

INNOVATIVE SOLUTIONS & SUPPORT INC
Form 10-Q
August 07, 2009
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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, 2009

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

19341

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(Address of principal executive offices)

(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 day. Yes No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§ 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 No

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

Large accelerated filer

Accelerated filer

Non-accelerated filer

Smaller reporting company

(Do not check if a smaller reporting company)

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

As of August 3, 2009, there were 16,736,329 shares of the Registrant's Common Stock, with par value of \$.001 per share, outstanding.

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INNOVATIVE SOLUTIONS AND SUPPORT, INC.

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| | June 30, | | September 30, 2008 |
|--|-----------------|----|---------------------------|
| | 2009 | | |
| <u>ASSETS</u> | | | |
| Current Assets: | | | |
| Cash and cash equivalents | \$ 39,307,938 | \$ | 35,031,932 |
| Accounts receivable, net | 4,747,604 | | 4,218,443 |
| Inventories | 5,495,720 | | 9,361,257 |
| Deferred income taxes | 326,969 | | 414,636 |
| Prepaid expenses and other current assets | 1,307,003 | | 1,406,260 |
| Total current assets | 51,185,234 | | 50,432,528 |
| Property and equipment, net | 8,605,705 | | 8,958,346 |
| Other assets | 477,784 | | 505,840 |
| Total assets | \$ 60,268,723 | \$ | 59,896,714 |
| <u>LIABILITIES AND SHAREHOLDERS' EQUITY</u> | | | |
| Current Liabilities: | | | |
| Current portion of capitalized lease obligations | \$ 9,908 | \$ | 9,908 |
| Accounts payable | 1,016,477 | | 2,349,981 |
| Accrued expenses | 2,403,137 | | 5,130,463 |
| Deferred revenue | 180,309 | | 450,923 |
| Total current liabilities | 3,609,831 | | 7,941,275 |
| Note payable | 4,335,000 | | 4,335,000 |
| Long-term portion of capitalized lease obligations | 29,717 | | 37,633 |
| Deferred revenue | 73,818 | | 114,075 |
| Deferred income taxes | 326,969 | | 414,636 |
| Other liabilities | 226,074 | | 249,969 |
| Total liabilities | 8,601,409 | | 13,092,588 |
| 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, 2009 and September 30, 2008 | | | |
| Common stock, \$.001 par value: 75,000,000 shares authorized, 18,197,779 and 18,177,024 shares issued at June 30, 2009 and September 30, 2008, respectively | | | |
| | 18,198 | | 18,177 |
| Additional paid-in capital | 46,316,149 | | 45,767,960 |
| Retained earnings | 24,575,843 | | 20,152,615 |
| Treasury stock, at cost, 1,470,510 and 1,445,510 shares at June 30, 2009 and September 30, 2008, respectively | (19,242,876) | | (19,134,626) |

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| | | | | |
|--|----|------------|----|------------|
| Total shareholders' equity | | 51,667,314 | | 46,804,126 |
| Total liabilities and shareholders' equity | \$ | 60,268,723 | \$ | 59,896,714 |

