

INTELLIGENT SYSTEMS CORP
Form 10-Q
November 08, 2018

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, 2018

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

(State or other jurisdiction of incorporation or organization)

58-1964787

(I.R.S. Employer Identification No.)

4355 Shackleford Road, Norcross, Georgia

(Address of principal executive offices)

30093

(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

Indicated by check mark whether the registrant has submitted electronically and posted on its corporate Website, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T 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," "smaller reporting company" and "emerging growth company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer

Non-accelerated filer

(Do not check if a smaller reporting company)

Accelerated filer

Smaller reporting company

Emerging growth company

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

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

As of October 31, 2018, 8,817,988 shares of Common Stock of the issuer were outstanding.

Intelligent Systems Corporation

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Part I Financial Information**Item 1. Financial Statements****Intelligent Systems Corporation****CONSOLIDATED BALANCE SHEETS***(in thousands, except share and per share amounts)*

As of	September 30, 2018	December 31, 2017
	(unaudited)	(audited)
ASSETS		
Current assets:		
Cash	\$ 17,350	\$ 14,024
Marketable securities	410	438
Accounts receivable, net	3,019	1,208
Notes and interest receivable, current portion	580	16
Other current assets	1,124	2,373
Total current assets	22,483	18,059
Investments	760	1,035
Notes and interest receivable, net of current portion	1,742	1,250
Property and equipment, at cost less accumulated depreciation	1,496	1,262
Other long-term assets	246	173
Total assets	\$ 26,727	\$ 21,779
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	\$ 269	\$ 321
Deferred revenue, current portion	923	853
Accrued payroll	1,319	595
Accrued expenses	71	98
Other current liabilities	749	408
Total current liabilities	3,331	2,275
Deferred revenue, net of current portion	67	51
Intelligent Systems Corporation stockholders' equity:		
Common stock, \$0.01 par value, 20,000,000 shares authorized, 8,797,988 and 8,777,988 issued and outstanding at September 30, 2018 and December 31, 2017, respectively	88	88
Additional paid-in capital	14,955	14,877
Accumulated other comprehensive loss	(162)	(143)

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Accumulated income	8,448	4,631
Total Intelligent Systems Corporation stockholders' equity	23,329	19,453
Total liabilities and stockholders' equity	\$ 26,727	\$ 21,779

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		Nine Months Ended	
	September 30,		September 30,	
	2018	2017	2018	2017
Revenue				
Services	\$5,286	\$1,851	\$13,757	\$6,543
Products	129	–	289	90
Total net revenue	5,415	1,851	14,046	6,633
Cost of revenue				
Services	2,323	808	5,972	2,950
Products	–	–	136	87
Total cost of revenue	2,323	808	6,108	3,037
Expenses				
Marketing	85	64	240	212
General and administrative	466	343	1,357	1,221
Research and development	805	1,132	2,467	2,961
Income (loss) from operations	1,736	(496)	3,874	(798)
Other income	245	1,868	128	1,842
Income before Income taxes	1,981	1,372	4,002	1,044
Income taxes	115	–	185	20
Net income	\$1,866	\$1,372	\$3,817	\$1,024
Earnings per share attributable to Intelligent Systems Corporation:				
Basic	\$0.21	\$0.16	\$0.43	\$0.12
Diluted	\$0.21	\$0.15	\$0.43	\$0.12
Basic weighted average common shares outstanding	8,797,988	8,777,988	8,789,099	8,762,571
Diluted weighted average common shares outstanding	8,976,415	8,894,864	8,943,652	8,883,241

**CONSOLIDATED
STATEMENTS OF
COMPREHENSIVE
INCOME (LOSS)***(unaudited, in
thousands)*

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2018	2017	2018	2017
Net income	\$1,866	\$1,372	\$3,817	\$1,024
Other comprehensive income:				
Foreign currency translation adjustments	(11)	–	4	(14)
Unrealized gain on available-for-sale marketable securities	(11)	6	(23)	27
Total comprehensive income	\$1,844	\$1,378	\$3,798	\$1,037

