

INNOVATIVE SOLUTIONS & SUPPORT INC  
Form 10-Q  
August 09, 2007

**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 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 June 30, 2007

OR

**o TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE  
ACT OF 1934**

[For the transition period from \_\_\_\_\_ to \_\_\_\_\_]

Commission File No. 0-31157

**INNOVATIVE SOLUTIONS AND SUPPORT, INC.**

(Exact name of registrant as specified in its charter)

**PENNSYLVANIA**  
(State or other jurisdiction  
of incorporation)

**23-2507402**  
(IRS Employer  
Identification No.)

**720 Pennsylvania Drive, Exton, Pennsylvania**  
(Address of principal executive offices)

**19341**  
(Zip Code)

**(610) 646-9800**  
(Registrant's telephone number, including area code)

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act.

Large accelerated filer  Accelerated filer  Non-accelerated filer

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

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Yes  No

As of August 1, 2007, there were 16,889,659 shares of the Registrant's Common Stock, with par value of \$.001 per share, outstanding.

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INNOVATIVE SOLUTIONS AND SUPPORT, INC.

FORM 10-Q June 30, 2007

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## PART I FINANCIAL INFORMATION

## Item 1 Financial Statements

## INNOVATIVE SOLUTIONS AND SUPPORT, INC.

## CONDENSED CONSOLIDATED BALANCE SHEET

(unaudited)

	As of June 30, 2007	As of September 30, 2006
<b><u>ASSETS</u></b>		
Current Assets:		
Cash and cash equivalents	\$ 56,827,784	\$ 62,984,829
Accounts receivable, less allowance for doubtful accounts of \$ 0 and \$100,000 at June 30, 2007 and September 30, 2006	1,787,970	3,333,131
Inventories	7,612,013	6,466,156
Deferred income taxes	1,408,727	1,082,931
Prepaid expenses and other current assets	7,816,869	4,065,696
Total current assets	75,453,363	77,932,743
Property and Equipment:		
Computers and test equipment	4,923,446	4,592,410
Corporate airplane	3,053,474	3,027,502
Furniture and office equipment	918,722	748,827
Manufacturing facility	5,488,824	5,426,761
Land	1,021,245	1,021,245
	15,405,711	14,816,745
Less- Accumulated depreciation and amortization	(6,442,212	) (5,846,272
Net property and equipment	8,963,499	8,970,473
Other assets	2,788,564	329,664
Total assets	\$ 87,205,426	\$ 87,232,880
<b><u>LIABILITIES AND SHAREHOLDERS' EQUITY</u></b>		
Current Liabilities		
Current portion of capitalized lease obligations	\$ 6,337	\$ 7,891
Accounts payable	3,997,871	358,818
Accrued expenses	3,610,888	3,122,542
Deferred revenue	225,371	591,626
Total current liabilities	7,840,467	4,080,877
Note payable	4,335,000	4,335,000
Long-term portion of capitalized lease obligations		4,587
Deferred revenue	68,138	120,991
Deferred income taxes	357,755	490,072
Commitments and contingencies		
Shareholders' Equity:		
Preferred stock, 10,000,000 shares authorized, \$.001 par value, of which 200,000 shares are authorized as Class A Convertible stock. No shares issued and outstanding at June 30, 2007 and September 30, 2006		

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Common stock, \$.001 par value: 75,000,000 shares authorized, 18,156,311 and 18,088,121 shares issued at June 30, 2007 and September 30, 2006	18,156	18,088
Additional paid-in capital	44,441,444	43,230,352
Retained earnings	48,230,894	53,039,341
Treasury stock, at cost, 1,272,510, shares at June 30, 2007 and September 30, 2006	(18,086,428	) (18,086,428
Total shareholders' equity	74,604,066	78,201,353
Total liabilities and shareholders' equity	\$ 87,205,426	\$ 87,232,880

The accompanying notes are an integral part of these statements.

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## INNOVATIVE SOLUTIONS AND SUPPORT, INC.

## CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(unaudited)

	Three Months Ended June 30, 2007	Three Months Ended June 30, 2006	Nine Months Ended June 30, 2007	Nine Month Ended June 30, 2006
Net sales:				
Product	\$ 3,981,660	\$ 2,844,223	\$ 10,316,479	\$ 11,532,191
Engineering - modification & development	1,862,745	146,799	2,911,872	608,970
Total net sales	5,844,405	2,991,022	13,228,351	12,141,161
Cost of sales				
Product	1,985,572	1,576,908	6,027,327	6,118,692
Engineering - modification & development	1,653,663	90,393	2,663,881	445,345
Total cost of sales	3,639,235	1,667,301	8,691,208	6,564,037
Gross profit	2,205,170	1,323,721	4,537,143	5,577,124
Operating expenses:				
Research and development	1,107,385	1,695,304	3,912,480	5,147,093
Selling, general and administrative	4,192,013	2,543,635	11,124,795	6,641,121
Total operating expenses	5,299,398	4,238,939	15,037,275	11,788,214
Operating loss	(3,094,228 )	(2,915,218 )	(10,500,132 )	(6,211,090 )
Interest income	780,734	848,601	2,387,542	2,449,672
Interest expense	(52,280 )	(50,068 )	(152,824 )	(138,063 )
Loss before income taxes	(2,365,774 )	(2,116,685 )	(8,265,414 )	(3,899,481 )
Income tax benefit	(1,014,917 )	(955,071 )	(3,456,967 )	(1,966,336 )
Net loss	\$ (1,350,857 )	\$ (1,161,614 )	\$ (4,808,447 )	\$ (1,933,145 )
Net loss per common share:				
Basic	\$ (0.08 )	\$ (0.07 )	\$ (0.29 )	\$ (0.11 )
Diluted	\$ (0.08 )	\$ (0.07 )	\$ (0.29 )	\$ (0.11 )
Weighted average shares outstanding:				
Basic	16,881,900	17,013,737	16,857,164	17,582,519
Diluted	16,881,900	17,013,737	16,857,164	17,582,519

The accompanying notes are an integral part of these statements.

