First Bancorp, Inc /ME/
Form 10-Q
May 09, 2018

UNITED STATES SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, DC 20549

FORM 10-Q

[X] Quarterly Report Pursuant to Section 13 or 15(d) of The Securities Exchange Act of 1934
For the quarterly period ended March 31, 2018

Commission File Number 0-26589

THE FIRST BANCORP, INC.
(Exact name of Registrant as specified in its charter)

| | |
|---|---|
| MAINE | 01-0404322 |
| (State or other jurisdiction of incorporation or organization) | (I.R.S. Employer Identification No.) |

| | |
|---|---|
| MAIN STREET, DAMARISCOTTA, MAINE | 04543 |
| (Address of principal executive offices) | (Zip code) |

(207) 563-3195
Registrant's telephone number, including area code

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every,Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).
Yes [X] No[_]

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

Large accelerated filer [_] Accelerated filer [X] Non-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 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 Act).
Yes [_] No [X]

Indicate the number of shares outstanding of each of the registrant's classes of common stock as of May 1, 2018
Common Stock: 10,849,447 shares

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Table of Contents

Part I. Financial Information
Selected Financial Data (Unaudited)
The First Bancorp, Inc. and Subsidiary

| Dollars in thousands, | As of and for the three months ended March 31, | |
|---|---|---|
| except for per share amounts | 2018 | 2017 |
| Summary of Operations | | |
| Interest Income | $16,451 | $14,491 |
| Interest Expense | 4,042 | 3,015 |
| Net Interest Income | 12,409 | 11,476 |
| Provision for Loan Losses | 500 | 500 |
| Non-Interest Income | 3,132 | 2,843 |
| Non-Interest Expense | 8,579 | 7,698 |
| Net Income | 5,506 | 4,637 |
| Per Common Share Data | | |
| Basic Earnings per Share | $0.51 | $0.43 |
| Diluted Earnings per Share | 0.51 | 0.43 |
| Cash Dividends Declared | 0.24 | 0.23 |
| Book Value per Common Share | 16.72 | 16.17 |
| Tangible Book Value per Common Share[2] | 13.95 | 13.39 |
| Market Value | 27.98 | 27.25 |
| Financial Ratios | | |
| Return on Average Equity[1] | 12.27 % | 10.71 % |
| Return on Average Tangible Common Equity[1,2] | 14.69 % | 12.92 % |
| Return on Average Assets[1] | 1.21 % | 1.07 % |
| Average Equity to Average Assets | 9.83 % | 10.03 % |
| Average Tangible Equity to Average Assets[2] | 8.21 % | 8.31 % |
| Net Interest Margin Tax-Equivalent[1,2] | 3.00 % | 3.05 % |
| Dividend Payout Ratio | 47.06 % | 53.49 % |
| Allowance for Loan Losses/Total Loans | 0.92 % | 0.95 % |
| Non-Performing Loans to Total Loans | 1.20 % | 0.78 % |
| Non-Performing Assets to Total Assets | 0.83 % | 0.52 % |
| Efficiency Ratio[2] | 53.75 % | 50.17 % |
| At Period End | | |
| Total Assets | $1,871,815 | $1,763,828 |
| Total Loans | 1,188,002 | 1,089,735 |
| Total Investment Securities | 574,406 | 566,816 |
| Total Deposits | 1,428,192 | 1,346,483 |
| Total Shareholders' Equity | 181,372 | 174,853 |

[1]Annualized using a 365-day basis for both 2018 and 2017.
[2]These ratios use non-GAAP financial measures. See Management's Discussion and Analysis of Financial Condition and Results of Operations for additional disclosures and information.

Item 1 – Financial Statements

Report of Independent Registered Public Accounting Firm

The Board of Directors and Shareholders
The First Bancorp, Inc.

We have reviewed the accompanying interim consolidated financial information of The First Bancorp, Inc. and Subsidiary as of March 31, 2018 and 2017 and for the three-month periods then ended. These financial statements are the responsibility of the Company's management.

We conducted our reviews in accordance with standards of the Public Company Accounting Oversight Board (United States). A review of interim financial information consists principally of applying analytical procedures to financial data and making inquiries of persons responsible for financial and accounting matters. It is substantially less in scope than an audit in accordance with standards of the Public Company Accounting Oversight Board (United States), the objective of which is to express an opinion regarding the financial statements taken as a whole. Accordingly, we do not express such an opinion.

