INTELLIGENT SYSTEMS CORP
Form 10-Q
August 12, 2016

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 June 30, 2016

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**
(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 July 31, 2016, 8,731,299 shares of Common Stock of the issuer were outstanding.

Intelligent Systems Corporation

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Ex. 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).
Ex. 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.)
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)

As of	**June 30, 2016** (unaudited)	**December 31, 2015** (audited)
ASSETS		
Current assets:		
Cash	$ 16,843	$ 18,059
Marketable securities	418	396
Accounts receivable, net	532	962
Other current assets	1,201	2,846
Restricted cash	2,200	2,200
Total current assets	21,194	24,463
Investments	245	1,015
Property and equipment, at cost less accumulated depreciation	650	636
Other long-term assets	118	59
Total assets	$ 22,207	$ 26,173
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	$ 122	$ 78
Deferred revenue, current portion	2,157	1,830
Accrued payroll	648	495
Accrued expenses	28	25
Other current liabilities	279	243
Liabilities from discontinued operations	--	120
Total current liabilities	3,234	2,791
Deferred revenue, net of current portion	131	195
Other long-term liabilities	18	18
Intelligent Systems Corporation stockholders' equity:		
Common stock, $0.01 par value, 20,000,000 shares authorized, 8,731,299 issued and outstanding at June 30, 2016 and December 31, 2015	87	87
Additional paid-in capital	17,829	20,875
Accumulated other comprehensive loss	(161)	(184)
Retained earnings	4,115	5,270

Total Intelligent Systems Corporation stockholders’ equity	21,870	26,048
Noncontrolling interest	(3,046)	(2,879)
Total stockholders’ equity	18,824	23,169
Total liabilities and stockholders’ equity	$ 22,207	$ 26,173

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 June 30, 2016	Three Months Ended June 30, 2015	Six Months Ended June 30, 2016	Six Months Ended June 30, 2015
Revenue				
Products	$149	$139	$378	$275
Services	1,401	1,069	2,818	2,002
Total net revenue	1,550	1,208	3,196	2,277
Cost of revenue				
Products	58	52	122	112
Services	719	626	1,367	1,170
Total cost of revenue	777	678	1,489	1,282
Expenses				
Marketing	99	52	195	123
General and administrative	383	725	939	1,093
Research and development	611	718	1,256	1,412
Loss from operations	(320)	(965)	(683)	(1,633)
Other income (loss)	21	27	(642)	29
Loss from continuing operations before income taxes	(299)	(938)	(1,325)	(1,604)
Income taxes	(2)	--	(3)	3
Loss from continuing operations	(297)	(938)	(1,322)	(1,607)
Gain (loss) on sale of discontinued operations, net of taxes	--	(20)	--	18,726
Loss from discontinued operations, net of taxes	--	--	--	(3)
Net income (loss)	(297)	(958)	(1,322)	17,116
Net loss attributable to noncontrolling interest	80	165	167	388
Net income (loss) attributable to Intelligent Systems Corporation	$(217)	$(793)	$(1,155)	$17,504
Earnings (loss) per share attributable to Intelligent Systems Corporation:				
Basic: Continuing operations	$(0.02)	$(0.09)	$(0.13)	$(0.14)
Discontinued operations	--	--	--	2.11
Earnings (loss) per share	$(0.02)	$(0.09)	$(0.13)	$1.97
Diluted: Continuing operations	$(0.02)	$(0.09)	$(0.13)	$(0.14)
Discontinued operations	--	--	--	2.09
Earnings (loss) per share	$(0.02)	$(0.09)	$(0.13)	$1.95
Basic weighted average common shares outstanding	8,731,299	8,806,875	8,731,299	8,882,452
Diluted weighted average common shares outstanding	8,731,299	8,806,875	8,731,299	8,977,839
Net income (loss) attributable to Intelligent Systems Corporation:				
Loss from continuing operations	$(217)	$(773)	$(1,155)	$(1,219)
Income (loss) from discontinued operations	--	(20)	--	18,723

Net income (loss) attributable to Intelligent Systems Corporation	$(217)	$(793)	$(1,155)	$17,504

The accompanying notes are an integral part of these consolidated financial statements.