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, | | Nine months ended June 30, | |
|--|-----------------------------|----------------|----------------------------|-----------------|
| | 2009 | 2008 | 2009 | 2008 |
| Net sales: | | | | |
| Product | \$ 6,645,822 | \$ 7,178,212 | \$ 24,900,246 | \$ 17,290,973 |
| Engineering - modification and development | 1,113,478 | 1,573,097 | 3,900,126 | 3,020,343 |
| Total net sales | 7,759,300 | 8,751,309 | 28,800,372 | 20,311,316 |
| Cost of sales: | | | | |
| Product | 3,302,823 | 3,850,657 | 13,213,569 | 10,331,738 |
| Engineering - modification and development | 318,222 | 717,646 | 880,262 | 1,686,285 |
| Total cost of sales | 3,621,045 | 4,568,303 | 14,093,831 | 12,018,023 |
| Gross profit | 4,138,255 | 4,183,006 | 14,706,541 | 8,293,293 |
| Operating expenses: | | | | |
| Research and development | 1,287,397 | 3,221,698 | 4,178,585 | 7,738,942 |
| Selling, general and administrative | 1,840,571 | 3,282,183 | 6,471,958 | 13,952,535 |
| Asset impairment | | 2,475,000 | | 2,475,000 |
| Total operating expenses | 3,127,968 | 8,978,881 | 10,650,543 | 24,166,477 |
| Operating income (loss) | 1,010,287 | (4,795,875) | 4,055,998 | (15,873,184) |
| Interest income | 62,594 | 284,079 | 360,907 | 1,315,219 |
| Interest expense | (19,798) | (33,064) | (74,513) | (122,183) |
| Other income | | | 50,073 | 300,000 |
| Income (loss) before income taxes | 1,053,083 | (4,544,860) | 4,392,465 | (14,380,148) |
| Income tax expense (benefit) | (199,228) | (255,989) | (30,762) | 1,090,821 |
| Net income (loss) | \$ 1,252,311 | \$ (4,288,871) | \$ 4,423,227 | \$ (15,470,969) |
| Net income (loss) per common share: | | | | |
| Basic | \$ 0.07 | \$ (0.25) | \$ 0.26 | \$ (0.92) |
| Diluted | \$ 0.07 | \$ (0.25) | \$ 0.26 | \$ (0.92) |
| Weighted average shares outstanding: | | | | |
| Basic | 16,727,269 | 16,893,499 | 16,727,269 | 16,897,313 |
| Diluted | 16,750,308 | 16,893,499 | 16,746,631 | 16,897,313 |

The accompanying notes are an integral part of these statements.

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INNOVATIVE SOLUTIONS AND SUPPORT, INC.

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(unaudited)

| | For the Nine Months Ended June 30, | |
|--|------------------------------------|-----------------|
| | 2009 | 2008 |
| CASH FLOWS FROM OPERATING ACTIVITIES: | | |
| Net income (loss) | \$ 4,423,227 | \$ (15,470,969) |
| Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities: | | |
| Depreciation and amortization | 767,849 | 761,666 |
| Share-based compensation expense: | | |
| Stock options | 395,006 | 809,792 |
| Nonvested stock awards | 150,110 | 149,940 |
| Tax benefit from share-based arrangements: | | |
| Stock options | | 12,491 |
| Nonvested stock awards | 3,094 | 6,286 |
| (Gain) loss on disposal of property and equipment | 260 | (3,000) |
| Excess and obsolete inventory expense | 666,580 | 78,913 |
| Asset Impairment | | 2,475,000 |
| Deferred income taxes | | 1,227,955 |
| (Increase) decrease in: | | |
| Accounts receivable | (529,160) | 1,285,003 |
| Inventories | 3,198,957 | (1,669,066) |
| Prepaid expenses and other current assets | 98,247 | 4,933,932 |
| Other non current assets | (74,534) | (6,180) |
| Increase (decrease) in: | | |
| Accounts payable | (1,402,254) | (1,135,941) |
| Accrued expenses | (2,032,173) | (976,452) |
| Income taxes payable | (718,039) | |
| Deferred revenue | (310,871) | (218,236) |
| Other non current liabilities | | 223,893 |
| Net cash provided by (used in) operating activities | 4,636,299 | (7,514,973) |
| CASH FLOWS FROM INVESTING ACTIVITIES: | | |
| Purchases of property and equipment | (244,127) | (536,532) |
| Proceeds on sale of property and equipment | | 3,000 |
| Net cash used in investing activities | (244,127) | (533,532) |
| CASH FLOWS FROM FINANCING ACTIVITIES: | | |
| Proceeds from exercise of stock options | | 32,873 |
| Purchase of treasury shares | (108,250) | (57,178) |
| Repayment of capitalized lease obligations | (7,916) | (7,372) |
| Net cash (used in) provided by financing activities | (116,166) | (31,677) |
| Net increase (decrease) in cash and cash equivalents | 4,276,006 | (8,080,182) |
| Cash and cash equivalents, beginning of period | 35,031,932 | 49,151,078 |
| Cash and cash equivalents, end of period | \$ 39,307,938 | \$ 41,070,896 |
| SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION | | |
| Cash paid for interest | \$ 44,488 | \$ 92,066 |
| Cash paid for income tax | \$ 704,486 | \$ 9,073 |

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| | | | | |
|---|----|--------|----|-----------|
| Cash received from income tax refunds | \$ | 25,115 | \$ | 5,107,269 |
| <i>Noncash Investing Activities:</i> | | | | |
| Accrual for purchases of property and equipment | \$ | 68,750 | \$ | |

The accompanying notes are an integral part of these statements.