Based on our reviews, we are not aware of any material modifications that should be made to the accompanying interim consolidated financial statements for them to be in conformity with accounting principles generally accepted in the United States of America.

/s/ Berry Dunn McNeil & Parker, LLC
Bangor, Maine
May 9, 2018

Consolidated Balance Sheets (Unaudited)
The First Bancorp, Inc. and Subsidiary

| | March 31, 2018 | December 31, 2017 | March 31, 2017 |
|---|---|---|---|
| Assets | | | |
| Cash and cash equivalents | $16,559,000 | $19,207,000 | $17,600,000 |
| Interest bearing deposits in other banks | 280,000 | 860,000 | 3,272,000 |
| Securities available for sale | 303,769,000 | 300,172,000 | 312,624,000 |
| Securities to be held to maturity (fair value of $255,851,000 at March 31, 2018, $259,655,000 at December 31, 2017 and $239,378,000 at March 31, 2017) | 258,690,000 | 256,567,000 | 240,829,000 |
| Restricted equity securities, at cost | 11,947,000 | 10,358,000 | 13,363,000 |
| Loans held for sale | 284,000 | 386,000 | 979,000 |
| Loans | 1,188,002,000 | 1,164,139,000 | 1,089,735,000 |
| Less allowance for loan losses | 10,957,000 | 10,729,000 | 10,367,000 |
| Net loans | 1,177,045,000 | 1,153,410,000 | 1,079,368,000 |
| Accrued interest receivable | 7,222,000 | 5,867,000 | 6,854,000 |
| Premises and equipment, net | 22,043,000 | 22,502,000 | 21,760,000 |
| Other real estate owned | 1,121,000 | 1,012,000 | 525,000 |
| Goodwill | 29,805,000 | 29,805,000 | 29,805,000 |
| Other assets | 43,050,000 | 42,784,000 | 36,849,000 |
| Total assets | $1,871,815,000 | $1,842,930,000 | $1,763,828,000 |
| Liabilities | | | |
| Demand deposits | $137,674,000 | $145,332,000 | $130,319,000 |
| NOW deposits | 314,587,000 | 318,043,000 | 323,919,000 |
| Money market deposits | 108,726,000 | 163,898,000 | 142,220,000 |
| Savings deposits | 232,458,000 | 232,605,000 | 222,976,000 |
| Certificates of deposit | 634,747,000 | 559,001,000 | 527,049,000 |
| Total deposits | 1,428,192,000 | 1,418,879,000 | 1,346,483,000 |
| Borrowed funds – short term | 129,112,000 | 113,638,000 | 106,342,000 |
| Borrowed funds – long term | 115,117,000 | 115,120,000 | 120,125,000 |
| Other liabilities | 18,022,000 | 13,972,000 | 16,025,000 |
| Total liabilities | 1,690,443,000 | 1,661,609,000 | 1,588,975,000 |
| Shareholders' equity | | | |
| Common stock, one cent par value per share | 108,000 | 108,000 | 108,000 |
| Additional paid-in capital | 61,999,000 | 61,747,000 | 60,991,000 |
| Retained earnings | 123,876,000 | 121,144,000 | 113,697,000 |
| Accumulated other comprehensive income (loss) | | | |
| Net unrealized loss on securities available for sale | (6,210,000) | (2,901,000) | (934,000) |
| Net unrealized loss on securities transferred from available for sale to held to maturity | (182,000) | (174,000) | (133,000) |
| Net unrealized gain on cash flow hedging derivative instruments | 1,928,000 | 1,544,000 | 1,226,000 |
| Net unrealized loss on postretirement benefit costs | (147,000) | (147,000) | (102,000) |
| Total shareholders' equity | 181,372,000 | 181,321,000 | 174,853,000 |
| Total liabilities & shareholders' equity | $1,871,815,000 | $1,842,930,000 | $1,763,828,000 |
| Common Stock | | | |
| Number of shares authorized | 18,000,000 | 18,000,000 | 18,000,000 |
| Number of shares issued and outstanding | 10,846,562 | 10,829,918 | 10,814,132 |
| Book value per common share | $16.72 | $16.74 | $16.17 |

| | | | |
|---|---|---|---|
| Tangible book value per common share | $13.95 | $13.97 | $13.39 |

See Report of Independent Registered Public Accounting Firm. The accompanying notes are an integral part of these consolidated financial statements.