## INNOVATIVE SOLUTIONS AND SUPPORT, INC.

## CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(unaudited)

	For the Nine Months Ended June 30, 2007	For the Nine Months Ended June 30, 2006
<b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>		
Net loss	\$ (4,808,447 )	\$ (1,933,145 )
Adjustments to reconcile net loss to net cash provided by (used in) operating activities:		
Depreciation and amortization	619,786	628,750
Share-based compensation expense:		
Stock options	361,869	539,635
Nonvested stock awards	170,000	239,919
Tax benefit (expense) from share-based arrangements		
Stock options exercised	164,680	210,282
Nonvested stock awards	37,449	(8,456 )
Excess tax benefits from share-based payment arrangements	(156,442 )	(12,335 )
Loss on disposal of fixed assets	2,486	156
Excess and obsolete inventory expense	100,000	47,817
Deferred income taxes	(458,113 )	(159,113 )
(Increase) decrease in:		
Accounts receivable	1,545,161	3,828,449
Inventories	(1,245,857 )	(2,025,147 )
Prepaid expenses and other current assets	(3,751,173 )	743,348
Increase (decrease) in:		
Accounts payable	3,639,053	325,987
Accrued expenses	478,290	(705,519 )
Deferred revenue	(419,108 )	362,784
Net cash provided by (used in) operating activities	(3,720,366 )	2,083,412
<b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>		
Cash paid for property and equipment	(596,698 )	(387,430 )
Purchases of other assets	(2,477,500 )	(240,000 )
Net cash used in investing activities	(3,074,198 )	(627,430 )
<b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>		
Proceeds from exercise of stock options	487,218	131,136
Purchase of treasury stock		(18,086,428 )
Repayment of capitalized lease obligation	(6,141 )	(5,888 )
Excess tax benefits from share-based payment arrangements	156,442	12,335
Net cash provided by (used in) financing activities	637,519	(17,948,845 )
Net decrease in cash and cash equivalents	\$ (6,157,045 )	\$ (16,492,863 )
Cash and cash equivalents, beginning of year	\$ 62,984,829	\$ 83,172,582
Cash and cash equivalents, end of period	\$ 56,827,784	\$ 66,679,719
<b>SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION:</b>		
Cash paid for interest	\$ 123,701	\$ 108,938
Cash paid for income taxes	\$	\$ 440,338
Cash received from income tax refund	\$ (2,314,697 )	\$ (3,267,575 )

The accompanying notes are an integral part of these statements.





**Innovative Solutions and Support Inc.****Notes to Condensed Consolidated Financial Statements****1. Basis of Presentation:**

Innovative Solutions and Support, Inc. (the Company) was incorporated in Pennsylvania on February 12, 1988. The Company's primary business is the design, manufacture and sale of flat panel display systems, flight information computers and advanced monitoring systems for military, government, commercial air transport and corporate aviation markets.

The balance sheet as of June 30, 2007, the statement of operations for the three months and nine months ended June 30, 2007 and 2006 and the statements of cash flows for the nine months ended June 30, 2007 and 2006 have been prepared by the Company without audit. In the opinion of management, all adjustments, consisting of normal and recurring adjustments, necessary to present fairly the financial position, results of operations and cash flows at June 30, 2007 and for all periods presented have been made.

Certain information and footnote disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States of America have been condensed or omitted. It is suggested that these financial statements be read in conjunction with the financial statements and notes thereto included in the Company's Form 10-K for the year ended September 30, 2006 as filed with the Securities and Exchange Commission. The results of operations for the three months and nine months ended June 30, 2007 are not necessarily indicative of the operating results for the full year.

The balance sheet as of September 30, 2006 presented in this quarterly report on Form 10-Q has been reclassified to include the \$100,000 optional first-year pay down on our loan agreement with the Chester County, Pennsylvania Industrial Development Authority as long-term debt. For fiscal year 2006, the impact of the reclassification was to decrease the current portion of notes payable by \$100,000 and to increase long-term notes payable by \$100,000. The reclassification does not have a significant impact on working capital and has no impact on the financial covenants associated with the notes payable agreement as the lender has waived compliance with the existing covenants through the fiscal quarter ending on June 30, 2008. The Company believes that it will be in compliance with all covenants at June 30, 2008.

**2. Net income per Share**

Net income per share (EPS) is calculated using the principles of SFAS No. 128, Earnings Per Share.

For the nine month periods ended June 30, 2007 and 2006, there were 576,000 and 625,000 options to purchase common stock outstanding that were excluded from the computation of diluted earnings per share as the effect would be antidilutive.

**3. Concentrations**

For the three months ended June 30, 2007, three customers accounted for 31%, 22% and 13% of net sales or 66% on a combined basis. For the three months ended June 30, 2006, two customers accounted for 16%, and 10% of net sales or 26% on a combined basis. For the nine months ended June 30, 2007, two customers accounted for 22% and 19% of net sales or 41% on a combined basis. For the nine months ended June 30, 2006, two customers accounted for 12%, and 10% of net sales or 22% on a combined basis.