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**Innovative Solutions and Support Inc.
Notes to Condensed Consolidated Financial Statements**

(Unaudited)

1. Summary of Significant Accounting Policies

Description of the Company

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.

Basis of Presentation

The accompanying unaudited condensed consolidated financial statements are presented pursuant to the rules and regulations of the United States Securities and Exchange Commission in accordance with the disclosure requirements for the quarterly report on Form 10-Q and therefore do not include all of the information and footnotes required by generally accepted accounting principles for complete annual financial statements. In the opinion of Company management, the unaudited condensed consolidated financial statements reflect all adjustments (consisting of normal recurring adjustments) necessary to fairly state the results for the interim periods presented. The condensed consolidated balance sheet as of September 30, 2008 is derived from audited financial statements. Operating results for the three and nine months ended June 30, 2009 are not necessarily indicative of the results that may be expected for the fiscal year ending September 30, 2009. These unaudited condensed consolidated financial statements should be read in conjunction with the audited consolidated financial statements and notes of the Company included in the Company's Annual Report on Form 10-K/A for the fiscal year ended September 30, 2008.

Our condensed consolidated financial statements include the accounts of our wholly-owned subsidiaries. All intercompany balances and transactions have been eliminated in consolidation.

Use of Estimates

Preparation of consolidated financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect reported amounts of assets and liabilities, and disclosure of contingent assets and liabilities, as of the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ materially from those estimates.

Cash and Cash Equivalents

Highly liquid investments purchased with an original maturity of three months or less are classified as cash equivalents. Cash equivalents at June 30, 2009 and September 30, 2008 consist of funds invested in money market accounts with financial institutions.

Property and Equipment

Property and equipment is stated at cost. Depreciation is provided using an accelerated method over estimated useful lives of the assets (the lesser of three to seven years or over the lease term), except for the airplane and manufacturing facility, which are depreciated using the straight-line method over estimated useful lives of ten years and thirty-nine years, respectively. Major additions and improvements are capitalized, while maintenance and repairs that do not improve or extend the life of assets are charged to expense as incurred.

Long-Lived Assets

The Company assesses the impairment of long-lived assets in accordance with Statement of Financial Accounting Standards (SFAS) No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets* (SFAS 144). This statement requires that long-lived assets be reviewed for impairment whenever events or changes in circumstances indicate the carrying amount of an asset may not be recoverable. In addition, long-lived assets to be disposed of should be reported at the lower of the carrying amount or fair value less cost to sell. The Company considers historical performance and future estimated results in its evaluation of potential impairment and then compares the carrying amount of the asset to estimated future cash flows expected to result from use of the asset. If the carrying amount of the asset exceeds the estimated expected undiscounted future cash flows, the Company measures the amount of the impairment by comparing the carrying amount of the asset to its fair value. The estimation of fair value is generally measured by discounting expected future cash flows. No impairment charges were recorded during the nine months ended June 30, 2009.

During the nine months ended June 30, 2008 the Company recorded an asset impairment of \$2.5 million, the full carrying value of the asset. The impairment was related to previously acquired engineering software which is no longer part of the Company's product offering and will generate no future cash flows.

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Revenue Recognition

The Company enters into sales arrangements with customers that, in general, provide for the Company to design, develop, manufacture and deliver flight information computers, large flat-panel displays, and advanced monitoring systems that measure and display critical flight information, including data relative to aircraft separation, airspeed, and altitude, as well as engine and fuel data measurements. The Company's sales arrangements may include multiple deliverables as defined in Emerging Issues Task Force (EITF) Issue No. 00-21, *Revenue Arrangements with Multiple Deliverables* (EITF 00-21), which typically include design and engineering services and the production and delivery of the flat panel display and related components.