Consolidated Statements of Income and Comprehensive Income (Unaudited)
The First Bancorp, Inc. and Subsidiary

| | For the three months ended March 31, 2018 | 2017 |
|---|---|---|
| Interest income | | |
| Interest and fees on loans (includes tax-exempt income of $211,000 as of March 31, 2018 and $186,000 as of March 31, 2017) | $12,391,000 | $10,652,000 |
| Interest on deposits with other banks | 11,000 | 15,000 |
| Interest and dividends on investments (includes tax-exempt income of $1,719,000 as of March 31, 2018 and $1,569,000 as of March 31, 2017) | 4,049,000 | 3,824,000 |
| Total interest income | 16,451,000 | 14,491,000 |
| Interest expense | | |
| Interest on deposits | 3,099,000 | 1,994,000 |
| Interest on borrowed funds | 943,000 | 1,021,000 |
| Total interest expense | 4,042,000 | 3,015,000 |
| Net interest income | 12,409,000 | 11,476,000 |
| Provision for loan losses | 500,000 | 500,000 |
| Net interest income after provision for loan losses | 11,909,000 | 10,976,000 |
| Non-interest income | | |
| Investment management and fiduciary income | 740,000 | 631,000 |
| Service charges on deposit accounts | 527,000 | 502,000 |
| Net securities gains | 136,000 | 3,000 |
| Mortgage origination and servicing income, net of amortization | 331,000 | 332,000 |
| Other operating income | 1,398,000 | 1,375,000 |
| Total non-interest income | 3,132,000 | 2,843,000 |
| Non-interest expense | | |
| Salaries and employee benefits | 4,490,000 | 3,970,000 |
| Occupancy expense | 699,000 | 624,000 |
| Furniture and equipment expense | 929,000 | 870,000 |
| FDIC insurance premiums | 279,000 | 240,000 |
| Amortization of identified intangibles | 11,000 | 11,000 |
| Other operating expense | 2,171,000 | 1,983,000 |
| Total non-interest expense | 8,579,000 | 7,698,000 |
| Income before income taxes | 6,462,000 | 6,121,000 |
| Income tax expense | 956,000 | 1,484,000 |
| NET INCOME | $5,506,000 | $4,637,000 |
| Basic earnings per common share | $0.51 | $0.43 |
| Diluted earnings per common share | $0.51 | $0.43 |
| Other comprehensive income (loss) net of tax | | |
| Net unrealized gain (loss) on securities available for sale | (3,309,000) | 1,000 |
| Net unrealized loss on securities transferred from available for sale to held to maturity, net of amortization | (8,000) | (4,000) |
| Net unrealized gain on cash flow hedging derivative instruments | 384,000 | 63,000 |
| Other comprehensive income (loss) | (2,933,000) | 60,000 |
| Comprehensive income | $2,573,000 | $4,697,000 |

See Report of Independent Registered Public Accounting Firm.
The accompanying notes are an integral part of these consolidated financial statements.

Consolidated Statements of Changes in Shareholders' Equity (Unaudited)
The First Bancorp, Inc. and Subsidiary