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):	Nine Months Ended Sept. 30,	
	2018	2017
OPERATING ACTIVITIES:		
Net income	\$3,817	\$1,024
Adjustments to reconcile net income from continuing operations to net cash used for operating activities:		
Depreciation and amortization	429	238
Stock-based compensation expense	44	39
Gain on sale of long-term investment	-	(1,838)
Non-cash investment expense	255	93
Non-cash interest income	(37)	-
Equity in loss of affiliate company	25	50
Changes in operating assets and liabilities:		
Accounts receivable	(1,811)	(404)
Other current assets	1,249	142
Interest receivable	16	-
Other long-term assets	(73)	(58)
Accounts payable	(52)	(109)
Accrued payroll	724	77
Deferred revenue, current portion	70	(214)
Accrued expenses	(27)	56
Other current liabilities	341	(49)
Deferred revenue, net of current portion	16	(52)
Net cash provided by (used for) operating activities	4,986	(1,005)
INVESTING ACTIVITIES:		
Purchases of property and equipment	(663)	(432)
Advances of notes receivable	(1,035)	(751)
Proceeds from sale of long-term investment	-	1,936
Purchase of long-term investment	-	(1,000)
Net cash used for investing activities	(1,698)	(247)
FINANCING ACTIVITIES:		
Sale of capital stock pursuant to exercise of option	34	-
Net cash provided by financing activities	34	-
Effects of exchange rate changes on cash	4	(14)
Net increase (decrease) in cash	3,326	(1,266)

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Cash at beginning of period	14,024	17,724
Cash at end of period	\$17,350	\$16,458

SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION:

Cash paid during the period for income taxes	\$-	\$20
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The accompanying notes are an integral part of these Consolidated Financial Statements.

Intelligent Systems Corporation**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS***(unaudited)*

Basis of Presentation – Throughout this report, the terms “we”, “us”, “ours”, “ISC” and “company” refer to Intelligent Systems Corporation, including 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 the information and notes required for complete financial statements. In the opinion of ISC management, these

1. 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 nine month periods ended September 30, 2018 and 2017. The interim results for the three and nine months ended September 30, 2018 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, 2017, as filed in our Annual Report on Form 10-K.

There have been no material changes in the Company’s significant accounting policies, other than the adoption of accounting pronouncement ASU 2014-09, Revenue from Contracts with Customers (Topic 606), in the first quarter of 2018 as described in Note 2, as compared to the significant accounting policies described in the Company’s Annual Report on Form 10-K for the year ended December 31, 2017.

As a result of the implementation of Topic 606, certain revenue, and the associated cost of revenue, in the comparative periods, previously aggregated as product revenue has been reviewed and reclassified, based upon its performance obligations, from product revenue to service revenue. The impact to our fiscal quarters and the year ended December 31, 2017 was as follows:

	Three Months Ended				Twelve
	Dec. 31, 2017	Sept. 30, 2017	June 30, 2017	Mar. 31, 2017	Months Ended Dec. 31, 2017
<i>(in thousands)</i>					
Revenue					
Services	\$ 166	\$ 162	\$ 159	\$ 149	\$ 636
Products	(166)	(162)	(159)	(149)	(636)
Total net revenue	–	–	–	–	–
Cost of Revenue					
Services	62	51	50	46	209

Products	(62)	(51)	(50)	(46)	(209)
Total cost of revenue	-	-	-	-	-
Net Income	\$-	\$-	\$-	\$-	\$-

2. New Accounting Standards –

Accounting Pronouncements Adopted:

In May 2014, the Financial Accounting Standards Board ("FASB") issued ASU 2014-09, Revenue from Contracts with Customers (Topic 606) which amended the existing accounting standards for revenue recognition. ASU 2014-09 establishes principles for recognizing revenue upon the transfer of promised goods or services to customers, in an amount that reflects the expected consideration received in exchange for those goods or services. The Company adopted ASU 2014-09 in the first quarter of 2018 using the full retrospective approach. Because the Company's primary source of revenues is from monthly transaction processing services and software maintenance and support services which are recognized monthly as incurred, as well as professional services which are performance obligation based, the impact on its consolidated financial statements is not material. For the three and nine months ended September 30, 2017, the company restated approximately \$17,000 and \$123,000, respectively, in revenue and \$4,000 and \$24,000, respectively, in cost of revenue for a net \$13,000 and \$99,000, respectively, restatement to retained earnings.

Recent Accounting Pronouncements Not Yet Adopted:

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. As of September 30, 2018, the Company's total lease commitments are approximately \$1,346,000. The adoption of this standard is not expected to have a material effect on the Company's operating results or financial condition.

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.

