INTELLIGENT SYSTEMS CORP
Form 10-Q
August 10, 2017

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, 2017

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

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, a smaller reporting company or an emerging growth 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. (Check one):

Large accelerated filer		Accelerated filer
Non-accelerated filer	(Do not check if a smaller reporting company)	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 July 31, 2017, 8,777,988 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, 2017** (unaudited)	**December 31, 2016** (audited)
ASSETS		
Current assets:		
Cash	$ 15,917	$ 17,724
Marketable securities	436	418
Accounts receivable, net	1,677	1,329
Other current assets	930	1,160
Total current assets	18,960	20,631
Investments	1,150	1,272
Property and equipment, at cost less accumulated depreciation	609	700
Other long-term assets	69	101
Total assets	$ 20,788	$ 22,704
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	$ 121	$ 301
Deferred revenue, current portion	936	1,474
Accrued payroll	538	515
Accrued expenses	74	43
Other current liabilities	345	1,338
Total current liabilities	2,014	3,671
Deferred revenue, net of current portion	54	85
Other long-term liabilities	18	18
Intelligent Systems Corporation stockholders' equity:		
Common stock, $0.01 par value, 20,000,000 shares authorized, 8,777,988 and 8,743,299 issued and outstanding at June 30, 2017 and December 31, 2016, respectively	88	87
Additional paid-in capital	14,852	17,864
Accumulated other comprehensive loss	(134)	(163)
Accumulated income	3,896	4,158
Total Intelligent Systems Corporation stockholders' equity	18,702	21,946
Noncontrolling interest	--	(3,016)

Total stockholders’ equity	18,702	18,930
Total liabilities and stockholders’ equity	$ 20,788	$ 22,704

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, 2017	Three Months Ended June 30, 2016	Six Months Ended June 30, 2017	Six Months Ended June 30, 2016
Revenue				
Products	$302	$149	$504	$378
Services	2,834	1,401	4,384	2,818
Total net revenue	3,136	1,550	4,888	3,196
Cost of revenue				
Products	147	58	203	122
Services	1,199	719	2,046	1,367
Total cost of revenue	1,346	777	2,249	1,489
Expenses				
Marketing	69	99	148	195
General and administrative	397	383	878	939
Research and development	1,042	611	1,829	1,256
Income (loss) from operations	282	(320)	(216)	(683)
Other income (loss)	(59)	21	(26)	(642)
Income (loss) before Income taxes	223	(299)	(242)	(1,325)
Income taxes	20	(2)	20	(3)
Net income (loss)	203	(297)	(262)	(1,322)
Net loss attributable to noncontrolling interest	--	80	--	167
Net income (loss) attributable to Intelligent Systems Corporation	$203	$(217)	$(262)	$(1,155)
Earnings (loss) per share attributable to Intelligent Systems Corporation:				
Basic	$0.02	$(0.02)	$(0.03)	$(0.13)
Diluted	$0.02	$(0.02)	$(0.03)	$(0.13)
Basic weighted average common shares outstanding	8,766,425	8,731,299	8,754,862	8,731,299
Diluted weighted average common shares outstanding	8,878,266	8,731,299	8,754,862	8,731,299

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (LOSS)

(unaudited, in thousands)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2017	**2016**	**2017**	**2016**
Net income (loss)	$203	$(297)	$(262)	$(1,322)
Other comprehensive income (loss):				
Foreign currency translation adjustments	(6)	4	(14)	1
Unrealized gain on available-for-sale marketable securities	5	13	21	22
Total comprehensive income (loss)	202	(280)	(255)	(1,299)
Comprehensive loss attributable to noncontrolling interest	--	80	--	167
Comprehensive income (loss) attributable to Intelligent Systems Corporation	$202	$(200)	$(255)	$(1,132)

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, 2017**	**2016**
OPERATING ACTIVITIES:		
Net loss	$(262)	$(1,322)
Adjustments to reconcile net loss from continuing operations to net cash used for operating activities:		
Depreciation and amortization	162	111
Stock-based compensation expense	27	10
Non-cash investment expense	93	750
Equity in loss of affiliate company	32	19
Changes in operating assets and liabilities:		
Accounts receivable	(348)	431
Other current assets	230	(603)
Other long-term assets	32	(59)
Accounts payable	(180)	44
Accrued payroll	23	153
Deferred revenue, current portion	(538)	327
Accrued expenses	31	3
Other current liabilities	7	36
Deferred revenue, net of current portion	(31)	(64)
Net cash used for operating activities	(722)	(164)
INVESTING ACTIVITIES:		
Purchases of property and equipment	(71)	(125)
Proceeds from sale of long-term investment	--	2,248
Purchase of long-term investment	(1,000)	--
Net cash provided by (used for) investing activities	(1,071)	2,123
FINANCING Activities:		
Distribution of dividend to stockholders	--	(3,056)
Net cash used for financing activities	--	(3,056)
Net cash used for operating activities of discontinued operations	--	(120)
Effects of exchange rate changes on cash	(14)	1
Net decrease in cash	(1,807)	(1,216)
Cash at beginning of period	17,724	18,059
Cash at end of period	$15,917	$16,843

SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION:		
Cash paid during the period for income taxes	$20	$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, 2017 and 2016. The interim results for the three and six months ended June 30, 2017 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, 2016, as filed in our Annual Report on Form 10-K.