| | Common stock and additional paid-in capital | | Retained earnings | Accumulated other comprehensive income (loss) | Total shareholders' equity |
|---|---|---|---|---|---|
| | Shares | Amount | | | |
| Balance at December 31, 2016 | 10,793,946 | $60,831,000 | $111,693,000 | $(3,000) | $172,521,000 |
| Net income | — | — | 4,637,000 | — | 4,637,000 |
| Net unrealized gain on securities available for sale, net of tax | — | — | — | 1,000 | 1,000 |
| Net unrealized gain on cash flow hedging derivative instruments, net of tax | — | — | — | 63,000 | 63,000 |
| Net unrealized loss on securities transferred from available for sale to held to maturity, net of tax | — | — | — | (4,000) | (4,000) |
| Comprehensive income | — | — | 4,637,000 | 60,000 | 4,697,000 |
| Cash dividends declared ($0.23 per share) | — | — | (2,487,000) | — | (2,487,000) |
| Equity compensation expense | — | 83,000 | — | — | 83,000 |
| Payment to repurchase common stock | (5,258) | — | (146,000) | | (146,000) |
| Issuance of restricted stock | 18,850 | — | — | — | — |
| Proceeds from sale of common stock | 6,594 | 185,000 | — | — | 185,000 |
| Balance at March 31, 2017 | 10,814,132 | $61,099,000 | $113,697,000 | $57,000 | $174,853,000 |
| | | | | | |
| Balance at December 31, 2017 | 10,829,918 | $61,855,000 | $121,144,000 | $(1,678,000) | $181,321,000 |
| Net income | — | — | 5,506,000 | — | 5,506,000 |
| Net unrealized loss on securities available for sale, net of tax | — | — | — | (3,309,000) | (3,309,000) |
| Net unrealized gain on cash flow hedging derivative instruments, net of tax | — | — | — | 384,000 | 384,000 |
| Net unrealized loss on securities transferred from available for sale to held to maturity, net of tax | — | — | — | (8,000) | (8,000) |
| Comprehensive income | — | — | 5,506,000 | (2,933,000) | 2,573,000 |
| Cash dividends declared ($0.24 per share) | — | — | (2,607,000) | — | (2,607,000) |
| Equity compensation expense | — | 95,000 | — | — | 95,000 |
| Payment to repurchase common stock | (5,725) | — | (167,000) | — | (167,000) |
| Issuance of restricted stock | 16,795 | — | — | — | — |
| Proceeds from sale of common stock | 5,574 | 157,000 | — | — | 157,000 |
| Balance at March 31, 2018 | 10,846,562 | $62,107,000 | $123,876,000 | $(4,611,000) | $181,372,000 |

See Report of Independent Registered Public Accounting Firm.
The accompanying notes are an integral part of these consolidated financial statements.

Consolidated Statements of Cash Flows (Unaudited)
The First Bancorp, Inc. and Subsidiary

| | For the three months ended March 31, 2018 | March 31, 2017 |
|---|---|---|
| Cash flows from operating activities | | |
| Net income | $5,506,000 | $4,637,000 |
| Adjustments to reconcile net income to net cash provided by operating activities | | |
| Depreciation | 464,000 | 457,000 |
| Change in deferred taxes | (163,000) | 80,000 |
| Provision for loan losses | 500,000 | 500,000 |
| Loans originated for resale | (4,835,000) | (10,069,000) |
| Proceeds from sales and transfers of loans | 5,016,000 | 10,024,000 |
| Net gain on sales of loans | (79,000) | (152,000) |
| Net gain on sale or call of securities | (136,000) | (3,000) |
| Net amortization of premiums on investments | 552,000 | 904,000 |
| Net gain on sale of other real estate owned | (13,000) | (1,000) |
| Equity compensation expense | 95,000 | 83,000 |
| Net increase in other assets and accrued interest | (1,214,000) | (2,192,000) |
| Net increase (decrease) in other liabilities | 5,014,000 | (1,269,000) |
| Net loss on disposal of premises and equipment | 127,000 | 7,000 |
| Amortization of investment in limited partnership | 43,000 | 45,000 |
| Net acquisition amortization | 11,000 | 11,000 |
| Net cash provided by operating activities | 10,888,000 | 3,062,000 |
| Cash flows from investing activities | | |
| (Increase) decrease in interest-bearing deposits in other banks | 580,000 | (2,979,000) |
| Proceeds from sales of securities available for sale | 459,000 | 3,000 |
| Proceeds from maturities, payments and calls of securities available for sale | 14,579,000 | 103,781,000 |
| Proceeds from maturities, payments and calls of securities to be held to maturity | 2,751,000 | 2,756,000 |
| Proceeds from sales of other real estate owned | 133,000 | 44,000 |
| Purchases of securities available for sale | (23,262,000) | (117,017,000) |
| Purchases of securities to be held to maturity | (4,862,000) | (16,637,000) |
| Purchase of restricted equity securities | (1,589,000) | (1,433,000) |
| Net increase in loans | (24,364,000) | (18,673,000) |
| Capital expenditures | (132,000) | (22,000) |
| Net cash used by investing activities | (35,707,000) | (50,177,000) |
| Cash flows from financing activities | | |
| Net increase (decrease) in demand, savings, and money market accounts | (66,433,000) | 53,097,000 |
| Net increase in certificates of deposit | 75,746,000 | 50,429,000 |
| Net increase (decrease) in short-term borrowings | 15,491,000 | (52,434,000) |
| Repayment on long-term borrowings | (20,000) | — |
| Payment to repurchase common stock | (167,000) | (146,000) |
| Proceeds from sale of common stock | 157,000 | 185,000 |
| Dividends paid | (2,603,000) | (3,782,000) |
| Net cash provided by financing activities | 22,171,000 | 47,349,000 |
| Net increase (decrease) in cash and cash equivalents | (2,648,000) | 234,000 |
| Cash and cash equivalents at beginning of period | 19,207,000 | 17,366,000 |
| Cash and cash equivalents at end of period | $16,559,000 | $17,600,000 |
| Interest paid | $3,925,000 | $2,975,000 |

| | | |
|---|---|---|
| Income taxes paid (refunded) | (8,000 ) | — |
| Non-cash transactions | | |
| Net transfer from loans to other real estate owned | $229,000 | $193,000 |