Investments – In the quarter ended June 30, 2018, we recorded an impairment charge of \$250,000 to reduce the carrying value of our minority equity ownership in one of our investee companies, a privately held technology company and program manager in the FinTech industry. Given the investee's limited funding to support its operation and sales and marketing efforts, we are not comfortable assigning a higher realizable value to our investment at this point and therefore believe an impairment charge is prudent and required. CoreCard remains in an ongoing business relationship with the company pursuant to a Processing Agreement and a Program Management Services Agreement. CoreCard is positioned to assume the program management aspects of the investee company if the need should arise to ensure their program(s) ongoing viability and the completion of the Processing Agreement with CoreCard.

In the quarter ended June 30, 2017, we recorded an impairment charge of \$90,000 to reduce the carrying value of our minority equity ownership in an investee company, a privately-held technology company in the FinTech industry. During the quarter ended June 30, 2017, the investee closed on a Series A preferred stock financing with higher preference to our Series Seed preferred stock which resulted in substantial dilution to our investment. Subsequently, in the quarter ended December 31, 2017, the investee sold its intellectual property and is winding down its operations. As such, we recorded an additional impairment charge of \$10,000 to fully write-down our minority equity ownership in the investee company to zero. Given the operational and contractual wind-down costs of the investee coupled with the Series A preferred stock preference to our Series Seed preferred stock, we believe a full write-down was warranted. CoreCard remains in an ongoing contractual business relationship with the company through the wind-down period pursuant to a Processing Agreement and anticipates receiving liquidated damages as contractually allowed per the Processing Agreement. CoreCard has recognized processing services revenue from the investee company greater than our investment.

In the quarter ended September 30, 2017, the remaining cash held in escrow from the sale of one of our investee companies to Cisco, Inc. in the fourth quarter of 2015, was released. Since we had no reasonable way to estimate the amount of escrow, if any, to be released to us at the initial time of the sale, no provision was previously recorded in the financial statements. We received cash of \$372,000, which was recognized as a gain in the third quarter of 2017.

In the quarter ended September 30, 2017, we sold shares in a tender offer for stock of one of our investee companies, a privately-held technology company in the FinTech industry. We sold approximately ninety-one percent of our shares. We recognized a gain of \$1,466,000 over our carrying value of \$98,000. We retained a small equity stake in the investee and CoreCard remains in an ongoing business relationship with the company pursuant to a Processing Agreement previously entered into by the parties.

Notes Receivable – In the quarter ended September 30, 2017, we entered into a Loan Agreement with a privately-held identity and professional services company with ties to the FinTech industry. We committed to lend up to \$1,500,000 with an initial advance of \$750,000. In the quarter ended December 31, 2017, we advanced an additional \$500,000 for a total advancement of \$1,250,000 as of December 31, 2017. In the quarter ended June 30, 2018, we advanced the final \$250,000 increment on the Loan Agreement. The loan bears interest at the rate of 6.0 percent annually with the maturity date for each Promissory Note on the fourth anniversary of funding of such Promissory Note, extendable by one additional year at the borrower's election. We are entitled to purchase, at a nominal price, certain Warrant Units in conjunction with each advance. Upon exercising the Warrant Units, we are entitled to receive up to fourteen percent ownership of Common A Units in the company.

Additionally, on March 16, 2018, we advanced \$250,000, on June 13, 2018, we advanced \$225,000, and on September 25, 2018, we advanced \$75,000 on three separate simple Promissory Notes to the aforementioned identity and professional services company. Each note bears interest at the rate of 6.0 percent annually with the maturity date six months from the date of funding the Note. On September 16, 2018, we extended the maturity date on the first of these Promissory Notes an additional six months to March 16, 2019.

In the quarter ended March 31, 2018, we entered into a Convertible Loan Agreement with a private limited India based company in the FinTech industry. We committed to lend up to \$435,000 with an initial advance of \$235,000. The loan bears interest at the rate of 5.0 percent annually with the maturity date on the third anniversary of funding of such Promissory Note. We are entitled to convert the principal on the initial note for up to ten percent ownership of shares of the company.