Multiple Element Arrangements -

The Company identifies all goods and/or services that are to be delivered separately under such a sales arrangement and allocates revenue to each deliverable (if more than one) based on that deliverable's fair value. The Company then considers the appropriate recognition method for each deliverable; deliverables under multiple element arrangements are typically purchased engineering and design services and product sales. To the extent that an arrangement contains defined design and development activities as an identified deliverable in addition to products (resulting in a multiple element arrangement), the Company recognizes as Engineering Modification and Development (EMD) revenue amounts earned during the design and development phase of the contract following the guidance included in the American Institute of Certified Public Accountants (AICPA) Statement of Position 81-1, *Accounting for Performance of Construction-Type and Certain Production-Type Contracts* (SOP 81-1). To the extent that multiple element arrangements include product sales, revenue is generally recognized once revenue recognition criteria for the product deliverable has been met based on the provisions of Staff Accounting Bulletin No. 104, *Revenue Recognition* (SAB 104).

Single Element Arrangements

Products -

To the extent that a single element arrangement provides for product sales and repairs, revenue is generally recognized once revenue recognition criteria for the product deliverable has been met based on the provisions of SAB 104. The Company also receives orders for existing equipment and parts. Revenue from the sale of such products is generally recognized upon shipment to the customer.

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.

Engineering Services -

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The Company also may enter into service arrangements to perform specified design and development services related to its products. The Company recognizes revenue from these arrangements as EMD revenue, following the guidance included in SOP 81-1. The Company considers the nature of these service arrangements (including term, size of contract, level of effort) when determining the appropriate accounting treatment for a particular contract. The Company recognizes the revenue from these contracts using either the percentage-of-completion method or completed contract method of accounting.

The Company records revenue relating to these contracts using the percentage-of-completion method when the Company determines that progress toward completion is reasonable and reliably estimable and the contract is long-term in nature; the Company uses the completed contract method for all others.

Warranty

Estimated cost to repair or replace products under warranty is provided when sales of product are recorded.

Income Taxes

Income taxes are recorded in accordance with SFAS No. 109, *Accounting for Income Taxes* (SFAS 109), which principally utilizes a balance sheet approach to provide for income taxes. Under this method, 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. 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. A valuation allowance is established when it is more likely than not that all or a portion of a deferred tax asset will not be realized. The Company files a consolidated United States federal income tax return (see Note 3).

Effective October 1, 2007 (the first day of fiscal 2008), the Company adopted Financial Accounting Standards Board (FASB) Interpretation No. 48, *Accounting for Uncertainty in Income Taxes* (FIN 48). FIN 48 prescribes a comprehensive model for how a company should recognize, measure, present and disclose in its financial statements uncertain tax positions that the company has taken

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or expects to take on a tax return. The Company has elected to record any interest or penalties from the uncertain tax position as income tax expense.

Research and Development

Research and development charges incurred for product design, product enhancements and future product development are expensed as incurred. Product development and design charges incurred related to a specific customer agreement that are billable are capitalized and then charged to cost of sales engineering modification and development as the revenue related to the agreements are recognized.

Comprehensive Income

Pursuant to SFAS No. 130, *Reporting Comprehensive Income*, the Company is required to classify items of other comprehensive income by their nature in a financial statement and display the accumulated balance of other comprehensive income separately from retained earnings and additional paid-in capital in the equity section of our condensed consolidated balance sheets. Through June 30, 2009, comprehensive income consists of net income and there were no items of other comprehensive income for any of the periods presented.

Fair Value of Financial Instruments

The Company adopted SFAS No. 157, *Fair Value Measurements* (SFAS 157) in the first quarter of fiscal 2009 for financial assets and liabilities. This standard defines fair value as the price at which an asset could be exchanged in a current transaction between knowledgeable, willing parties. A liability's fair value is defined as the amount that would be paid to transfer the liability to a new obligor, not the amount that would be paid to settle the liability with the creditor.

Assets and liabilities measured at fair value are categorized based upon the level of judgment associated with the inputs used to measure their fair value. Hierarchical levels, defined by SFAS 157 and directly related to the amount of subjectivity associated with the inputs to fair valuation of these assets and liabilities, are as follows:

Level 1 Unadjusted quoted prices that are available in active markets for the identical assets or liabilities at the measurement date.

Level 2 Other observable inputs available at the measurement date, other than quoted prices included in Level 1, either directly or indirectly, including:

- Quoted prices for similar assets or liabilities in active markets;

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- Quoted prices for identical or similar assets in non-active markets;
- Inputs other than quoted prices that are observable for the asset or liability; and
- Inputs that are derived principally from or corroborated by other observable market data.