2. *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 Lumense has no reasonable prospects to fund its operations and product development, we believe a full write-down was prudent and required.

   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 Final, Inc., a privately-held technology company in the FinTech industry. During the quarter ended June 30, 2017, Final 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. As such, we felt a ninety percent write-down was warranted.

3. *Stock-based Compensation* – At June 30, 2017, 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 six month periods ended June 30, 2017 and 2016 has been recognized as a component of general and administrative expenses in the accompanying Consolidated Financial Statements. We recorded $14,000 and $5,000 of stock-based compensation expense for the three months ended June 30, 2017 and 2016, respectively, and $27,000 and $10,000 for the six months ended June 30, 2017 and 2016, respectively.

As of June 30, 2017, there is $105,000 of unrecognized compensation cost related to stock options. During the quarter ended June 30, 2017, an aggregate of 12,000 options were granted to three independent members of our board of directors pursuant to the 2011 Non-Employee Director 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. During the three and six months ended June 30, 2017, 60,000 options were exercised and 12,000 options expired unexercised. The following table summarizes options as of June 30, 2017:

	# of Shares	Wgt Avg Exercise Price	Wgt Avg Remaining Contractual Life in Years	Aggregate Intrinsic Value
Outstanding at June 30, 2017	244,500	$ 2.17	5.5	$ 341,000
Vested and exercisable at June 30, 2017	196,500	$ 1.76	4.5	$ 341,000

The estimated fair value of options granted is calculated using the Black-Scholes option pricing model with assumptions as previously disclosed in our 2016 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 2017 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, 2017. 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, 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.

4. 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.

5. *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.

6. *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, 2017 and 2016. 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,**	
	2017	**2016**	**2017**	**2016**
Customer A	6.1 %	14.7%	8.1 %	19.0%
Customer B	8.9 %	3.0 %	10.6%	2.5 %
Customer C	9.1 %	15.5%	11.3%	12.4%
Customer D	46.6%	14.9%	35.1%	14.8%
Customer E	5.8 %	10.6%	7.0 %	9.5 %

7. *Commitments and Contingencies* – Please refer to Note 8 to our Consolidated Financial Statements included in our 2016 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.

8. *Stockholders' Equity* – On December 30, 2016, Intelligent Systems and its wholly owned subsidiary CoreCard MergerSub, Inc. entered into an Agreement and Plan of Merger with CoreCard Software, Inc., our majority owned subsidiary, providing for the recapitalization of CoreCard. Pursuant to the Merger Agreement, MergerSub merged with and into CoreCard on January 1, 2017. As a result of the merger, we now own 100% of the outstanding shares of CoreCard. As such, beginning January 1, 2017, we no longer reduce income or losses by the amount that had been allocable in prior periods to the non-controlling common stock interest in CoreCard.

As a result of the recapitalization of CoreCard, we recorded the following adjustments to our shareholders' equity to eliminate the minority interest component. There was no impact on the statement of operations for the three and six months ended June 30, 2017.

(in thousands)	**As of December 31, 2016**	**Adjustments**	**As of January 1, 2017**
Intelligent Systems Corporation stockholders' equity:			
Common stock	$ 87	$ --	$ 87
Additional paid-in capital	17,864	(3,038)	14,826
Accumulated other comprehensive loss	(163)	22	(141)

Accumulated income	4,158	--	4,158
Total Intelligent Systems Corporation stockholders' equity	21,946	(3,016)	18,930
Noncontrolling interest	(3,016)	3,016	--
Total stockholders' equity	$ 18,930	$ --	$ 18,930

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, 2017 and December 31, 2016. 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.

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

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, 2016 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. 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 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 are likely 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 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 275 employees located in India and Romania. We are likely to incur losses in the near future because revenue for processing services is spread out over multi-year contracts while we are currently 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.

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.

Results of Operations

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

Revenue – Total revenue from continuing operations in the three and six month periods ended June 30, 2017 was $3,136,000 and $4,888,000, respectively, which represents increases of 102 percent and 53 percent compared to the respective periods in 2016.

Revenue from products, which includes software license fees (and, in some cases monthly support fees when the license and support fees are bundled) was $302,000 and $504,000 in the three and six month periods, respectively, ended June 30, 2017, compared to $149,000 and $378,000 in the same periods in 2016. The increase reflects growth in the number of accounts covered by certain software licenses as well as revenue associated with the implementation of a second license for a global software license customer in the quarter ended June 30, 2017.