Stock-based Compensation – At September 30, 2018, we have three stock-based compensation plans in effect. We record compensation cost related to unvested stock awards by recognizing the unamortized grant date fair value on a straight line basis over the vesting periods of each award. We have estimated forfeiture rates based on our historical experience. Stock option compensation expense for the three and nine month periods ended September 30, 2018 and 5. 2017 has been recognized as a component of general and administrative expenses in the accompanying Consolidated Financial Statements. We recorded \$18,000 and \$12,000 of stock-based compensation expense for the three months ended September 30, 2018 and 2017, respectively, and \$44,000 and \$39,000 for the nine months ended September 30, 2018 and 2017, respectively.

As of September 30, 2018, there is \$91,000 of unrecognized compensation cost related to stock options. No options were granted during the quarter ended September 30, 2018. During the nine months ended September 30, 2018, 20,000 options were exercised and 4,000 options expired unexercised. The following table summarizes options as of September 30, 2018:

	# of Shares	Wgt. Avg. Exercise Price	Wgt. Avg. Remaining Contractual Life in Years	Aggregate Intrinsic Value
Outstanding at September 30, 2018	227,500	\$ 2.47	4.9	\$1,843,765
Vested and exercisable at September 30, 2018	199,000	\$ 2.03	4.3	\$1,700,110

The estimated fair value of options granted is calculated using the Black-Scholes option pricing model with assumptions as previously disclosed in our 2017 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 third quarter of 2018 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, 2018. The amount of aggregate intrinsic value will change based on the market value of the company's stock.

Fair Value of Financial Instruments – The carrying value of cash, marketable securities, accounts receivable, notes receivable, accounts payable and certain other financial instruments (such as 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, trade accounts and notes 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.

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 marketable securities are available-for-sale investments and 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 since the investee companies are relatively small, early stage private companies for which there is no comparable valuation data available without unreasonable time and expense.

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 nine month periods ended September 30, 2018 and 2017. 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 September 30, 2018		Nine Months Ended September 30, 2017	
Customer A	3.4%	15.4%	5.8%	10.1%
Customer B	3.8%	14.3%	4.5%	11.6%
Customer C	7.0%	13.1%	7.1%	11.8%
Customer D	17.0%	7.3%	17.4%	27.4%
Customer E	37.5%	–%	35.3%	–%

Commitments and Contingencies – Please refer to Note 9 to our Consolidated Financial Statements included in our 2017 Form 10-K for a description of our commitments and contingencies. Effective April 1, 2018, we executed the First Addendum to our Lease Agreement for Intelligent Systems. The Addendum provides for the extension of the Lease Agreement for an additional three year term from April 1, 2018 through March 31, 2021 on the same terms and conditions as the original Lease Agreement. Effective June 1, 2018, we executed the Fifth Addendum to our Lease Agreement for CoreCard Software. The Addendum provides for the extension of the Lease Agreement for an additional three year term from June 1, 2018 through May 31, 2021 on the same terms and conditions as the original Lease Agreement. Accordingly, our future minimum lease payments for offices and data centers expiring through May 31, 2022 are as follows:

Year ended December 31, (in thousands)

2018 (October 1 – December 31)	\$ 120
2019	478
2020	462
2021	242
2022	44
Total minimum lease payments	\$1,346

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 September 30, 2018 and December 31, 2017. 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 2013.

11. *Shareholders' Equity* –

Share Repurchase Program:

On November 6, 2018, the Board of Directors authorized a share repurchase program to purchase up to \$5,000,000 of common stock. The program has no expiration date, but it may be suspended or discontinued at any time. We have not repurchased any shares under this program through November 8, 2018.

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, 2017 as filed with the Securities and Exchange Commission.

Overview

Our consolidated 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. 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 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 results vary in part depending on the size and number of software licenses recognized as well the value and number of professional services contracts recognized in a particular period. As an example, for the three and nine

months ended September 30, 2018, we reported revenue greater than the previous year due, in part, to revenue associated with professional services provided to both a new license customer, with a long-term commitment, and to an existing global license customer for customizations of our base product offering as well as the recognition of license add-on tiers for multiple customers all of which positively impacted our consolidated results. We anticipate software license revenue from the aforementioned new license customer in future quarters. As we continue to grow our Processing Services business, we continue to gain economies of scale on the investments we have made in the infrastructure, resources, processes and software features developed over the past number of years to support this growing side of our business. We are adding new processing customers at a faster pace than we are adding new license customers, resulting in steady growth in the processing revenue stream with the third quarter of 2018 growing 16 percent and 22 percent, respectively, over the second quarter and first quarter of 2018. The infrastructure of our multi customer environment is scalable for the future. A significant portion of our expenses is related to personnel, including approximately 385 employees located in India and Romania. In the fourth quarter of 2017, we opened a second office near Mumbai, India, to enable us to attract additional talent required for our software development and testing. In addition, we have certain corporate office expenses associated with being a public company that impact our operating results.