Intelligent Systems Corporation

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (LOSS)

(unaudited, in thousands)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2016	**2015**	**2016**	**2015**
Net income (loss)	$(297)	$(958)	$(1,322)	$17,116
Other comprehensive income (loss):				
Foreign currency translation adjustments	4	(1)	1	(6)
Unrealized gain (loss) on available-for-sale marketable securities	13	(20)	22	(18)
Total comprehensive income (loss)	(280)	(979)	(1,299)	17,092
Comprehensive loss attributable to noncontrolling interest	80	165	167	388
Comprehensive income (loss) attributable to Intelligent Systems Corporation	$(200)	$(814)	$(1,132)	$17,480

The accompanying notes are an integral part of these consolidated financial statements.

Intelligent Systems Corporation

CONSOLIDATED STATEMENTS OF CASH FLOWS

(unaudited, in thousands)

CASH PROVIDED BY (USED FOR):	**Six Months Ended June 30, 2016**	**2015**
OPERATING ACTIVITIES:		
Net income (loss)	$(1,322)	$17,116
Income from discontinued operations	--	(18,723)
Net loss from continuing operations	(1,322)	(1,607)
Adjustments to reconcile net loss from continuing operations to net cash used for operating activities:		
Depreciation and amortization	111	86
Stock-based compensation expense	10	8
Non-cash investment expense	750	--
Equity in loss of affiliate company	19	20
Changes in operating assets and liabilities:		
Accounts receivable	431	(41)
Other current assets	(603)	105
Other long-term assets	(59)	15
Accounts payable	44	(20)
Accrued payroll	153	13
Deferred revenue, current portion	327	289
Accrued expenses	3	4
Other current liabilities	36	(37)
Deferred revenue, net of current portion	(64)	(4)
Other long-term liabilities	--	(18)
Net cash used for operating activities	(164)	(1,187)
INVESTING ACTIVITIES:		
Purchases of property and equipment	(125)	(217)
Proceeds from sale of long-term investment	2,248	--
Purchase of long-term investment	--	(80)
Net cash provided by (used for) investing activities	2,123	(297)
FINANCING ACTIVITIES:		
Distribution of dividend to stockholders	(3,056)	--
Sale of capital stock pursuant to exercise of option	--	8
Repurchase of capital stock pursuant to tender offer	--	(692)
Net cash used for financing activities	(3,056)	(684)
Net cash provided by (used for) operating activities from discontinued operations	(120)	(204)

Net cash provided by (used for) investing activities from discontinued operations	--	18,202
Net cash provided by (used for) discontinued operations	(120)	17,998
Effects of exchange rate changes on cash	1	(6)
Net increase (decrease) in cash	(1,216)	15,824
Cash at beginning of period	18,059	2,624
Cash at end of period	$16,843	$18,448
SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION:		
Cash paid during the period for income taxes	$120	$--

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, includi its wholly-owned and majority-owned subsidiaries. The unaudited Consolidated Financial Statements presented in this Form 10-Q have been prepared in accordance with accounting principles generally accepted in the United States applicable to interim financial statements. Accordingly, they do not include all of the information and notes required for complete financial statements. In the opinion of ISC management, these Consolidated Financial Statements contain all adjustments (which comprise only normal and recurring accruals) necessary to present fairly the financial position and results of operations as of and for the three and six month periods ended June 30, 2016 and 2015. The interim results for the three and six months ended June 30, 2016 are not necessarily indicative of the results to be expected for the full year. These statements should be read in conjunction with our Consolidated Financial Statements and notes thereto for the fiscal year ended December 31, 2015, as filed in our Annual Report on Form 10-K.