See Report of Independent Registered Public Accounting Firm.

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

Notes to Consolidated Financial Statements
The First Bancorp, Inc. and Subsidiary

Note 1 – Basis of Presentation

The First Bancorp, Inc. ("the Company") is a financial holding company that owns all of the common stock of First National Bank ("the Bank"). The accompanying unaudited consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America ("GAAP") for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by GAAP for complete financial statements. In the opinion of Management, all adjustments (consisting of normally recurring accruals) considered necessary for a fair presentation have been included. All significant intercompany transactions and balances are eliminated in consolidation. The income reported for the 2018 period is not necessarily indicative of the results that may be expected for the year ending December 31, 2018. For further information, refer to the consolidated financial statements and notes included in the Company's annual report on Form 10-K for the year ended December 31, 2017.

Subsequent Events

Events occurring subsequent to March 31, 2018, have been evaluated as to their potential impact to the financial statements.

Note 2 – Investment Securities

The following table summarizes the amortized cost and estimated fair value of investment securities at March 31, 2018:

| | Amortized Cost | Unrealized Gains | Unrealized Losses | Fair Value (Estimated) |
|---|---|---|---|---|
| Securities available for sale | | | | |
| Mortgage-backed securities | $302,935,000 | $191,000 | $(7,798,000) | $295,328,000 |
| State and political subdivisions | 5,765,000 | 3,000 | (257,000) | 5,511,000 |
| Other equity securities | 2,930,000 | — | — | 2,930,000 |
| | $311,630,000 | $194,000 | $(8,055,000) | $303,769,000 |
| Securities to be held to maturity | | | | |
| U.S. Government-sponsored agencies | $11,155,000 | $— | $(515,000) | $10,640,000 |
| Mortgage-backed securities | 21,990,000 | 469,000 | (289,000) | 22,170,000 |
| State and political subdivisions | 221,245,000 | 1,497,000 | (4,001,000) | 218,741,000 |
| Corporate securities | 4,300,000 | — | — | 4,300,000 |
| | $258,690,000 | $1,966,000 | $(4,805,000) | $255,851,000 |
| Restricted equity securities | | | | |
| Federal Home Loan Bank Stock | $10,910,000 | $— | $— | $10,910,000 |
| Federal Reserve Bank Stock | 1,037,000 | — | — | 1,037,000 |
| | $11,947,000 | $— | $— | $11,947,000 |

The following table summarizes the amortized cost and estimated fair value of investment securities at December 31, 2017:

Amortized
Cost

*Income tax expense (benefit).* The income tax expense for the three months ended December 31, 2012 was $96,000 as compared to a tax benefit of $252,000 for the three months ended December 31, 2011. The income tax expense for the three months ended December 31, 2012 was the result of the pre-tax income for the quarter compared to the pre-tax loss from the same period in the prior year.

The effective tax rate for the three months ended December 31, 2012 was 23%. The effective tax rate differs from the statutory rate for the three months ended December 31, 2012 due primarily to a decrease in the liability recorded for uncertain tax positions due to the lapse of applicable statutes of limitation, and the Domestic Production Activities Deduction.

The effective tax rate for the three months ended December 31, 2011 was (42%). The effective tax rate differs from the statutory rate for the three months ended December 31, 2011, due primarily to the current tax benefits resulting from the loss recorded, and a decrease in the liability recorded for uncertain tax positions due to the lapse of applicable statutes of limitation.

On January 2, 2013, the American Taxpayer Relief Act of 2012 (the Tax Relief Act ) was enacted. The Tax Relief Act included a two-year extension of the Research and Development Tax Credit

( R&D Tax Credit ), which retroactively reinstated and extended the federal R&D Tax Credit for amounts paid or incurred from January 1, 2012 to December 31, 2013. The Company is in the process of evaluating the impact of the R&D Tax Credit extension, and will record the impact of this legislation in the quarter ending March 31, 2013 as required by ASC Topic 740, *Income Taxes* .