Level 3 Unobservable inputs that cannot be corroborated by observable market data and reflect the use of significant management judgment. These values are generally determined using pricing models for which the assumptions utilize management's estimates of market participant assumptions.

The following table sets forth by level within the fair value hierarchy the Company's financial assets and liabilities that were accounted for at fair value on a recurring basis as of June 30, 2009, according to the valuation techniques the Company used to determine their fair values.

| Fair Value Measurements on June 30, 2009 | | | |
|---|---|--|--|
| | Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |
| Assets | | | |
| Cash and cash equivalents: | | | |
| Money market funds | \$ 36,214,154 | \$ 0 | \$ 0 |

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Stock-Based Compensation

The Company accounts for stock-based compensation under SFAS No. 123 (revised 2004), *Share-Based Payment* (SFAS 123(R)). SFAS 123(R) requires the Company to measure the cost of employee services received in exchange for an award of equity instruments based on the grant-date fair value of the award using an option pricing model. That cost is recognized over the period during which an employee is required to provide service in exchange for the award.

Concentrations

Major Customers and Products

For the three months ended June 30, 2009, three of the Company's customers, American Airlines, the United States Department of Defense and Western Aircraft, accounted for 24%, 21% and 13% of net sales, respectively. During the nine months ended June 30, 2009, two of the Company's customers, American Airlines and the United States Department of Defense, accounted for 30% and 12% of net sales, respectively.

For the three months ended June 30, 2008, three of the Company's customers, Eclipse Aviation Corp. (Eclipse), Federal Express and American Airlines accounted for 44%, 15% and 14% of net sales, respectively. For the nine months ended June 30, 2008 Eclipse accounted for 52% of net sales.

Major Suppliers

The Company currently buys several of its components from single source suppliers. Although there are a limited number of manufacturers of particular components, management believes other suppliers could provide similar components on comparable terms.

During the three and nine months ended June 30, 2009 one supplier, ABX Air Inc., accounted for 30% and 31% of the Company's total inventory related purchases, respectively.

Concentration of Credit Risk

Financial instruments that potentially subject the Company to concentration of credit risk consist principally of cash balances and accounts receivable. The Company invests its excess cash where preservation of principal is the major consideration. The Company's customer base principally consists of companies within the aviation industry. The Company routinely requests advance payments from new customers.

The Company has maintained a reserve for doubtful accounts in the amount of \$0 and \$4.1 million, as of June 30, 2009 and September 30, 2008, respectively. The large balance in the reserve for doubtful accounts at September 30, 2008 was directly related to accounts receivable from Eclipse, a customer that filed for bankruptcy under Chapter 11 subsequent to the Company's fiscal year end. During the three months ended December 31, 2008 the Company wrote off the entire Eclipse receivable against the previously established reserve.

Recent Accounting Pronouncements

In September 2006, the 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 adoption did not have a material impact on the Company's financial statements.

In February 2008, the FASB issued FASB Staff Position (FSP) 157-2, *Effective Date of FASB Statement No. 157* which delays the effective date of SFAS 157 for nonfinancial assets and nonfinancial liabilities, except those that are recognized or disclosed at fair value on a recurring basis, at least annually, until fiscal years beginning after November 15, 2008, and interim periods within those fiscal years. The Company does not expect the adoption to have any impact on the Company's financial statements.

In December 2007, the FASB issued SFAS 160, *Noncontrolling Interests in Consolidated Financial Statements - Amendment of ARB No. 51* (SFAS 160). SFAS 160 establishes accounting and reporting standards for ownership interests in subsidiaries held by parties other than the parent, changes in a parent's ownership of a noncontrolling interest, calculation and disclosure of the consolidated net income attributable to the parent and the noncontrolling interest, changes in a parent's ownership interest while the parent retains its controlling financial interest and fair value measurement of any retained noncontrolling equity investment. SFAS 160 is effective for financial statements issued for fiscal years beginning after December 15, 2008 (the Company's fiscal year 2010). The Company does not expect the adoption to have any impact on its financial statements.