**4. Inventories**

Inventories are stated at the lower of cost (first-in, first-out) or market and consist of the following:

	<b>June 30 2007</b>	<b>September 30 2006</b>
Raw materials	\$ 5,215,140	\$ 3,006,088
Work-in-process	1,550,276	2,237,489
Finished goods	846,597	1,222,579
	\$ 7,612,013	\$ 6,466,156



## 5. Warranty

The Company provides for the estimated cost of product warranties at the time revenue is recognized. Warranty cost is recorded as cost of sales and the reserve balance recorded as an accrued expense in the financial statements. While the Company engages in extensive product quality programs and processes, the Company's warranty obligation is affected by product failure rates and the related material, labor and delivery costs incurred in correcting a product failure. Should actual product failure rates, material or labor costs differ from the Company's estimates, further revisions to the estimated warranty liability would be required.

Warranty cost and accrual information for the three months ended June 30, 2007 is highlighted below:

Warranty accrual at March 31, 2007	\$ 550,706
Accrued expense for the three months ended June 30, 2007	75,882
Warranty costs for the three months ended June 30, 2007	(54,405 )
Warranty accrual at June 30, 2007	\$ 572,183

Warranty cost and accrual information for the nine months ended June 30, 2007 is highlighted below:

Warranty accrual at September 30, 2006	\$ 617,116
Accrued expense for the nine months ended June 30, 2007	135,295
Warranty costs for the nine months ended June 30, 2007	(180,228 )
Warranty accrual at June 30, 2007	\$ 572,183

## 6. Share-Based Compensation

Effective October 1, 2005 the Company adopted the provisions of Statement of Financial Accounting Standards ( SFAS ) No. 123(R), Share-Based Payment ( SFAS 123(R) ), using the modified prospective approach and now accounts for share-based compensation applying the fair value method for expensing stock options and non-vested stock awards.

Total share-based compensation expense was \$198,000 and \$244,000 for the three months ended June 30, 2007 and 2006, respectively. The total income tax benefit recognized in the statement of operations for share-based compensation arrangements was \$85,000 and \$110,000 for the three months ended June 30, 2007 and 2006, respectively. Total share-based compensation expense was \$532,000 and \$780,000 for the nine months ended June 30, 2007 and 2006, respectively, and the total income tax benefit recognized in the statement of operations for share based compensation arrangements was \$222,000 and \$393,000, respectively. Compensation expense related to share-based awards is recorded as a component of general and administrative expense.

The Company maintains the 1998 Stock Option Plan (the Plan ) and the 2003 Restricted Stock Plan (the Restricted Plan ). These plans were approved by the Company's shareholders.

### Stock Options

The Plan provides for the granting of incentive and nonqualified stock options to employees, officers, directors and independent contractors and consultants. Through June 30, 2007 no stock options have been granted to independent contractors or consultants under this Plan. Total compensation expense was \$138,000 and \$184,000 for the three months ended June 30, 2007 and 2006 and \$362,000 and \$540,000 for the nine months ended June 30, 2007 and 2006, respectively. Incentive stock options granted under the Plan have exercise prices that must be at least equal to the fair value of the common stock on the date of grant. Nonqualified stock options granted under the Plan have exercise prices that may be less than, equal to or greater than the fair value of the common stock on the date of grant. The Company has reserved 3,389,000 shares of Common Stock for awards under the Plan. As of June 30, 2007 there were 1,682,000 shares remaining and available for grant under the Plan.

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A summary of option activity under the Plan as of June 30, 2007 and changes during the period then ended is as follows:

	Options	Weighted Average Exercise Price	Weighted Average Remaining Contractual Life	Aggregate Intrinsic Value
Outstanding at September 30, 2006	701,854	\$ 9.93		
Granted	49,000	24.42		
Exercised	(57,292)	8.50		
Cancelled	(117,700)	14.74		
Outstanding at June 30, 2007	575,862	\$ 10.33	6.35	\$ 7,425,214
Exercisable at June 30, 2007	362,462	\$ 6.78	5.25	\$ 5,958,127

The weighted-average grant date fair value of individual options granted during the nine months ended June 30, 2007 and 2006 was \$14.38 and \$7.37, respectively. The total intrinsic value of options exercised during the nine months ended June 30, 2007 and 2006 was \$609,000 and \$130,000, respectively.

The following table summarizes information about stock options under the Plan at June 30, 2007:

Options Outstanding				Options Exercisable			
Range of Exercise Prices	Outstanding As of June 30, 2007	Weighted-Average Remaining Contractual Life	Weighted-Average Exercise Price	As of June 30 2007	Weighted-Average Exercise Price		
\$ 0.00 - 5.00	205,263	5.48	\$ 4.18	203,163	\$ 4.18		
\$ 5.01 - 10.00	144,199	4.47	7.70	114,799	7.70		
\$ 10.01 - 15.00	111,000	8.13	14.02	19,500	13.57		
\$ 15.01 - 20.00	49,200	7.88	16.79	15,200	16.99		
\$ 20.01 - 26.97	66,200	9.02	24.11	9,800	20.66		
	575,862			362,462			

The fair value of each option grant is estimated on the date of grant using the Black-Scholes option pricing model. Options are exercised over a maximum term of ten years from the date of grant and typically vest over periods of five years from the grant date. The expected term of options represents the period of time that the options granted are expected to be outstanding and is based on historical experience. Expected volatility is based on historical volatility of the Company's stock. The risk free interest rate is based on U.S. Treasuries with constant maturities in effect at the time of the grant. Compensation expense for employee stock options also includes an estimate for forfeitures and is recognized ratably over the vesting term. The table below sets forth the fair value assumptions used to record compensation expense for the period identified:

	Nine Months Ended June 30, 2007	Nine Months Ended June 30, 2006		
Expected lives (years)	5.72	5.00		
Weighted average risk-free interest rate	4.90	%	4.18	%
Expected volatility	59.56	%	55.17	%
Expected dividend rate				

As of June 30, 2007, there was approximately \$1.7 million of unrecognized compensation cost, net of forfeitures, related to non-vested stock options, which is expected to be recognized over a period of approximately 5 years.

