increase of 2 percent and 16 percent compared to the respective periods in 2012. Service revenue includes three components: revenue from annual maintenance and support contracts for our installed customer base, revenue from professional services (such as software customizations or modifications) and revenue from our card processing services. The growth in the quarter and year-to-date periods in 2013 as compared to the same periods in 2012 is attributed to an increase in the amounts paid for maintenance services by the installed customer base as well as an increase in revenue from card processing services. The number and timing of professional services contracts vary significantly from period to period based on customer requirements and priorities and were lower in both the quarter and year-to-date periods in 2013 than the comparable periods in 2012.

Cost of Revenue – Total cost of revenue was 54 percent and 53 percent of total revenue in the three and nine month periods ended September 30, 2013, respectively, compared to 55 percent in both the three and nine month periods ended September 30, 2012. The changes between periods reflect variations in ChemFree's and CoreCard's product and service mix from period to period.

Cost of *product* revenue was 53 percent and 50 percent of product revenue in the three and nine months ended September 30, 2013, respectively, compared to costs of 50 percent of product revenue in the same periods in 2012. In the third quarter of 2013, the higher cost of sales as a percent of product revenue reflects the fact that a higher proportion of ChemFree's revenue was derived from equipment sales which have a higher cost of sales than do consumables or lease revenue.

Cost of *service* revenue (which relates to our CoreCard business only) was significantly lower as a percentage of service revenue in both the three and nine month periods ended September 30, 2013, as compared to the respective periods last year. The mix of service revenue in a given period, as well as the number of customers and new products being supported, impacts the gross margin on service revenue. Cost of service revenue includes three components: the costs to provide annual maintenance and support services to our installed base of licensed customers, costs to provide professional services and costs to provide our card processing services. The cost and gross margins on such services vary depending on the customer mix, service requirements and project complexity as well as the mix of our U.S. and offshore employees working on the various aspects of services provided. We have reduced the costs required to deliver maintenance and customer support to our installed base of license customers. In addition, although our actual costs to provide card processing services are higher in 2013 than in 2012 (because we continue to devote the resources necessary to support this new service initiative, including additional direct costs for regulatory compliance, infrastructure and customer support), the costs increased at a lower rate than did processing revenue resulting in an improvement in gross margin. However, we expect these costs to continue to outpace processing revenue for the foreseeable future. Cost associated with delivering professional services vary considerably from period to period depending on the project complexity and mix of employees delivering such services.

Operating Expenses – Consolidated marketing expenses were lower by 19 percent ($110,000) and 18 percent ($316,000) in the three and nine month periods ended September 30, 2013 compared to the same periods in 2012, mainly due to lower sales commissions due to a third party. Consolidated general and administrative expenses were lower by 6 percent ($40,000) and 8 percent ($191,000) in the three and nine-month periods ended September 30, 2013 compared to the respective period in 2012. In the three month period ended September 30, 2013, the reduction included a number of items, none of which was individually significant whereas, in the nine month period of 2013, the reduction in expenses is due mainly to lower legal expenses. Consolidated research and development expenses were higher by 7 percent ($37,000) and 2 percent ($32,000) in the three and nine month periods ended September 30, 2013 respectively, compared to the same periods in 2012. Changes between periods reflect mainly differences in a given period in the mix and number of U.S. and offshore technical personnel expenses that are charged to direct cost of services revenue for maintenance, processing and professional services in a given period versus base R&D activities.

Equity in Income (Loss) of Affiliate Company – On a quarterly basis, we recognize our pro rata share of the earnings or losses of an affiliate company that we record on the equity method. We recorded net equity income of $5,000 in the three and nine month periods ended September 30, 2013, respectively, compared to net equity loss of $5,000 and $16,000 in the three and nine months ended September 30, 2012, respectively. Changes between periods reflect improved profitability of the affiliate company.

Income Taxes – We recorded $42,000 in the nine month period ended September 30, 2013, for state income tax expense, which amounts include $22,000 in connection with uncertain tax positions. In 2012, the nine month amount of $48,000 for income taxes includes $13,000 in connection with uncertain tax positions.

Liquidity and Capital Resources

Our cash balance at September 30, 2013 was $2,839,000 as compared to $2,347,000 at December 31, 2012. During the nine months ended September 30, 2013, a principal source of cash was receipt of a scheduled $250,000 payment from the purchaser of our former VISaer subsidiary (as explained in more detail in Note 2 to the Consolidated Financial Statements contained in our 2012 Annual Report on Form 10-K). We generated $642,000 cash from operations during the nine month period ended September 30, 2013. Major working capital changes included:

- an increase in accounts receivable of $135,000 reflecting higher billings in the third quarter of 2013 as compared to the fourth quarter of 2012.
- A reduction of $257,000 in deferred revenue, current portion reflecting contracts completed and recognized in the nine month period, which had been in process at December 31, 2012.

During the nine months ended September 30, 2013, we used $339,000 to upgrade accounting software and purchase computer and manufacturing equipment. We also used $67,000 to purchase additional marketable securities.