2. *Sale of Subsidiary; Discontinued Operations* – On March 31, 2015, we and CRC Industries, Inc., a Pennsylvania corporation (“CRC”), entered into a Stock Purchase Agreement (the “Stock Purchase Agreement”) whereby we sold all of the issued and outstanding stock of our wholly owned subsidiary, ChemFree Corporation (“ChemFree”), to CRC (the “ChemFree Sale”). The purchase price for the all-cash sale was $21,600,000, subject to customary post-closing adjustments, including a working capital adjustment. The company retained all net cash of ChemFree as of the closing date. In the quarter ended March 31, 2015, the company recorded a gain on the sale of ChemFree of $18,746,000 and retroactively classified the ChemFree operations as discontinued operations in all periods presented. Subsequently, in the quarter ended June 30, 2015, the company recorded $20,000 of expense related to the sale of ChemFree for a net gain of $18,726,000 on the sale of ChemFree in the year-to-date period of 2015. The company is applying operating loss and capital loss carryforwards against the gain on sale and expects to incur an alternative minimum tax liability of approximately $120,000 on the transaction, which amount is included in liabilities of discontinued operations as of December 31, 2015. The estimated tax was paid in the quarter ended March 31, 2016. At the closing, a total of $3,300,000 of the purchase price was placed in escrow for purposes of securing our obligations to indemnify CRC and to refund a portion of the purchase price if ChemFree’s actual working capital amount on the closing date is less than the agreed upon target set forth in the Stock Purchase Agreement. In 2015, $880,000 of the escrow amount, net of the final working capital adjustment of $220,000 was released to the company. The remaining escrow balance of $2,200,000, which will remain in escrow until September 30, 2016, is shown as Restricted Cash as of December 31, 2015 and June 30, 2016.

The following condensed financial information is provided for the ChemFree discontinued operations for the periods shown:

	Three Months	Six Months Ended

(unaudited, in thousands)	**Ended June 30, 2016**	**2015**	**June 30, 2016**	**2015**
Net sales	$ --	$ --	$ --	$ 2,902
Operating loss	--	--	--	(3)
Net income before income taxes	--	--	--	6
Income taxes	--	--	--	9
Net loss from discontinued operations	$ --	$ --	$ --	$ (3)

The only liabilities of discontinued operations, presented separately on the balance sheet as of December 31, 2015, consist of $120,000 in current tax liabilities, which were paid before June 30, 2016.

3. *Investment Write-down* – In the quarter ended March 31, 2016, we recorded an impairment charge of $700,000 to reduce the carrying value of our minority equity ownership in Lumense, Inc., an early stage sensor technology company, to $50,000. Subsequently in the quarter ended June 30, 2016, we recorded an additional impairment charge of $50,000 to fully write-down our minority equity ownership in Lumense, Inc. to zero. Given that Lumense has no reasonable prospects to fund its operations and product development, we believe a full write-down is prudent and required.

4. *Stock-based Compensation* – At June 30, 2016, we had three 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 $5,000 and $4,000 of stock-based compensation expense for the three months ended June 30, 2016 and 2015, respectively, and $10,000 and $8,000 for the six month periods ended June 30, 2016 and 2015, respectively.

As of June 30, 2016, there is $42,000 of unrecognized compensation cost related to stock options. During the quarter ended June 30, 2016, an aggregate of 12,000 options were granted to three independent members of our board of directors pursuant to the 2011 Non-Employee Director Stock Option Plan (Director Plan). Pursuant to the terms of the Director Plan, the options were granted at fair value on the date of the Annual Shareholders meeting.

The following table summarizes stock options as of June 30, 2016:

	# of Shares	**Wgt Avg Exercise Price**	**Wgt Avg Remaining Contractual Life in Years**	**Aggregate Intrinsic Value**
Outstanding at June 30, 2016	286,500	$ 1.83	5.2	$ 541,530
Vested and exercisable at June 30, 2016	268,500	$ 1.74	4.9	$ 534,390

The estimated fair value of options granted is calculated using the Black-Scholes option pricing model with assumptions as previously disclosed in our 2015 Form 10-K.