At September 30, 2012, the Company considered all available evidence, including the recent history of income before income taxes, together with projections of profitability in future periods. As a result of this analysis, the Company determined that the positive evidence was sufficient to conclude that it was appropriate to reverse the valuation allowance previously recorded against its net federal deferred tax assets. At December 31, 2012, the balance of the deferred tax valuation allowance relates principally to net operating losses ( NOL ) of certain state taxing jurisdictions. The Company will continue to maintain the balance of the valuation allowance until an appropriate level of profitability is sustained in certain jurisdictions to warrant a conclusion that it is no longer more likely than not that a portion of these net state deferred tax assets will not be realized in future periods. There is currently no assurance of such future income before taxes. The Company believes that its estimate of future taxable income is inherently uncertain, and if its

Table of Contents

current or future operations generate losses, further adjustments to the valuation allowance are possible.

*Net income (loss).* As a result of the components described above, the Company reported net income for the three months ended December 31, 2012 of $318,000 compared to a net loss of ($343,000) for the three months ended December 31, 2011. On a fully diluted basis, the income per share of $0.02 for the three months ended December 31, 2012 compares to a loss per share of ($0.02) for the three months ended December 31, 2011.

**Liquidity and Capital Resources**

The following table highlights key financial measurements of the Company:

| | December 31, 2012 | September 30, 2012 |
|---|---|---|
| Cash and cash equivalents | $ 17,027,886 | $ 42,977,501 |
| Accounts receivable, net | 4,238,626 | 3,978,512 |
| Current assets | 30,087,512 | 54,377,366 |
| Current liabilities | 4,549,848 | 5,289,828 |
| Deferred revenue | 1,161,532 | 1,426,552 |
| Total debt and other non-current liabilities (1) | 206,577 | 227,000 |
| Quick ratio (2) | 4.67 | 8.88 |
| Current ratio (3) | 6.61 | 10.28 |

| | Three Months Ending December 31, 2012 | 2011 |
|---|---|---|
| Cash flow activites: | | |
| Net cash (used in) provided by operating activites | $ (1,660,929) | $ 621,585 |
| Net cash (used in) investing activites | (43,231) | (111,898) |
| Net cash (used in) financing activites | (24,245,455) | (351,902) |

(1) Excludes deferred revenue

(2) Calculated as: Cash and Cash Equivalents and Accounts Receivable, net divided by Current Liabilities

(3) Calculated as: Current Assets divided by Current Liabilities

The Company s principal source of liquidity has been from cash flows generated from current year operations and the ability to access cash accumulated from prior year operations. Cash is used principally to finance inventory, accounts receivable and payroll which are all collectively leveraged to execute the Company s growth strategies and return value to its shareholders.

***Operating activities***

Despite the net income for the quarter, the Company used cash in operating activities of $1.7 million for the three months ended December 31, 2012 compared to providing cash of $0.6 million for the three months ended December 31, 2011. The cash used in operating activities during the three months ended December 31, 2012 was primarily the result of an increase in revenue recognized not invoiced of $1.4 million. Revenue recognized not yet invoiced principally represent sales recorded under the percentage-of-completion method of accounting that have not been billed to customers in accordance with applicable contract terms on EMD projects. The Company believes that the cash invested in funding the EMD programs will be recovered from customers as project milestones are completed over the next twelve months.

***Investing activities***

For the three months ended December 31, 2012 and 2011, the Company spent $43,000 and $112,000, respectively, primarily for the purchase of production and laboratory test equipment.

***Financing activities***

On December 7, 2012 the Company s Board of Directors declared a special cash dividend in the amount of $1.50 per share, payable

Table of Contents

on December 27, 2012 to shareholders of record as of the close of business on December 17, 2012. The aggregate amount of the payment made in connection with the dividend was approximately $25 million. For the three months ended December 2012, the Company received $0.8 million from the exercise of options to acquire shares of common stock. There was a small repurchase of 175 shares of common stock during the three months ended December 31, 2012. For the three months ended December 2011, the Company used $0.3 million for the repurchase of 88,516 shares of common stock.