We currently project that we will have sufficient liquidity from cash on hand, continued cash positive operations at ChemFree, projected customer payments at CoreCard and periodic working capital borrowings or sale of marketable securities, if needed, to support our operations and capital equipment purchases in the foreseeable future. We renewed our line of credit in June 2012 with a maximum principal availability of $1.25 million based on qualified receivables and inventory levels which we will use as necessary to support short-term cash needs. The line of credit expires June 30, 2014, subject to the bank renewing the line for an additional period. We have not drawn down under the bank line of credit in more than two years. We presently project that we will have sufficient accounts receivable, inventory balances and tangible net worth for the foreseeable future to support the borrowing base and loan covenants for any required draws under our bank line of credit. Delays in meeting project milestones or software delivery commitments at CoreCard could cause customers to postpone payments and increase our need for cash. Presently, we do not believe there is a material risk that we will not perform successfully on any contracts but if customer payments are delayed for any reason, if we do not control costs or if we encounter unforeseen technical or quality problems, then we could require more cash than presently planned.

Long-term, we currently expect that liquidity will improve and consolidated operations will generate sufficient cash to fund their requirements with use of our credit facility to accommodate short-term needs. Other long-term sources of liquidity include potential sales of investments, subsidiaries or other assets although there are no current plans to do so. Furthermore, the timing and amount of any such transactions are uncertain and, to the extent they involve non-consolidated companies, generally not within our control.

Off-Balance Sheet Arrangements

We do not currently have any off-balance sheet arrangements that are reasonably likely to have a current or future material effect on our financial condition, liquidity or results of operations.

Critical Accounting Policies and Estimates

The discussion and analysis of our financial condition and results of operations is based upon our Consolidated Financial Statements which have been prepared in accordance with accounting principles generally accepted in the United States. The preparation of these financial statements requires us to make estimates and judgments that affect the reported amount of assets, liabilities, revenues and expenses. We consider certain accounting policies related to revenue recognition, valuation of intangibles and valuation of investments to be critical policies due to the estimation processes involved in each. For a detailed description on the application of these and other accounting policies, see Note 1 to the Consolidated Financial Statements contained in our Annual Report on Form 10-K for the fiscal year ended December 31, 2012. Reference is also made to the discussion of the application of these critical accounting policies and estimates contained in Management's Discussion and Analysis of Financial Condition and Results of Operations in our Annual Report on Form 10-K for 2012. During the three and nine month periods ended September 30, 2013, there were no significant or material changes in the application of critical accounting policies that would require an update to the information provided in the Form 10-K.

Factors That May Affect Future Operations

Future operations in both the Information Technology Products and Services and Industrial Products segments are subject to risks and uncertainties that may negatively impact our future results of operations or projected cash requirements. It is difficult to predict future quarterly and annual results with certainty. Any trend or delay that affects even one of our subsidiaries could have a negative impact on the company's consolidated results of operations or cash requirements on a quarterly or annual basis. In addition, the carrying value of our investments is impacted by a number of factors which are generally beyond our control since we are typically a non-controlling shareholder in a private company with limited liquidity.

Among the numerous factors that may affect our consolidated results of operations or financial condition are the following:

Information Technology Products and Services Industry

Weakness or instability in the global financial markets could have a negative impact on CoreCard due to potential customers (most of whom perform some type of financial services) delaying decisions to purchase software or initiate processing services with CoreCard.

As an alternative to licensing its software, CoreCard offers processing services running on the CoreCard software system. There are numerous risks associated with entering any new line of business and if CoreCard fails to manage the risks associated with its processing operations, it could have a negative impact on our business.

Stricter regulations and reluctance by financial institutions to act as sponsor banks for prospective customers could increase CoreCard's losses and cash requirements.

Delays in software development projects could cause our customers to postpone implementations or delay payments, which would increase our costs and reduce our revenue and cash.

Our CoreCard subsidiary could fail to deliver software products which meet the business and technology requirements of its target markets within a reasonable time frame and at a price point that supports a profitable, sustainable business model.

CoreCard's processing business is impacted, directly or indirectly, by more regulations than its licensed software business. If the company fails to provide services that comply with (or allow its customers to comply with) applicable regulations or processing standards, it could be subject to financial or other penalties that could negatively impact its business.

Software errors or poor quality control may delay product releases, increase our costs, result in non-acceptance of our software by customers or delay revenue recognition.

CoreCard could fail to expand its base of customers as quickly as anticipated, resulting in lower revenue and profits (or increased losses) and increased cash needs.

CoreCard could fail to retain key software developers and managers who have accumulated years of know-how in our target markets and company products, or fail to attract and train a sufficient number of new software developers and testers to support our product development plans and customer requirements at projected cost levels.
Increasing and changing government regulations in the United States and foreign countries related to such issues as data privacy, financial and credit transactions could require changes to our products and services which could increase our costs and could affect our existing customer relationships or prevent us from getting new customers.