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 second quarter of 2016 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 June 30, 2016. The amount of aggregate intrinsic value will change based on the fair value of the company's stock.

5. *Fair Value of Financial Instruments* – The carrying value of cash, 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.

Financial instruments that potentially subject us to concentrations of credit risk consist principally of cash, marketable securities, and trade accounts. 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.

6. *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.

7. *Concentration of Revenue* – The following table indicates the percentage of consolidated revenue represented by each customer that represented more than 10 percent of consolidated revenue in the three and six month periods ended June 30, 2016 and 2015. Most of our customers have multi-year contracts with recurring revenue as well as professional services fees that vary by period depending on their business needs.

	Three Months Ended June 30,		Six Months Ended June 30,	
	2016	**2015**	**2016**	**2015**
Customer A	14.7%	24.9%	19.0%	23.7%
Customer B	15.5%	15.4%	12.4%	19.0%
Customer C	10.6%	8.3 %	9.5 %	8.6 %
Customer D	14.9%	--	14.8%	--

8. *Commitments and Contingencies* – Please refer to Note 8 to our Consolidated Financial Statements included in our 2015 Form 10-K for a description of our commitments and contingencies. 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. *Income Taxes* – We recognize deferred tax liabilities and assets for the expected future tax consequences of events that have been included in the financial statements or tax returns. Deferred tax liabilities and assets are determined based on the difference between the financial statement and tax bases of assets and liabilities using enacted tax rates in effect for the year in which the differences are expected to reverse. Deferred tax assets are recognized, net of a valuation allowance, for the estimated future tax effects of deductible temporary differences and tax credit carry-forwards. A valuation allowance against deferred tax assets is recorded when, and if, based upon available evidence, it is more likely than not that some or all deferred tax assets will not be realized.

There were no unrecognized tax benefits at June 30, 2016 and December 31, 2015. Our policy is to recognize interest and penalties accrued on any unrecognized tax benefits as a component of income tax expense. There were no accrued interest or penalties associated with any unrecognized tax benefits, nor was any interest expense recognized during the periods presented. We have determined we have no 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 2012.

10. *Recent Accounting Pronouncements* – In February 2016, the FASB issued ASU 2016-02 – Leases (Topic 842) related to the accounting for leases. This pronouncement requires lessees to record most leases on their balance sheet, while expense recognition on the income statement remains similar to current lease accounting guidance. The guidance also eliminates real estate-specific provisions and modifies certain aspects of lessor accounting. Under the new guidance, lease classification as either a finance lease or an operating lease will determine how lease-related revenue and expense are recognized. The pronouncement is effective for fiscal years, and for interim periods within those fiscal years, beginning after December 15, 2018. We are currently evaluating the effect on our consolidated financial statements.

In March 2016, the FASB issued ASU 2016-08 – Revenue from Contracts with Customers (Topic 606) related to reporting revenue gross versus net, or principal versus agent considerations. This pronouncement is meant to clarify the guidance in FASB ASU 2014-09, Revenue from Contracts with Customers, as it pertains to principal versus agent considerations. Specifically, the guidance addresses how entities should identify goods and services being provided to a customer, the unit of account for a principal versus agent assessment, how to evaluate whether a good or service is controlled before being transferred to a customer, and how to assess whether an entity controls services performed by another party. The pronouncement has the same effective date as the new revenue standard, which is effective for fiscal years, and for interim periods within those fiscal years, beginning after December 15, 2017. We are currently evaluating the effect on our consolidated financial statements.

In March 2016, the FASB issued ASU 2016-09 – Compensations – Stock Compensation (Topic 718) related to simplifications of employee share-based payment accounting. This pronouncement eliminates the APIC pool concept and requires that excess tax benefits and tax deficiencies be recorded in the income statement when awards are settled. The pronouncement also addresses simplifications related to statement of cash flows classification, accounting for forfeitures, and minimum statutory tax withholding requirements. The pronouncement is effective for fiscal years, and for interim periods within those fiscal years, beginning after December 15, 2016. We are currently evaluating the effect on our consolidated financial statements.