### Non-vested Stock

The Restricted Plan for non-employee directors was approved by shareholders at the Company's February 26, 2004 Annual Meeting of Shareholders. The Plan calls for an annual award of non-vested stock having a fair market value of \$40,000 as of the close of business on October 1 of the current fiscal year for all eligible non-employee directors. The stock is awarded in four quarterly installments during the fiscal year provided the director is still serving on the board on the quarterly issue date. Total expense was \$60,000 for the three months ended June 30, 2007 and 2006 and \$170,000 and \$240,000 for the nine months ended June 30, 2007 and 2006, respectively. As of June 30, 2007, there is an estimated \$60,000 of unrecognized compensation expense related to nonvested stock awards under the Company's Restricted Plan. That cost is expected to be recognized over the balance of the fiscal year. The following table outlines restricted stock awards for the nine months ended June 30, 2007:

	Non-vested Stock Awards	Weighted Average Share Price
Balance at September 30, 2006	3,275	\$ 15.25
Granted	15,939	14.43
Issued	(10,898	) 14.68
Cancelled		
Balance at June 30, 2007	8,316	\$ 14.43

### 7. Stock Repurchase Program

On December 28, 2005 the Company's Board of Directors approved a common stock repurchase program to acquire up to 2,000,000 shares of its outstanding common stock. The program was in effect until June 30, 2006. Over the course of the program the Company repurchased 1,272,510 shares of its common stock at an average cost of \$14.21 per share.

### 8. Notes Payable

The Company entered into a \$4,335,000 loan agreement dated August 1, 2000 with the Chester County, Pennsylvania Industrial Development Authority. The purpose of the loan was to fund the construction of the Company's new office and manufacturing facility. The loan matures in 2015 and carries an interest rate set by the remarketing agent that is consistent with 30-day tax-exempt commercial paper.

The loan agreement requires the Company to maintain certain financial covenants including a ratio of liabilities to earnings before interest, taxes and depreciation and amortization (EBITDA), a fixed charge ratio and a minimum tangible net worth. As of June 30, 2006, the Company was in violation of these financial covenants. The defaults were subsequently waived and an amendment to the agreement was entered into with the lender whereby the existing covenants were suspended until the fiscal quarter ending on June 30, 2008. The Company believes that it will be in compliance with all covenants at June 30, 2008.

### 9. New Accounting Pronouncements

In September 2006, the Financial Accounting Standards Board (FASB) issued SFAS No. 157, Fair Value Measurements (SFAS 157). SFAS 157 defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles, and expands disclosures about fair value measurements. This statement does not require any new fair value measurements; however, the application of this statement

may change current practice for some entities. SFAS 157 is effective for fiscal years beginning after

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November 15, 2007. The Company is currently evaluating the impact of this pronouncement.

In September 2006, the Securities and Exchange Commission issued Staff Accounting Bulletin 108, *Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements* ( SAB 108 ). SAB 108 provides guidance on how prior year misstatements should be taken into consideration when quantifying misstatements in current year financial statements for purposes of determining whether the current year's financial statements are materially misstated. SAB 108 is effective for the first fiscal year ending after November 15, 2006. The Company has evaluated the impact of the adoption of this interpretation and does not believe that the adoption of the SAB 108 will have a material impact on the Company's financial position or results of operations.

In July 2006, the FASB issued FASB Interpretation 48, *Accounting for Uncertainty in Income Taxes* an interpretation of FASB Statement No. 109 ( FIN 48 ). FIN 48 clarifies the accounting for uncertainty in income taxes recognized in an enterprise's financial statements in accordance with FASB Statement No. 109, *Accounting for Income Taxes*. This Interpretation prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. This Interpretation also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure, and transition. FIN 48 is effective for fiscal years beginning after December 15, 2006. The Company is currently evaluating the impact of this pronouncement.

## **Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations**

### **Overview**

We design, manufacture and sell flat panel display systems, flight information computers, and advanced monitoring systems to the Department of Defense (DOD), government agencies, commercial air transport carriers and corporate/general aviation markets.

Our revenues are derived from the sale of our products to the retrofit market and, to a lesser extent, original equipment manufacturers (OEMs). Our customers include government and military entities and their commercial contractors, aircraft operators, aircraft modification centers and various OEMs. Although we occasionally sell our products directly to government entities, we primarily sell our products to commercial customers for end use in government and military programs.

We continue to invest in and seek additional opportunities for our Flat Panel Display System product line. In October 2005, the FAA awarded the Company a second Technical Standard Order (TSO) for our flat panel display system COCKPIT/IPTM. This TSO establishes our flat panel display system as meeting FAA requirements that have been put in place to ensure safe flight on a variety of aircraft types and, additionally, it addresses the most stringent Commercial Air Transport market requirements as provided in Title 14 of the Code of Federal Regulation, subpart 25, Commercial Air Transport. The TSO states "It has been noted that this display system employs an integrity monitoring system that assures integrity to a catastrophic/Level A design condition with the use of commercial graphic processors."

In October 2005, the Company in a teaming arrangement with ABX Air, received FAA Supplemental Type Certification (STC) of its Flat Panel Display System for use on B-767 aircraft. The STC provides B-767 operators with a low cost, rapidly implemented retrofit of their cockpit avionics with a modern pilot and copilot suite of high resolution multi-color LCD flat panel displays. Operators will benefit from improved dispatch reliability, logistics savings and adaptability to future requirements. The receipt of the STC positions the Company to pursue more than 1,700 B-757 and B-767 aircraft with similar needs for Flat Panel Display System upgrades. The STC also provides a foundation for incorporating the product into other airplanes as well.