In May 2008, the FASB issued SFAS 162, *The Hierarchy of Generally Accepted Accounting Principles* (SFAS 162). This statement identifies the sources of accounting principles and the framework for selecting the principles to be used in the preparation of financial

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statements of nongovernmental entities that are presented in conformity with generally accepted accounting principles in the United States. This statement was effective on November 15, 2008.

In June 2008, the FASB issued FASB Staff Position EITF 03-6-1, *Determining Whether Instruments Granted in Share-Based Payment Transactions are Participating Securities* (FSP EITF 03-6-1). FSP EITF 03-6-1 requires that unvested stock-based compensation awards that contain non-forfeitable rights to dividends or dividend equivalents (whether paid or unpaid) should be classified as participating securities and should be included in the computation of earnings per share pursuant to the class method as described by SFAS 128, *Earnings per Share*. FSP EITF 03-6-1 is effective for financial statements issued for fiscal years beginning on or after December 15, 2008 and earlier adoption is prohibited. The Company will adopt FSP EITF 03-6-1 on October 1, 2010. The Company does not expect the adoption to have a material impact on its financial statements.

In May 2009, the FASB issued SFAS No. 165, *Subsequent Events* (SFAS 165). SFAS 165 establishes general accounting for and disclosure of events that occur after the balance sheet date but before financial statements are issued or available to be issued. This statement also outlines the circumstances under which an entity would need to record transactions occurring after the balance sheet date in the financial statements. These new disclosures identify the date through which the entity has evaluated subsequent events. SFAS 165 is effective for interim or annual financial periods ending after June 15, 2009. The Company adopted SFAS 165 and the adoption had no impact on the consolidated financial statements.

In June 2009, the FASB issued SFAS No. 168, *The FASB Accounting Standards Codification and the Hierarchy of Generally Accepted Accounting Principles* (SFAS 168). SFAS 168 replaces SFAS 162, *The Hierarchy of Generally Accepted Accounting Principles* and establishes the FASB Accounting Standards Codification as the source of authoritative accounting principles recognized by the FASB to be applied by nongovernmental entities in the preparation of financial statements in conformity with Generally Accepted Accounting Principles. SFAS 168 is effective for interim and annual periods ending after September 15, 2009. The Company adopted FAS 168 effective July 1, 2009, and will make the required disclosures beginning with the Company's annual report on Form 10-K for the fiscal period ending September 30, 2009.

2. Detail of Certain Balance Sheet Accounts*Inventories*

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

| | June 30, 2009 | September 30, 2008 |
|-----------------|------------------|-----------------------|
| Raw materials | \$ 3,389,403 | \$ 4,705,134 |
| Work-in-process | 965,066 | 3,046,451 |
| Finished goods | 1,141,251 | 1,609,672 |
| | \$ 5,495,720 | \$ 9,361,257 |

Prepaid expenses and other current assets

Prepaid expenses and other current assets consist of the following:

| | June 30, 2009 | | September 30, 2008 |
|-------------------------------------|--------------------------|-----------|-------------------------------|
| Revenue recognized not yet invoiced | \$ 741,115 | \$ | 747,789 |
| Prepaid insurance | 172,827 | | 248,799 |
| Deferred engineering costs | 105,517 | | |
| Other | 287,544 | | 409,672 |
| | \$ 1,307,003 | \$ | 1,406,260 |

Table of Contents***Property and equipment***

Property and equipment, net consists of the following balances:

| | June 30, 2009 | September 30, 2008 |
|---|--------------------------|-------------------------------|
| Computer equipment | \$ 2,012,793 | \$ 1,960,664 |
| Corporate airplane | 3,082,186 | 3,076,400 |
| Furniture and office equipment | 1,074,029 | 1,074,029 |
| Manufacturing facility | 5,579,486 | 5,576,536 |
| Test equipment | 4,105,229 | 3,918,698 |
| Land | 1,021,245 | 1,021,245 |
| | 16,874,968 | 16,627,572 |
| Less- Accumulated depreciation and amortization | (8,269,263) | (7,669,226) |
| | \$ 8,605,705 | \$ 8,958,346 |

Depreciation and amortization related to property and equipment was approximately \$227,000 and \$241,000 for the three months ended June 30, 2009 and 2008, respectively.

Depreciation and amortization related to property and equipment was approximately \$665,000 and \$728,000 for the nine months ended June 30, 2009 and 2008, respectively.