In April 2016, the FASB issued ASU 2016-10 – Revenue from Contract with Customers (Topic 606) related to identifying performance obligations and licensing. This pronouncement is meant to clarify the guidance in FASB ASU 2014-09, Revenue from Contracts with Customers. Specifically, the guidance addresses an entity’s identification of its performance obligations in a contract, as well as an entity’s evaluation of the nature of its promise to grant a license of intellectual property and whether or not that revenue is recognized over time or at a point in time. The pronouncement has the same effective date as the new revenue standard, which is effective for fiscal years, and for interim periods within those fiscal years, beginning after December 15, 2017. We are currently evaluating the effect on our consolidated financial statements.

In May 2016, the FASB issued ASU 2016-12 – Revenue from Contracts with Customers (Topic 606) related to narrow scope improvements. This pronouncement is meant to clarify the guidance in FASB ASU 2014-09, Revenue from Contracts with Customers. The amendments in this update do not change the core principle of the guidance in Topic 606, but rather, the amendments in this update affect certain aspects of Topic 606 which include: assessing the collectability criterion, accounting for contracts that do not meet certain criteria, presentation of sales taxes and other similar taxes collected from customers, noncash consideration, contract modifications, and completed contracts. The pronouncement has the same effective date as the new revenue standard, which is effective for fiscal years, and for interim periods within those fiscal years, beginning after December 15, 2017. We are currently evaluating the effect on our consolidated financial statements.

We have considered all other recently issued accounting pronouncements and do not believe the adoption of such pronouncements will have a material impact on our Consolidated Financial Statements.

11. *Subsequent Event* – We have evaluated subsequent events through the date when these financial statements were issued and 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. 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 7. Management's Discussion and Analysis of Financial Condition and Results of Operations, in the Form 10-K for the year ended December 31, 2015 as filed with the Securities and Exchange Commission.

Overview

The results reported reflect the effect of the sale of ChemFree subsidiary on March 31, 2015, as explained in more detail in Note 2 to the Consolidated Financial Statements. Our consolidated continuing operations consist of our CoreCard Software subsidiary and its affiliate companies in Romania and India, as well as the corporate office which provides significant administrative, human resources and executive management support to CoreCard.

We provide technology solutions and processing services to the financial services market, commonly referred to as the FinTech industry. We derive our product revenue from licensing our comprehensive suite of financial transaction management software to accounts receivable businesses, financial institutions, retailers and processors to manage their credit and debit cards, prepaid cards, private label cards, fleet cards, loyalty programs, and accounts receivable and small loan transactions. Our service revenue consists of fees for software maintenance and support for licensed software products, fees for processing services that we provide to companies that outsource their financial transaction processing functions to us, and professional services primarily for software customizations provided to both license and processing customers.

We have frequently recognized consolidated operating losses on a quarterly and annual basis and may continue to do so in the foreseeable future. We may report operating profits on an irregular basis and our results vary in part depending on the size and number of software licenses with revenue recognized in a particular period and the level of expenses incurred to support existing customers and development and sales activities. A significant portion of our expense is related to personnel, including approximately 245 employees located in India and Romania. In addition, we offer 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 may continue to incur losses in the near future because revenue for processing services is spread out over multi-year contracts and we continue investing in the infrastructure, resources, processes and software features to support this developing business. In addition, we have certain corporate office expenses associated with being a public company that impact our operating results, even though our main operating entity, CoreCard, is likely to operate at breakeven or be profitable.

Our revenue fluctuates from period to period and our results are not necessarily indicative of the results to be expected in future periods. It is difficult to predict the level of consolidated revenue on a quarterly basis for a number of reasons, including the following:

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 or cancel 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.

Customers typically require our professional services to modify or enhance their CoreCard software implementation based on their specific business strategy and operational requirements, which vary from customer to customer and period to period.