In January 2007, the Company in a teaming arrangement with ABX Air received another STC from the FAA on its Flat Panel Display System for use on B-757 aircraft. Similar to the prior STC awarded by the FAA, this one provides B-757 operators with the same low cost, rapidly implemented retrofit of their cockpit avionics with a modern pilot and copilot suite of high resolution multi-color LCD flat panel displays.

Our cost of sales related to product is comprised of product material purchased through our supplier base and direct in-house assembly labor and overhead costs. Many of the components we use in assembling our products are standard, although certain parts are manufactured to meet our specifications. The overhead portion of cost of sales is primarily comprised of salaries and benefits, building occupancy, supplies, and outside service costs related to our production, purchasing, customer service, material control and quality departments as well as warranty costs.

Our cost of sales related to Engineering-modification & development is comprised of engineering labor, consulting services and other cost associated with specific design and development projects.

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We continue to invest in the development of new products and the enhancement of our existing product line. We expense research and development costs related to future product development as they are incurred.

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Our selling, general, and administrative expenses consist of marketing and business development expenses, professional expenses, salaries and benefits for executive and administrative personnel, facility costs, recruiting, legal, accounting, and other general corporate expenses.

#### **Reclassification**

The balance sheet as of September 30, 2006 presented has been reclassified to include the \$100,000 optional first-year pay down as long-term debt. For fiscal year 2006, the impact of the reclassification was a decrease to current portion of notes payable of \$100,000 and a corresponding increase to long-term notes payable of \$100,000. The reclassification does not have a significant impact on working capital and has no impact on the financial covenants associated with the notes payable agreement as the lender suspended the existing covenants through the fiscal quarter ending on June 30, 2008. The Company believes that it will be in compliance with all covenants at June 30, 2008.

#### **Three Months Ended June 30, 2007 Compared to the Three Months Ended June 30, 2006**

*Net sales.* Net sales increased \$2.8 million, or 93%, to \$5.8 million for the three months ended June 30, 2007 from \$3.0 million in the three months ended June 30, 2006. For the three months ended June 30, 2007, product sales increased \$1.1 million and Engineering-modification and development (EMD) sales increased \$1.7 million quarter over quarter. The increase in product sales was mostly the result of higher U.S. Government equipment deliveries coupled with flat panel deliveries on the Pilatus airplane. The increase in EMD sales reflects the accelerated work being performed on the Eclipse airplane.

*Cost of sales.* Cost of sales increased \$1.9 million or 112%, to \$3.6 million, or 62% of net sales in the three months ended June 30, 2007 from \$1.7 million, or 56 % of net sales in the three months ended June 30, 2006. The overall dollar increases consist of an increase of \$0.4 million in cost of sales related to product sales and an increase of \$1.5 million related to EMD sales. Both the dollar and percentage increase in cost of sales is primarily the result of a higher proportion of EMD sales in the quarter. EMD profit margins are usually lower than product sales.

*Research and development.* Research and development expense decreased \$0.6 million or 35% to \$1.1 million or 19% of net sales in the three months ended June 30, 2007 from \$1.7 million or 57% of net sales in the three months ended June 30, 2006. The decrease in research and development expense in the quarter was mainly due to allocating \$1.6 million of research and development expense to EMD cost of sales. The allocation was necessary to match non recurring engineering cost with corresponding non-recurring engineering sales in the period. Overall, engineering, research and development cost have increased \$0.9 million period over period and reflects the Company's continued commitment to product development, research and engineering.

*Selling, general, and administrative.* Selling, general, and administrative expenses increased \$1.6 million, or 64%, to \$4.1 million, or 71% of net sales in the three months ended June 30, 2007 from \$2.5 million or 83% of net sales in the three months ended June 30, 2006. The increase in the dollar amount was primarily the result of \$1.7 million of legal fees in the quarter that the Company incurred in connection with litigation related to protecting its Intellectual Property.

*Interest income.* Interest income was \$781,000 in the three months ended June 30, 2007 as compared \$849,000 in the three months ended June 30, 2006. The decrease in interest income was primarily the result of our reduced average cash balance in the current quarter as opposed to the prior year. Last year, in the quarter ended June 30, 2006 the Company purchased 310,900 shares of its stock at a cost of \$4.3 million.

*Interest expense.* Interest expense was \$52,000 in the three months ended June 30, 2007 as compared to \$50,000 in the three months ended June 30, 2006. The increase in interest expense in the three months ended June 30, 2007 was primarily the result of higher interest rates in the period.

*Income tax benefit.* The income tax benefit for the three months ended June 30, 2007 and 2006 was \$1.0 million.

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The effective tax rate for the three months ended June 30, 2007 was a benefit of 43%. The effective tax rate for the three months ended June 30, 2006 was a benefit of 45%. In each quarter the effective tax rate differs primarily from the statutory rate due to the utilization of research and experimentation tax credits carried back to prior periods as well as the expiration of the statute of limitations related to certain tax reserves released during the third quarter.

*Net loss.* As a result of the factors described above, our net loss in the three months ended June 30, 2007 was \$1.3 million, an increase of \$0.1 million from the net loss of \$1.2 million for the three months ended June 30, 2006.

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**Nine Months Ended June 30, 2007 Compared to the Nine Months Ended June 30, 2006**

*Net sales.* Net sales increased \$1.1 million, or 9%, to \$13.2 million for the nine months ended June 30, 2007 from \$12.1 million in the nine months ended June 30, 2006. EMD sales were up \$2.3 million reflecting accelerated work being performed on the Eclipse airplane program. The decrease of \$1.2 million in product sales reflects the completion (in the 3<sup>rd</sup> quarter of FY 2006) of C-130 retrofit business with the Canadian Department of National Defense.