Revenue from services was $2,834,000 and $4,384,000 in the three and six months ended June 30, 2017, which represents an increase of 102 percent and 56 percent compared to the respective periods in 2016. Revenue from transaction processing services, software maintenance and support services, and professional services were all greater in the second quarter and year-to-date periods of 2017 as compared to the same periods in 2016. 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 customers. Professional services generated more revenue due to an increase in the number and value of professional services contracts completed during the reporting periods in 2017 which was, in large part, a direct reflection of the customizations provided to the second instance of the global software license customer implemented in the quarter ended June 30, 2017, as well as a customizations to our base product offering for this same customer. 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 43 percent and 46 percent of total revenue, respectively, in the three month and six month periods ended June 30, 2017 compared to 50 percent and 47 percent of total revenue in the corresponding periods in 2016.

Cost of product revenue as a percent of product revenue was 49 percent and 40 percent, respectively, in the three and six month periods ended June 30, 2017, compared to 39 percent and 32 percent in the respective periods in 2016. The 2017 revenue included a license implementation component, which typically has higher direct cost than other license revenue as we deploy extra resources to support the implementation phase. The increase in product revenue percentages for both reporting periods in 2017 is indicative of the second implementation for a global license customer.

Cost of service revenue as a percentage of total service revenue was 42 percent and 47 percent, respectively, in the three and six months ended June 30, 2017 compared to 51 percent and 49 percent in the comparable periods in 2016. 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 2017, our cost of service revenue was more heavily weighted towards our professional services component which, historically, has utilized relatively more offshore employees at a lower cost. As a result, our cost of services revenue percentage in 2017 is below the 2016 percentage. In addition, we continue 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, 2017, total operating expenses from continuing operations were 38 percent and 19 percent greater than in the comparable period in 2016 primarily as the result of increased research and development expenses. Research and development expenses were $431,000 (71 percent) greater in the second quarter of 2017 and $573,000 (46 percent) greater year-to-date 2017 compared to the same periods last year, primarily due to payroll and related expenses for additional offshore technical personnel, as well as an increase in contractor fees for certain development efforts. The increase in R&D technical staff is a direct result of the revenue increase experienced throughout 2016 into 2017, resulting in a greater need for more customized development efforts. Marketing expenses decreased by $30,000 and $47,000, respectively, for the three and six month periods ended June 30, 2017 compared to the corresponding periods in 2016, primarily due to less marketing initiatives in 2017. General and administrative expenses increased in the second quarter of 2017 by $14,000 and decreased on a year-to-date 2017 basis by $61,000. The quarterly increase is primarily related to travel costs while the year-to-date decrease is mainly due to lower professional fees for both accounting and legal, as well as fewer personnel at the corporate office.

Other Income (Loss) – In the three and six months ended June 30, 2017, we recorded a loss of $59,000 and $26,000, respectively, compared to income of $21,000 and a loss of $642,000 for the comparable 2016 periods . Both 2017 periods are primarily comprised of the write-down of $90,000 on an investment, as described in more detail in Note 2 to the Consolidated Financial Statements, offset in part by income earned on our cash balances. The year-to-date 2016 loss is primarily attributable to the write-down of $750,000 on an investment, as described in more detail in Note 2 to the Consolidated Financial Statements, offset in part by income earned on our cash balances.

Noncontrolling Interest – As disclosed in Note 8 to the financial statements, effective January 1, 2017 we no longer allocate any net income (loss) to the minority interest held by former shareholders of CoreCard Software.

Liquidity and Capital Resources

Our cash balance at June 30, 2017 was $15,917,000 compared to $17,724,000 at December 31, 2016. The principal use of cash during the period was funding our investment of $1,000,000 in a privately held technology company on January 4, 2017; the liability for the investment funding was included in “Other Current Liabilities” at December 31, 2016.

During the six months ended June 30, 2017, continuing operations used $722,000 cash for operations of the FinTech business and corporate office. The most significant working capital changes since December 31, 2016 include a decrease in deferred revenue of $538,000 primarily due to the recognition of professional services contracts associated with customizations for a global license customer and accounts receivable increased by $348,000 as we generated milestone billings related to the same customizations. In addition, work-in-process (included in other current assets) decreased $181,000 as development costs associated with the aforementioned customization contracts was recognized.

We used $71,000 cash to acquire computer equipment primarily for the technical resources added in our India office, and to upgrade existing office equipment in the India office and in our U.S. based processing environment.

Subsequent to June 30, 2017, the remaining cash held in escrow from the sale of one of our investee companies, Lancope Inc., was released. We received cash of $372,000 in early July 2017.

We expect to have sufficient liquidity from cash on hand as well as projected customer payments to support our operations and capital equipment purchases in 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.

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, 2016. 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 2016. During the six month period ended June 30, 2017, 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 2016.

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.

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: August 10, 2017	By:	*/S/ J. Leland Strange* J. Leland Strange Chief Executive Officer, President
Date: August 10, 2017	By:	*/S/ Karen J. Reynolds* Karen J. Reynolds Chief Financial Officer

Exhibit Index

Exhibit No.	Descriptions
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