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 or annual 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.

We continue to maintain a strong cash position. In the latter part of December 2017, and in the first quarter of 2018, we purchased additional hardware and software for a new customer in anticipation of a new contract, which was executed in October 2018. During the third quarter of 2018, the customer reimbursed us for the equipment purchases as part of a Bill of Sale executed in the third quarter. This reimbursement, along with cash provided from operating activities, strengthened our cash position further. We intend to use cash balances to support the domestic and international operations associated with our CoreCard business and to expand our operations in the FinTech industry through financing the growth of CoreCard and, if appropriate opportunities become available, through acquisitions of businesses in this industry.

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 in the three and nine month periods ended September 30, 2018 was \$5,415,000 and \$14,046,000, respectively, which represents increases of 193 percent and 112 percent compared to the respective periods in 2017.

Revenue from services was \$5,286,000 and \$13,757,000 in the three and nine month periods ended September 30, 2018, respectively, which represents an increase of 186 percent and 110 percent compared to the respective periods in 2017. Revenue from transaction processing services, software maintenance and support services, and professional services were greater in the third quarter and year-to-date periods of 2018 as compared to the same periods of 2017 with 88 percent and 84 percent, respectively, of the increase derived from professional services. This increase was due to an increase in the value of professional services contracts completed during the reporting periods in 2018 which was, in large part, a direct reflection of the customizations that required us to pull our R&D resources to complete required tasks in an expedited timeframe for a new customer. Processing services benefited from an increase in the number of customers and accounts on file while maintenance revenue increased due to additional revenue associated with software customizations for our license customer base as well as an increase in the number of license implementations maintained. 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.

Revenue from products, which is primarily software license fees, was \$129,000 and \$289,000 in the three and nine month periods ended September 30, 2018, respectively, compared to \$0 and \$90,000 in the comparable periods of 2017. We recognized two different license customers add-on tier license fees in the third quarter of 2018 with no comparable license recognition in the third quarter of 2017. Monthly support fees previously bundled with the

applicable license have been reclassified as service revenue as a result of the adoption of ASU 2014-09, Revenue from Contracts with Customers Topic 606.

Cost of Revenue – Total cost of revenue was 43 percent of total revenue in both the three and nine month periods ended September 30, 2018 compared to 44 percent and 46 percent of total revenue in the corresponding periods of 2017.

Cost of service revenue as a percentage of total service revenue was 44 percent and 43 percent in the three and nine month periods ended September 30, 2018, respectively, compared to 44 percent and 45 percent in the respective periods in 2017. 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. The changes in the customer mix and project complexity as well as changes, as a percentage of the whole, in the three cost of service revenue components identified, result in fluctuations, both upwards and downwards, in the cost of service revenue as a percentage of total service revenue quarter over quarter and year over year. We continue to devote the resources necessary to support our growing processing business, including direct costs for regulatory compliance, infrastructure, network certifications, and customer support. As our processing customer base continues to increase, we anticipate we will experience economies of scale in our processing environment. 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.

Cost of product revenue as a percent of product revenue was zero percent and 47 percent in the three and nine month periods ended September 30, 2018, respectively, compared to zero and 96 percent in the respective periods in 2017. In the quarter ended September 30, 2018, revenue included three add-on license tier upgrade components with no associated cost resulting in zero cost of product revenue for the quarter. For the nine months ended September 30, 2018, the cost associated with the implementation of the license recognized in the first quarter of 2018 was greater than the related revenue. This is not an uncommon occurrence, as a customer's contract profitability is recognized over the life of the contract. The future benefit of the contractual maintenance support services revenue will provide a steady revenue stream to services revenue. As such, the year-to-date cost of product revenue as a percent of product revenue is greater than standalone third quarter of 2018. Similarly, the 2017 year-to-date revenue, included a license implementation with higher direct costs as we deployed extra resources to support the implementation phase.