*Cost of sales.* Cost of sales increased \$2.1 million or 32%, to \$8.7 million, or 66% of net sales in the nine months ended June 30, 2007 from \$6.6 million, or 54 % of net sales in the nine months ended June 30, 2006. The overall dollar increases consist of a decrease of \$0.1 million in cost of sales related to product sales and an increase of \$2.2 million related to EMD sales. Both the dollar and percentage increase in cost of sales is primarily the result of a higher proportion of EMD sales in the year-to-date period. EMD profit margins are usually lower than product sales.

*Research and development.* Research and development expenses decreased \$1.2 million or 24% to \$3.9 million or 30% of net sales in the nine months ended June 30, 2007 from \$5.1 million or 42% of net sales in the nine months ended June 30, 2006. The decrease in research and development expense in the period was primarily the result of allocating \$2.2 million of research and development expense to EMD cost of sales. The allocation was necessary to match non recurring engineering cost with corresponding non-recurring engineering sales in the period. Overall, engineering, research and development cost have increased \$1.0 million year over year and reflects the Company's continued commitment to product development, research and engineering.

*Selling, general, and administrative.* Selling, general, and administrative expenses increased \$4.5 million, or 68%, to \$11.1 million, or 84% of net sales in the nine months ended June 30, 2007 from \$6.6 million or 55% of net sales in the nine months ended June 30, 2006. The increase in the dollar amount was primarily the result of an increase of \$4.5 million of legal fees in the nine months ended June 30, 2007 that the Company incurred in connection with litigation relating to protecting its Intellectual Property.

*Interest income.* Interest income was \$2.4 million in the nine months ended June 30, 2007 and June 30, 2006. Higher interest rates have offset our reduced cash position and enabled us to maintain consistent interest income in the current period.

*Interest expense.* Interest expense was \$153,000 in the nine months ended June 30, 2007 as compared to \$138,000 in the nine months ended June 30, 2006. The increase in interest expense was primarily the result of higher interest rates in the period.

*Income tax benefit.* The income tax benefit for the nine months ended June 30, 2007 was \$3.5 million as compared to a \$2.0 million benefit for the nine months ended June 30, 2006. The increase in the amount of tax benefit was due to recording a larger loss before taxes for the nine months ended June 30, 2007 as compared to June 30, 2006.

The effective tax rate for the nine months ended June 30, 2007 was a benefit of 42%. The effective tax rate for the nine months ended June 30, 2006 was a benefit of 50%. In each quarter the effective tax rate differs from the statutory rate primarily due to the utilization of research and experimentation tax credits carried back to prior periods as well as the expiration of the statute of limitations related to certain tax reserves released during the third quarter.

In December of 2006, an additional two-year extension of the Research and Experimentation (R&E) Tax Credit was enacted into law. This retroactive extension is for amounts paid or incurred after March 31, 2005, and before January 1, 2008. The entire impact of this retroactive extension has been recognized in the nine months ended June 30, 2007, as required by SFAS 109, Accounting for Income Taxes.

*Net loss.* As a result of the factors described above, our net loss in the nine months ended June 30, 2007 was \$4.8 million, an increase of \$2.8 million from net loss of \$2.0 million for the nine months ended June 30, 2006.

**Liquidity and Capital Resources**

Our main source of liquidity has been cash flows from prior operations. We require cash principally to finance inventory, accounts receivable and payroll.

Our cash used in operating activities was \$3.7 million for the nine months ended June 30, 2007 as compared to cash provided from operating activities of \$2.1 million for the nine months ended June 30, 2006. The decrease was due primarily to higher net loss (\$2.9 million) and increased prepaid expenses (\$4.5 million) which were partially offset by increased accounts payable (\$3.3 million) and increased accrued expense (\$1.2 million).

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Our cash used in investing activities was \$3.1 million for the nine months ended June 30, 2007. This consisted of spending \$2.5 million on licensing fees and \$0.6 million for production and laboratory test equipment. Cash used in investing activities was \$627,000 for the nine months ended June 30, 2006 and primarily consisted of production certification, production equipment and, laboratory test equipment.

Net cash flow provided from financing activities was \$0.6 million for the nine months ended June 30, 2007 as compared to cash used in financing activities of \$17.9 million in the nine months ended June 30, 2006. In both periods the primary source of cash was from proceeds from the exercise of stock options. The primary use of cash for financing activities for the nine months ended June 30, 2006 was attributable to the Company purchasing 1,272,510 shares of our stock at a total cost of \$18.1 million.

The Company entered into a \$4,335,000 loan agreement dated August 1, 2000 with the Chester County, Pennsylvania Industrial Development Authority. The purpose of the loan was to fund the construction of the Company's new office and manufacturing facility. The loan matures in 2015 and carries an interest rate set by the remarketing agent that is consistent with 30-day tax-exempt commercial paper. The loan agreement requires the Company to maintain certain financial covenants including a ratio of liabilities to earnings before interest, taxes and depreciation and amortization (EBITDA), a fixed charge ratio and a minimum tangible net worth.

As of June 30, 2006, the Company was in violation of these financial covenants. The defaults were subsequently waived and an amendment to the agreement was entered into with the lender whereby the existing covenants were suspended until the fiscal quarter ending on June 30, 2008. The Company believes that it will be in compliance with all covenants at June 30, 2008.

Our future capital requirements depend on numerous factors, including market acceptance of our products, the timing and rate of expansion of our business, acquisitions, joint ventures and other factors. We have experienced increases in our expenditures since our inception consistent with growth in our operations, personnel and product line, and we anticipate that our expenditures will continue to increase in the foreseeable future. We believe that our cash and cash equivalents will provide sufficient capital to fund our operations for at least the next twelve months. However, we may need to raise additional funds through public or private financings or other arrangements in order to support more rapid expansion of our business than we now anticipate either through acquisitions or organic growth. Further, we may need to develop and introduce new or enhanced products, respond to competitive pressures, invest in or acquire businesses or technologies or 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, we may not be able to introduce new products or compete effectively in any of our markets, which could hurt our business.