Industrial Products Industry

One of ChemFree's customers represented 22 percent of our consolidated revenue in the first nine months of 2013 and any changes in the volume of orders or timeliness of payments from such customer could potentially have a negative impact on revenue, inventory levels and cash, at least in the near-term. For instance in the third quarter of 2013, the customer decided to temporarily reduce new machine orders due to some internal process changes which resulted in postponed shipments and significantly reduced revenue related to such customer in the quarter.
Delays in production or shortages of certain sole-sourced parts for our ChemFree products could impact revenue and orders. For example, recently one of ChemFree's suppliers of a sole-sourced component experienced an equipment malfunction which created a backlog of certain of ChemFree's products in the second quarter of 2013. Although the shortage and short-term impact of the shortage was resolved, longer term the company is taking steps to reduce its dependency on a single supplier where feasible.
Increases in prices of raw materials and sub-assemblies could reduce ChemFree's gross profit if it is not able to offset such increased costs with higher selling prices for its products or other reductions in production costs.
In certain situations, ChemFree's lease customers are permitted to terminate the lease covering one or more SmartWasher® machines. Effective July 1, 2013, one of ChemFree's lease customers opted to terminate its equipment lease and purchase the machines instead. This termination will significantly reduce lease revenue in future periods, although the customer expects to continue to purchase fluid and filter supplies.

Other

Delays in anticipated customer payments for any reason would increase our cash requirements and possibly our losses.
Competitive pressures (including pricing, changes in customer requirements and preferences, and competitor product offerings) may cause prospective customers to choose an alternative product solution, resulting in lower revenue and profits (or increased losses).
Declines in performance, financial condition or valuation of our minority-owned companies could cause us to write-down the carrying value of our investment or postpone an anticipated liquidity event, which could negatively impact our earnings and cash.
Our future capital needs are uncertain and depend on a number of factors; additional capital may not be available on acceptable terms, if at all.
Other general economic and political conditions could cause customers to delay or cancel purchases.

Item 4. Controls and Procedures

As of the end of the period covered by this report, the company carried out an evaluation, under the supervision and with the participation of the company’s management, including the company’s Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of the company’s disclosure controls and procedures pursuant to Rule 13a-15(b) under the Exchange Act. Based upon that evaluation, the Chief Executive Officer and Chief Financial Officer concluded that the company’s disclosure controls and procedures are effective. There were no significant changes in the company’s internal control over financial reporting or in other factors identified in connection with this evaluation that occurred during the period covered by this report that have materially affected, or are reasonably likely to materially affect, the company’s internal control over financial reporting.

Part II. OTHER INFORMATION

Item 1. Legal Proceedings

On April 2, 2013, ChemFree received a letter from Clearwater Environmental Services ("CES") regarding a claim for additional sales commission that CES alleges is owed to it pursuant to a sales agreement between CES and ChemFree that expired October 31, 2012. On April 8, 2013, ChemFree sent a letter in reply to CES disputing its claim. The company believes that all amounts due to CES have been paid in full in accordance with the terms of the sales agreement and intends to vigorously defend against this claim. ChemFree has initiated arbitration proceedings as required under the contract. While management believes it will prevail in the matter, there can be no assurance of the outcome of the dispute.

In the ordinary course of business, from time to time we may be involved in various pending or threatened legal actions. The litigation process is inherently uncertain and it is possible that the resolution of such matters might have a material adverse effect upon our financial condition and/or results of operations.

Item 6. Exhibits

The following exhibits are filed or furnished with this report:

3.1	Amended and Restated Articles of Incorporation of the Registrant dated May 4, 2011 (Incorporated by reference to Exhibit 3.(1) to the Registrant's Form 10-Q for the period ended March 31, 2011)
3.2	Bylaws of the Registrant dated December 7, 2007. (Incorporated by reference to Exhibit 3.2 of the Registrant's Form 8-K dated December 7, 2007.)
31.1	Certification of Chief Executive Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
31.2	Certification of Chief Financial Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
32.1	Certification of Chief Executive Officer and Chief Financial Officer furnished as required by Section 906 of the Sarbanes-Oxley Act of 2002.
101.INS**	XBRL Instance Document
101.SCH**	XBRL Taxonomy Extension Schema

101.CAL** XBRL Taxonomy Extension Calculation

101.DEF** XBRL Taxonomy Extension Definitions

101.LAB** XBRL Taxonomy Extension Labels

101.PRE** XBRL Taxonomy Extension Presentation

** XBRL information is furnished and not filed or a part of a registration statement or prospectus for purposes of sections 11 or 12 of the Securities Act of 1933, as amended, is deemed not filed for purposes of section 18 of the Securities Exchange Act of 1934, as amended, and otherwise is not subject to liability under these sections.

Signatures

Pursuant to the requirements of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned, hereunto duly authorized.

INTELLIGENT SYSTEMS CORPORATION
Registrant

Date: November 14, 2013

By: */s/ J. Leland Strange*
J. Leland Strange
Chief Executive Officer, President

Date: November 14, 2013

By: */s/ Bonnie L. Herron*
Bonnie L. Herron
Chief Financial Officer

Exhibit Index

Exhibit No.	**Descriptions**
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