The timing of new processing customer implementations is often dependent on third party approvals or processes which are typically not under our direct control.

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. The results for 2015 reflect the former ChemFree subsidiary as a discontinued operation.

Revenue – Total revenue from continuing operations in the three and six month periods ended June 30, 2016 was $1,550,000 and $3,196,000, respectively, which represent increases of 28 percent and 40 percent compared to the respective periods in 2015.

Revenue from products, which includes software license fees (and, in some cases monthly support fees when the license and support fees are bundled) was $149,000 and $378,000 in the three and six month periods, respectively, ended June 30, 2016, compared to $139,000 and $275,000 in the same periods in 2015. The increase reflects growth in the number of accounts covered by certain software licenses.

Revenue from services was $1,401,000 and $2,818,000 in the three and six months ended June 30, 2016, which represents an increase of 31 percent and 41 percent compared to the respective periods in 2015. Revenue from transaction processing services and professional services were both greater in the second quarter and year-to-date periods of 2016 as compared to the same periods in 2015. Processing services benefited from an increase in the number of customers and accounts on file while more revenue was generated from professional services due to an increase in the number and value of professional services contracts completed during the reporting periods in 2016. Maintenance revenue from annual contracts for technical and software support was lower in both the second quarter and year-to-date periods of 2016 as compared to the corresponding periods in 2015, due to a one-time maintenance billing in the second quarter of 2015. We expect that processing services will continue to grow as our customer base increases; however, the time required to implement new customer programs has proven longer than anticipated due to delays in third party integration and approval processes. It is not possible to predict with any accuracy the number and value of professional services contracts that our customers will require in a given period. Customers typically request our professional services to modify or enhance their CoreCard® software implementation based on their specific business strategy and operational requirements, which vary from customer to customer and period to period.

Cost of Revenue – Total cost of revenue was 50 percent and 47 percent of total revenue, respectively, in the three and six month periods ended June 30, 2016 compared to 56 percent of total revenue for both corresponding periods in 2015.

Cost of product revenue as a percent of product revenue was 39 percent and 32 percent, respectively, in the three and six month periods ended June 30, 2016, compared to 37 percent and 41 percent in the respective periods in 2015. Year-to-date revenue for 2016 grew at a 37 percent rate over the prior year while cost for the same time period increased only at a 9 percent rate. This is indicative of fewer resources being required to support our licensed customers after the initial implementation.

Cost of service revenue as a percentage of total service revenue was 51 percent and 49 percent, respectively, in the three and six months ended June 30, 2016 compared to 58 percent in both comparable periods in 2015. Cost of service revenue includes three components: 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 financial transaction processing services. The cost and gross margins on such services vary considerably depending on the customer mix, customer requirements and project complexity as well as the mix of our U.S. and offshore employees working on the various aspects of services provided. In addition, we continue to devote the resources necessary to support our developing processing business, including direct costs for regulatory compliance, infrastructure, network certifications, and customer support. As indicated by the lower cost to revenue percentages year over year, we are beginning to experience economies of scale in our processing environment. However, this may be subject to change in the future if new regulations or processing standards are implemented causing us to incur additional costs to comply.

Operating Expenses – In the three and six month periods ended June 30, 2016, total operating expenses from continuing operations were lower than in the corresponding periods in 2015 by 27 percent and 9 percent, respectively. Marketing expenses were higher by $47,000 and $72,000, respectively, for the three and six months ended June 30,2016 compared to the corresponding periods in 2015, primarily due to a focus on new marketing initiatives for CoreCard in 2016. General and administrative expenses were significantly lower in the second quarter of 2016 by $342,000 and on a year-to-date 2016 basis by $154,000, than in corresponding periods in 2015. This is primarily due to bonuses paid in the second quarter of 2015 directly related to the sale of ChemFree as well as transaction expenses for the tender offer which also occurred in the second quarter of 2015. Research and development expenses were 15 percent lower in the second quarter of 2016 and 11 percent lower year-to-date 2016 compared to the comparable periods in the prior year, mainly due to more technical personnel expenses being charged to direct cost of services for maintenance, professional services and processing.