### **Backlog**

As of June 30, 2007 and 2006, our backlog was \$72.7 million and \$34.3 million, respectively. The period over period increase in backlog principally reflects the increase in Flat Panel Display System orders. The Flat Panel Display System component as of June 30, 2007 is \$65.2 million, an increase of \$43.1 million over the June 30, 2006 balance of \$22.1 million. The current backlog is expected to fully liquidate over the next four fiscal years.

### **Critical Accounting Policies**

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, disclosure of contingent assets and liabilities at the date of the financial statements and the reported amount of revenues and expenses during the reporting period. The Company's most critical accounting policies are revenue recognition, income taxes, inventory valuation, share-based compensation and warranty reserves.

#### *Revenue recognition*

The Company recognizes revenue under the provisions of Staff Accounting Bulletin (SAB) No. 104, Revenue Recognition (SAB 104).

The Company enters into certain sales arrangements that include multiple deliverables as defined in EITF Issue No. 00-21, Revenue Arrangements with Multiple Deliverables. The Company identifies all goods and/or services that are to be delivered separately under a sales arrangement and allocates revenue to each deliverable based on fair value. In general, revenues are separated between product sales and EDM sales. The allocated revenue for each deliverable is then recognized using appropriate revenue recognition methods.

The Company accounts for transactions with software that is more than incidental to the products under SOP 97-2, Software Revenue Recognition and EITF Issue 03-5, Applicability of AICPA Statement of Position 97-2, Software Revenue Recognition, to Non-Software Deliverables in an Arrangement Containing More-Than-Incidental Software. Accordingly, revenue is recognized when all of the following criteria are met: 1) there is persuasive evidence that an arrangement exists; 2) delivery has occurred or services have been rendered; 3) the seller's price to the buyer is fixed or determinable; and 4) collectibility is reasonably assured.



Sales related to certain long-term contracts requiring development and delivery of products over several accounting periods are accounted for under the American Institute of Certified Public Accountants (AICPA) Statement of Position (SOP) 81-1, Accounting for Performance of Construction-Type and Certain Production-Type Contracts. We consider the nature of these contracts as well as the types of products and services provided when determining the appropriate accounting treatment for a particular contract. Certain long-term contracts are recorded on a percentage of completion basis using cost-to-cost methodology to measure progress towards completion.

The Company offers its customers extended warranties for additional fees. These warranty sales are recorded as deferred revenue and recognized as sales on a straight-line basis over the warranty period.

#### *Income taxes*

Income taxes are recorded in accordance with SFAS No. 109, Accounting for Income Taxes. Provisions for federal and state income taxes are calculated on reported financial statement pre-tax income based on current tax law. The Company recognizes deferred tax assets and liabilities for temporary differences between the financial reporting basis and the tax basis of the Company's assets and liabilities and expected benefits of utilizing net operating loss carryforwards. The impact on deferred taxes of changes in tax rates and laws, if any, applied to the years during which temporary differences are expected to be settled, are reflected in the consolidated financial statements in the period of enactment.

#### *Inventories*

Inventories are written down for estimated obsolescence equal to the difference between the cost of inventory and the estimated net realizable value based upon assumptions about future market conditions. If actual future demand or market conditions are less favorable than those projected by management, additional inventory write-downs may be required.

#### *Share-based compensation*

Effective October 1, 2005 the Company adopted the provisions of SFAS 123R, using the modified prospective approach and now accounts for share-based compensation applying the fair value method for expensing stock options. Accordingly, the adoption of SFAS 123R's fair value method results in compensation costs for the Company's 1998 Stock Option Plan.

#### *Warranty reserves*

We offer warranties on some products of various lengths. At the time of shipment, we establish a reserve for the estimated cost of warranties based on our best estimate of the amounts necessary to settle future and existing claims using historical data on products sold as of the balance sheet date. The length of the warranty period, the product's failure rates and the customer's usage affects warranty cost. If the actual cost of warranties differs from our estimated amounts, future results of operations could be adversely affected.

### **Business Segments**

We operate in one principal business segment which designs, manufactures and sells flight information computers, flat panel displays and advanced monitoring systems to the Department of Defense, government agencies, commercial air transport carriers and corporate/general aviation markets. We currently derive virtually all our net sales from the sale of this equipment. Almost all of the net sales, operating results and identifiable assets are in the United States.

### **New Accounting Pronouncements**

In September 2006, the Financial Accounting Standards Board (FASB) issued SFAS No. 157, Fair Value Measurements (SFAS 157). SFAS 157 defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles, and expands disclosures about fair value measurements. This statement does not require any new fair value measurements; however, the application of this Statement may change current practice for some entities. SFAS 157 is effective for fiscal years beginning after November 15, 2007. The Company is currently evaluating the impact of this pronouncement.

In September 2006, the Securities and Exchange Commission issued Staff Accounting Bulletin 108, Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements (SAB 108). SAB 108 provides guidance on how prior year misstatements should be taken into consideration when quantifying misstatements in current year financial statements for purposes of determining whether the current year's financial statements are materially misstated. SAB 108 is effective for the first fiscal year ending after November 15, 2006. The Company has evaluated the impact of the adoption of this interpretation and does not believe that the adoption of the SAB 108 will have a material impact on the Company's financial





position or results of operations.