Operating Expenses – In the three and nine month periods ended September 30, 2018, total operating expenses from consolidated operations were 12 percent and eight percent less than in the corresponding periods in 2017 primarily as the result of decreased research and development expenses. Research and development expenses for the three and nine months ended September 30, 2018, were \$327,000 (29 percent) and \$494,000 (17 percent), respectively, less in 2018 as compared to 2017, primarily due to re-allocating R&D resources from our base product offering development efforts to customizations reflected in cost of revenue. General and administrative expenses increased \$123,000 and \$136,000 for the three and nine month periods ended September 30, 2018, respectively, compared to the corresponding periods in 2017. The quarterly and year-to-date increase is mainly due to higher professional fees associated with the review of a new customer contract executed in October. Marketing expenses remain relatively consistent, from a total cost standpoint, with the comparable periods in the prior year. Our client base increased in 2017 and continues to increase in 2018 with minimal marketing efforts as we continue to have prospects contact us via online searches; however, we will continue to re-evaluate our marketing expenditures as needed to competitively position the Processing Services business.

Other Income (Loss) – In the three and nine months ended September 30, 2018, we recorded other income of \$245,000 and \$128,000, respectively, compared to other income of \$1,868,000 and \$1,842,000 for the comparable 2017 periods. In the quarter ended September 30, 2018, we recorded \$171,000 of one-time interest income related to finance charges on the sale of equipment purchased for a new license customer as well as recognizing income earned on our cash balances. The year-to-date 2018 period is inclusive of the write-down of \$250,000 on an investment, as described in more detail in Note 3 to the Consolidated Financial Statements. The quarter and year-to-date other income for 2017 is primarily comprised of the gain of \$1,466,000 on the sale of our investment in a privately-held technology company in the third quarter 2017, and the gain of \$372,000 from funds held in escrow on an investment sale from 2015, both of which are described in more detail in Note 3 to the Consolidated Financial Statements.

Income Taxes – We recorded \$115,000 and \$185,000 in the three and nine month periods ended September 30, 2018, respectively, for state income tax expense.

Liquidity and Capital Resources

Our cash balance at September 30, 2018 was \$17,350,000 compared to \$14,024,000 at December 31, 2017. During the nine months ended September 30, 2018, we provided \$4,986,000 of cash from operations compared to a use of cash of \$1,005,000 for the comparable period in 2017. The principal source of cash during the period was driven by operating activities including higher net income and the receipt, net of equipment purchases, of approximately \$1,745,000, plus associated finance carrying charges, for processing equipment, software and related licenses purchased on behalf of a new license customer. Such contract was executed, subsequent to the third quarter of 2018, in the form of a Software License and Support Agreement.

The principal uses of cash during the period were advances of \$250,000, \$225,000 and \$75,000 on three separate Promissory Notes, the funding of the final \$250,000 on a Loan Agreement, and the advance of \$235,000 on a Convertible Loan Agreement, all of which are described in more detail in Note 4 to the Consolidated Financial Statements. We used \$663,000 of cash to acquire computer equipment and related software primarily to enhance our existing processing environment in the U.S. as well for computer equipment for the technical resources added in our India office during 2018.

We expect to have sufficient liquidity from cash on hand as well as projected customer payments to support our operations and capital equipment purchases for the foreseeable future. Currently 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. Additionally, we may use excess cash to repurchase shares under the program authorized by our Board of Directors on November 6, 2018, to repurchase up to \$5,000,000 of common stock.

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, 2017. 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 2017. During the nine month period ended September 30, 2018, there were no significant or material changes in the application of critical accounting policies, other than the adoption of ASU 2014-09, Revenue from Contracts with Customers (Topic 606) and the related reclassifications as describe further in Notes 1 and 2 to the Consolidated Financial Statements, that would require an update to the information provided in the Form 10-K for 2017.

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:

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.

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.

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.

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.

Our processing business involves the processing and storage of sensitive business and personal information about our clients and their customers. Any type of security breach, attack, or misuse of data could deter clients from using our services and expose us to liability to parties whose data has been compromised, fines from regulatory authorities, and other material adverse consequences.

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.

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.

Part II. OTHER INFORMATION

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
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 8, 2018

By: */s/ J. Leland Strange*
J. Leland Strange

Chief Executive Officer, President

Date: November 8, 2018

By: */s/ Karen J. Reynolds*
Karen J. Reynolds

Chief Financial Officer

Exhibit Index

Exhibit No.	Descriptions
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