Future capital requirements depend upon numerous factors, including market acceptance of the Company s products, the timing and rate of expansion of business, acquisitions, joint ventures, and other factors. IS&S has experienced increases in expenditures since its inception, and anticipates that expenditures will continue to increase in the foreseeable future. The Company believes that its cash and cash equivalents will provide sufficient capital to fund operations for at least the next twelve months. Further, IS&S may need to develop and introduce new or enhanced products, to respond to competitive pressures, to invest in or acquire businesses or technologies, or to respond to unanticipated requirements or developments. If additional funds are raised through the issuance of equity securities, dilution to existing shareholders may result. If insufficient funds are available, the Company may not be able to introduce new products or to compete effectively.

**Backlog**

As of December 31, 2012 and September 30, 2012, backlog was $29.4 million and $19.7 million, respectively. Backlog represents the value of contracts and purchase orders received, less the revenue recognized to date on those contracts and purchase orders. The increase during the quarter of $9.7 million, or 49%, was the result of $16.2 million in new business, offset by $6.5 million of revenue recognized for the three months ended December 31, 2012. As of December 31, 2012, approximately 36% of the Company s backlog is not expected to be filled within fiscal year 2013.

Backlog activity for the three months ended December 31, 2012 (in thousands):

| Balance at September 30, 2012 | Bookings (net of De-bookings) | Recognized in Revenue | Balance at December 31, 2012 |
|---|---|---|---|
| $ 19,712 | $ 16,257 | $ 6,537 | $ 29,432 |

**Off-Balance Sheet Arrangements**

IS&S has no relationships with unconsolidated entities or financial partnerships, such as Special Purpose Entities or Variable Interest Entities, established for the purpose of facilitating off-balance sheet arrangements or other limited purposes.

**Item 3. Quantitative and Qualitative Disclosures About Market Risk**

The Company s operations are exposed to market risks primarily as a result of changes in interest rates. The Company does not use derivative financial instruments for speculative or trading purposes. The Company s exposure to market risk for changes in interest rates relates to its cash equivalents. The Company s cash equivalents consist of funds invested in money market accounts, which bear interest at variable rates. Accordingly, the Company does not participate in interest rate hedging, a change in interest rates earned on the cash equivalents would impact interest income and cash flows, but would not impact the fair market value of the related underlying instruments. Assuming that the balances during the three months ended December 31, 2012 (net of the special dividend of approximately $25 million paid on December 27, 2012), were constant and no actions were taken to alter the existing interest rate sensitivity, a hypothetical 1% increase in variable interest rates would have affected interest income by approximately $35,000, with a resulting impact on cash flows of approximately $35,000 for the three months ended December 31, 2012.

**Item 4. Controls and Procedures**

(a) An evaluation was performed under the supervision and with the participation of the Company s management, including its Chief Executive Officer ( CEO ) and Chief Financial Officer ( CFO ) of the effectiveness of the Company s disclosure controls and procedures, as such term is defined under Rule 13a-15e under the Exchange Act as of December 31, 2012. Based on that evaluation, the Company s management, including the CEO and CFO, concluded that the Company s disclosure controls and procedures are effective to provide reasonable assurance that information required to be disclosed by the Company in reports that it files or submits under the Exchange Act, is recorded, processed, summarized and reported as specified in SEC s rules and forms and that such information is accumulated and communicated to the Company s management, including the CEO and CFO, or persons performing similar functions, as appropriate to allow timely decisions regarding required disclosure.

Table of Contents

(b) There were no changes in the Company s internal control over financial reporting identified in connection with the evaluation of such controls that occurred during the Company s most recent fiscal quarter that have materially affected, or are reasonably likely to materially affect, the Company s internal control over financial reporting.

## PART II OTHER INFORMATION

### Item 1. Legal Proceedings

In the ordinary course of business, IS&S is at times subject to various legal proceedings and claims. The Company does not believe any such matters that are currently pending will have a material adverse effect on the results of operations or financial position.

On November 29, 2011, AMR Corporation, the parent company of American Airlines, Inc. ( AAI ) and certain of its other U.S. based subsidiaries filed voluntary petitions for Chapter 11 reorganization in the U.S. Bankruptcy Court for the Southern District of New York (the Bankruptcy ). For the three months ended December 31, 2012 and 2011 AAI accounted for 13% and 19% of net sales, respectively. AAI continued to purchase products from the Company in the ordinary course of business after November 29, 2011.