In July 2006, the FASB issued FASB Interpretation 48, *Accounting for Uncertainty in Income Taxes* an interpretation of FASB Statement No. 109 ( FIN 48 ). FIN 48 clarifies the accounting for uncertainty in income taxes recognized in an enterprise's financial statements in accordance with FASB Statement No. 109, *Accounting for Income Taxes*. This Interpretation prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. This Interpretation also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure, and transition. FIN 48 is effective for fiscal years beginning after December 15, 2006. The Company is currently evaluating the impact of this pronouncement.

#### FORWARD-LOOKING STATEMENTS

This Form 10-Q contains statements, which, to the extent that they are not recitations of historical fact, constitute forward-looking statements within the meaning of the Securities Act of 1933 and the Securities Exchange Act of 1934. The words anticipate, believe, estimate, expect, intend, may, plan, outlook, would, should, guidance, potential, continue, project, forecast and similar expressions are intended to identify forward-looking statements. Forward-looking statements are not guarantees of future performance and involve risks, uncertainties and assumptions, which are difficult to predict. Therefore, actual outcomes and results may differ materially from what is expressed or implied by these statements. Numerous factors, including potentially the following factors, could affect the Company's forward-looking statements and actual performance:

- continued market acceptance of our air data systems products;
- the ability to obtain future contracts and awards;
- the availability of government funding and customer requirements;
- difficulties in developing and producing our flat panel display systems, or COCKPIT/IP™, or other planned products or product enhancements;
- market acceptance of our COCKPIT/IP™ system or other planned products or product enhancements;
- our ability to gain regulatory approval of our products in a timely manner;
- delays in receiving components from third party suppliers;
- the competitive environment;
- the termination of programs or contracts for convenience by customers;
- failure to retain key personnel;
- new product offerings from competitors;
- potential future acquisitions;
- protection of intellectual property rights;
- our ability to service the international market, and
- other factors disclosed from time to time in our filings with the Securities and Exchange Commission.

Readers are cautioned not to place undue reliance on these forward-looking statements, which speak only as of the date of this Form 10-Q. The Company does not undertake any obligation to publicly release any revisions to these forward-looking statements to reflect events,

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circumstances or changes in expectations after the date of this Form 10-Q, or to reflect the occurrence of unanticipated events. The forward-looking statements in this document are intended to be subject to the safe harbor protection provided by Sections 27A of the Securities Act and 21E of the Exchange Act.

For a discussion identifying some important factors that could cause actual results to vary materially from those anticipated in the forward-looking statements, see the Company's Securities and Exchange Commission filings including, but not limited to, the

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discussions of Risk Factors contained in the Company's Annual Report on Form 10-K for the fiscal year ended September 30, 2006.

**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 and an industrial revenue bond. The Company's cash equivalents consist of funds invested in money market accounts, which bear interest at a variable rate, while the industrial revenue bond carries an interest rate that is consistent with 30-day, tax-exempt commercial paper. As the interest rates are variable, and we do not engage in hedging activities, a change in interest rates earned on the cash equivalents or paid on the industrial revenue bond would impact interest income and expense along with cash flows, but would not impact the fair market value of the related underlying instruments.

**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, or CEO, and Chief Financial Officer, or CFO, of the effectiveness of the Company's disclosure controls and procedures, as such term is defined under Rule 13a-15e under the Securities Exchange Act of 1934, as amended (the Exchange Act) as of June 30, 2007. 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 Securities and Exchange Commission 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.

(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 has materially affected, or is reasonably likely to materially affect, the Company's internal control over financial reporting.

**PART II OTHER INFORMATION**

**Item 1. Legal Proceedings**

On September 13, 2005, the Company filed a lawsuit in the United States District Court for the Western District of Tennessee against J2, Inc., a company founded and jointly owned by Joseph Caesar, a former employee of the Company; James Zachary, a former sales consultant for the Company. The complaint alleged that the J2/Kollsman Air Data Computer then being marketed by J2 and manufactured by Kollsman, Inc., infringed a patent assigned to ISS. After additional information regarding the activities of Caesar and Zachary during the development of the J2/Kollsman Air Data Computer, the Company added to its complaint claims of trade secret misappropriation, breach of contract, and breach of fiduciary duty, based on the Company's belief that confidential and proprietary ISS information, including trade secret information, had been used in the development and marketing of the J2/Kollsman Air Data Computer. On January 31, 2006, Kollsman, Inc., and Caesar and Zachary, as individuals, were added to the lawsuit as defendants. On July, 7, 2006, the complaint was amended to add Zachary Technologies, Inc., a company founded and owned by Zachary. Discovery in this suit is now complete and dispositive motions have been filed. The case is set for trial in October 2007.

On January 17, 2007, the Company filed suit in Pennsylvania state court against Fred Strathman, a former software consultant for ISS, alleging that Strathman had improperly used ISS trade secret and proprietary information in assisting J2 and Kollsman in developing the J2/Kollsman Air Data Computer. Mr. Strathman has not yet answered the complaint in the Pennsylvania state court suit against him.

Through June 30, 2007 and 2006, the Company had incurred approximately \$4.5 million and \$1.8 million, respectively in legal fees in connection with the two matters described above.

**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, 2006.

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

None

**Item 3. Defaults upon Senior Securities**

None

**Item 4. Submission of Matters to a Vote of Security Holders**

None

**Item 5. Other Information**

None

**Item 6. Exhibits**

(a) Exhibits

31.1 Certification of Chief Executive Officer Pursuant to Rule 13a-14(a)

31.2 Certification of Chief Financial Officer Pursuant to Rule 13a-14(a)

32.1 Certification Pursuant to U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

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**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 thereunto duly authorized.

**INNOVATIVE SOLUTIONS AND SUPPORT, INC.**

Date: August 8, 2007

By: /s/ JAMES J. REILLY  
JAMES J. REILLY  
CHIEF FINANCIAL OFFICER

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