Other assets

Other assets consist of the following:

| | June 30, 2009 | September 30, 2008 |
|--|--------------------------|-------------------------------|
| Intangible assets, net of accumulated amortization of \$192,540 and \$89,950 at June 30, 2009 and September 30, 2008, respectively | \$ 186,460 | \$ 289,050 |
| Installation kits | 118,660 | 118,660 |
| Other | 172,664 | 98,130 |
| | \$ 477,784 | \$ 505,840 |

Intangible assets consist of licensing and certification rights which are amortized over a defined number of units. No impairment charge was recorded in the nine months ended June 30, 2009.

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Total intangible amortization expense was approximately \$19,300 and \$10,100 for the three months ended June 30, 2009 and 2008, respectively. Total amortization expense for the nine months ended June 30, 2009 and 2008 was \$102,600 and \$22,100, respectively. Because the intangible assets are being amortized over a defined number of units, the future amortization expense over the next five years cannot be determined at this time.

Accrued expenses

Accrued expenses consist of the following:

| | June 30, 2009 | | September 30, 2008 |
|--|--------------------------|----|-------------------------------|
| Warranty (a) | \$ 704,559 | \$ | 736,815 |
| Salary, benefits and payroll taxes | 500,118 | | 904,904 |
| Reduction in workforce / Severance (b) | 256,218 | | 904,163 |
| Professional fees | 302,959 | | 474,730 |
| Income taxes payable | 96,774 | | 798,801 |
| Materials on order | 92,778 | | 467,759 |
| Other | 449,731 | | 843,291 |
| | \$ 2,403,137 | \$ | 5,130,463 |

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(a) 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, 2009 is highlighted below:

| | | |
|--|----|----------|
| Warranty accrual at March 31, 2009 | \$ | 706,834 |
| Accrued expense for the three months ended June 30, 2009 | | 46,887 |
| Warranty costs for the three months ended June 30, 2009 | | (49,162) |
| Warranty accrual at June 30, 2009 | \$ | 704,559 |

Warranty cost and accrual information for the nine months ended June 30, 2009 is highlighted below:

| | | |
|---|----|-----------|
| Warranty accrual at September 30, 2008 | \$ | 736,815 |
| Accrued expense for the nine months ended June 30, 2009 | | 194,186 |
| Warranty costs for the nine months ended June 30, 2009 | | (226,442) |
| Warranty accrual at June 30, 2009 | \$ | 704,559 |

(b) The amount included in Reduction in workforce / Severance as of June 30, 2009 is severance relating to the former Chief Executive Officer which is payable under the terms of the Release Agreement dated November 10, 2008.

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 includes an optional redemption schedule allowing the Company the option of forgoing any principal pay-down until such time the bonds expire in 2015. The Company has exercised its option not to pay-down the outstanding balance and accordingly, the balance of the notes payable will be due in 2015. As of June 30, 2009 the fair value of the Company's notes payable approximates its carrying value.

Effective November 30, 2007 the loan covenants require the Company to maintain at all times unencumbered cash and marketable securities having a market value of at least \$20.0 million and a minimum tangible net worth of \$65.0 million. The lender, however, agreed on January 10, 2008 to discontinue the tangible net worth covenant so that the only remaining requirement is that the Company maintain at all times unencumbered cash and marketable securities having a value of at least \$20.0 million.

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The interest cost related to this debt for three months ended June 30, 2009 and 2008 was \$9,000 and \$22,000 respectively. The interest cost related to this debt for nine months ended June 30, 2009 and 2008 was \$42,000 and \$89,000 respectively. The interest rate on this debt was 0.8% at June 30, 2009. The Company is also required to maintain a letter of credit in the amount of \$4.4 million covering the debt.

The Company repaid this loan in full on August 3, 2009 for an aggregate payment of \$4,335,000.