As of November 29, 2011, the Company had pre-Bankruptcy outstanding accounts receivable of $760,000 from AAI. The Company believes it is probable that the outstanding receivables will be collected in full and therefore, no reserve has been recorded against these assets as of the balance sheet date. In the 90 days preceding the filing of the Bankruptcy petition, the Company received $828,000 from AAI in the ordinary course of business. Under the U.S. bankruptcy laws, debtors have the right to avoid certain payments made during the 90 days preceding the filing of the bankruptcy petition. No such avoidance action has been asserted or filed, and the Company believes that it would have valid defenses against any such action.

On September 26, 2011, Farhad Daghigh, a former employee of the Company, filed a lawsuit against IS&S in the Court of Common Pleas of Chester County alleging breach of contract and violation of the Pennsylvania Wage Payment and Collection Law claiming unpaid sales commissions, prejudgment interest, and liquidated damages totaling approximately $583,000 for the fiscal years ended 2007, 2008, 2009 and 2010. The Company vehemently denies any allegations of liability and will vigorously defend the lawsuit. This matter has not been resolved as of the date hereof. The Company believes that the probability of an unfavorable outcome on this claim is remote, and, therefore, no contingent liability has been recorded as at December 31, 2012.

On January 17, 2007 the Company filed suit in the Court of Common Pleas for Delaware County, Pennsylvania against Strathman Associates, a former software consultant for IS&S, alleging that Strathman had improperly used IS&S trade secret and proprietary information in assisting J2 and Kollsman in developing the J2/Kollsman Air Data Computer. This matter has not been resolved as of the date hereof.

### Item 1A. Risk Factors

There are no material changes to the risk factors described under Item 1A of our Form 10-K for the year ended September 30, 2012.

**Item 2. Unregistered Sales of Equity Securities and Use of Proceeds**

The table below provides information concerning the Company s repurchases of shares of common stock during the quarter ended December 31, 2012 pursuant to the Company s repurchase program.

| Month Ended | Total Number of Shares Purchased | Average Price Paid per Share | Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs | Number of Shares that May Yet Be Purchased Under the Program (1) |
|---|---|---|---|---|
| October 31, 2012 | 175 | $ 3.96 | 175 | 713,703 |
| November 30, 2012 | | | | 713,703 |
| December 31, 2012 | | | | 713,703 |
| | 175 | $ 3.96 | 175 | |

(1) A description of the maximum number of shares of common stock that may be purchased under the Company s repurchase program is set forth in Note 4 to the Company s condensed consolidated financial statements contained in this quarterly report on Form 10-Q.

See Note 4 to the Company s condensed consolidated financial statements contained in this quarterly report on Form 10-Q for a more detailed discussion of the terms of the Company s repurchase program.

Table of Contents

**Item 3. Defaults upon Senior Securities**

None

**Item 4. Mine Safety Disclosures**

Not applicable

**Item 5. Other Information**

None

**Item 6. Exhibits**

(a) Exhibits

| | |
|---|---|
| 31.1 | Certification of Chief Executive Officer Pursuant to Rule 13a-14(a) **(1)** |
| 31.2 | Certification of Chief Financial Officer Pursuant to Rule 13a-14(a) **(1)** |
| 32.1 | Certification Pursuant to U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 **(2)** |
| 101.INS | XBRL Instance Document **(3)** |
| 101.SCH | XBRL Taxonomy Extension Scheme Document **(3)** |
| 101.CAL | XBRL Taxonomy Extension Calculation Linkbase Document **(3)** |

101.DEF XBRL Taxonomy Extension Definition Linkbase Document **(3)**

101.LAB XBRL Taxonomy Extension Label Linkbase Document **(3)**

101.PRE XBRL Taxonomy Extension Presentation Linkbase Document **(3)**

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(1) Filed herewith

(2) Furnished herewith

(3) Pursuant to Regulation S T, these interactive data files are deemed not filed or incorporated in any registration statement or prospectus for purposes of Sections 11 or 12 of the Securities Act of 1933 or Section 18 of the Securities Exchange Act of 1934 and otherwise are not subject to liability under those sections.

Table of Contents

**SIGNATURE**

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 thereunto duly authorized.

| | | |
|---|---|---|
| | **INNOVATIVE SOLUTIONS AND SUPPORT, INC.** | |
| Date: February 11, 2013 | By: | /s/ RONALD C. ALBRECHT<br>RONALD C. ALBRECHT<br>CHIEF FINANCIAL OFFICER |