Other Income (Loss) – In the three and six months ended June 30, 2016, we recorded income of $21,000 and a loss of $642,000 in other income, respectively. The 2016 second quarter income is comprised primarily of the write-down of $50,000 on an investment offset by a gain of $37,000 on a final payment after the escrow period on a prior minatory investment sale as well as income earned on our cash balances. On a year-to-date 2016 basis, the loss is primarily attributable to the write-down of $750,000 on an investment, as described in more detail in Note 3 to the Consolidated Financial Statements, offset in part by income earned on our cash balances.

Gain on Sale of Discontinued Operations – As explained in more detail in Note 2 to the Consolidated Financial Statements, we recorded a gain of $18,726,000 on the sale of our ChemFree subsidiary in the year-to-date period of 2015.

Liquidity and Capital Resources

Our cash balance at June 30, 2016 was $16,843,000 compared to $18,059,000 at December 31, 2015. The principal use of cash during the period was the payment of a special cash dividend on February 8, 2016 of $0.35 per share totaling $3,056,000 to our shareholders of record as of January 29, 2016. The principle source of cash of $2,248,000 was from the sale of one of our investee companies, Lancope, Inc., to Cisco, Inc., on December 23, 2015. We recognized a gain of $2,034,000 against our carrying value of $214,000 in the fourth quarter of 2015. Cash from the sale was received in early January 2016.

During the six months ended June 30, 2016, continuing operations used $164,000 cash for operations as well as $125,000 mainly for computer equipment purchases.

In the six months ended June 30, 2016, discontinued operations used $120,000 to pay the estimated 2015 tax liability related to the gain on sale that had been accrued in 2015.

We renewed our line of credit in June 2014 with a maximum principal availability of $1.25 million based on qualified receivables; however, we have not borrowed under the bank line of credit in the past five years and do not expect to need to do so in the foreseeable future. As a result, when the line of credit expired on June 30, 2016, we decided not to renew the bank line for an additional period.

We expect to have sufficient liquidity from cash on hand as well as projected customer payments at CoreCard to support our operations and capital equipment purchases in the foreseeable future. We expect to use cash in excess of what is required for our current operations for opportunities we believe will expand our CoreCard and FinTech business, although there can be no assurance that appropriate opportunities will arise.

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 investments and accrued costs and expenses to be critical policies due to the estimation processes involved in each. Management discusses its estimates and judgments with the Audit Committee of the Board of Directors. 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, 2015. 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 2015. During the six month period ended June 30, 2016, 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 for 2015.

Factors That May Affect Future Operations

Future operations 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.

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

Weakness or instability in the global financial markets could have a negative impact due to potential customers (most of whom perform some type of financial services) delaying decisions to purchase software or initiate processing services.
As an alternative to licensing our software, we offer processing services running on the CoreCard software system. There are numerous risks associated with entering any new line of business and if we fail to manage the risks associated with processing operations, it could have a negative impact on our business.
Increased federal and state regulations and reluctance by financial institutions to act as sponsor banks for prospective customers could increase our 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.
We 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.
Our processing business is impacted, directly or indirectly, by more regulations than our licensed software business. If we fail to provide services that comply with (or allow our customers to comply with) applicable regulations or processing standards, we could be subject to financial or other penalties that could negatively impact our 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.
We could fail to expand our base of customers as quickly as anticipated, resulting in lower revenue and profits (or increased losses) and increased cash needs.
We 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.
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).
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.

Item 6. Exhibits

The following exhibits are filed or furnished with this report:

Ex. 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).
Ex. 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.)
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.

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: August 12, 2016 By: */s/ J. Leland Strange*
J. Leland Strange
Chief Executive Officer, President

Date: August 12, 2016 By: */s/ Karen J. Reynolds*
Karen J. Reynolds
Chief Financial Officer

Exhibit Index

Exhibit No.		**Descriptions**
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

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