3. Income Taxes

The income tax benefit for the three and nine months ended June 30, 2009 was \$199,000 and \$31,000, respectively, as compared to an income tax benefit of \$256,000 and an income tax expense of \$1.1 million for the three and nine months ended June 30, 2008. The decrease in the income tax benefit for the three months ended June 30, 2009 and 2008 is due to a decrease in the FIN 48 liability upon the expiration of certain state statutes of limitations in the three months ended June 30, 2008. The decrease in the income tax expense for the nine months ended June 30, 2009 is primarily due to the establishment of a full valuation allowance on net deferred tax assets as of the period ended March 31, 2008. The establishment of the allowance as of March 31, 2008 caused the Company to recognize income tax expense in that period relating to net deferred tax assets that are not likely to be realized. The Company continues to maintain a full valuation allowance on net deferred tax assets as of the period ended June 30, 2009 that are in excess of the amounts expected to be utilized in the current fiscal year. In accordance with SFAS 109 the Company will continue to evaluate the need for a full or partial valuation allowance on a quarterly basis.

The effective tax rates for the three months ended June 30, 2009 and 2008 were (19%) and 6%, respectively. The effective tax rate differs from the statutory rate for the three months ended June 30, 2009 due to: 1) the reversal of certain deductible temporary differences which at September 30, 2008 were offset by a valuation allowance; such items will be deductible for income tax purposes

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in the current fiscal year based on forecasted earnings, and 2) the utilization of research and experimentation tax credits. The effective tax rate differs from the statutory rate for the three months ended June 30, 2008 due to the establishment of a full valuation allowance on net deferred tax assets during the preceding quarter.

The effective tax rates for the nine months ended June 30, 2009 and 2008 were (1%) and (8%), respectively. The effective tax rate differs from the statutory rate for the nine months ended June 30, 2009 due to: 1) the reversal of certain deductible temporary differences which at September 30, 2008 were offset by a valuation allowance; such items will be deductible for income tax purposes in the current fiscal year based on forecasted earnings, and 2) the utilization of research and experimentation tax credits. The effective tax rate differs from the statutory rate for the nine months ended June 30, 2008 due to the establishment of a full valuation allowance on net deferred tax assets during the quarter ended March 31, 2008.

4. Capital Stock

At June 30, 2009, our Articles of Incorporation provide us the authority to issue 75,000,000 shares of common stock and 10,000,000 shares of blank check preferred stock.

Share-based compensation

Effective October 1, 2005, the Company adopted the provisions of SFAS No.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 \$168,000 and \$400,000 for the three months ended June 30, 2009 and 2008, respectively. The tax impact for the three months ended June 30, 2009 and 2008 was a decrease in excess tax benefits, which are recorded to paid-in capital, of \$1,000 and \$0, respectively.

Total share-based compensation expense was \$545,000 and \$960,000 for the nine months ended June 30, 2009 and 2008, respectively. The excess tax benefits recorded in additional paid-in capital for share-based compensation arrangements were \$3,000 and \$0 for the nine months ended June 30, 2009 and 2008, 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 1998 Plan) and the 2003 Restricted Stock Plan (the Restricted Plan). These plans were approved by the Company's shareholders. The 1998 Plan expired on November 13, 2008 and no additional shares may be granted under the Plan after that date. In addition, at the Annual Meeting of Shareholders of Innovative Solutions and Support, Inc. held on March 12, 2009, the shareholders of the Company approved the Company's 2009 Stock-Based Incentive Compensation Plan (the 2009 Plan), which is discussed below.

Stock options

The 1998 Plan provides for the granting of incentive and nonqualified stock options to employees, officers, directors, and independent contractors and consultants. Through June 30, 2009, no stock options have been granted to independent contractors or consultants under this Plan. Total compensation expense was \$118,000 and \$350,000 for the three months ended June 30, 2009 and 2008, respectively. Total compensation expense was \$395,000 and \$810,000 for the nine months ended June 30, 2009 and 2008, respectively.

Total compensation expense under the Restricted Plan was \$50,000 for both the three months ended June 30, 2009 and 2008. Total compensation expense was \$150,000 for both the nine months ended June 30, 2009 and 2008. The expense relates to shares that are issued to non-employee members of the Board of Directors on a quarterly basis as part of their compensation.

Incentive stock options granted under the 1998 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 1998 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 had reserved 3,389,000 shares of Common Stock for awards under the plan.

Incentive stock options granted under the 2009 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 2009 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 1,200,000 shares of Common Stock for awards under the plan. The 2009 Plan expires on March 12, 2019.

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2009 Stock-Based Incentive Compensation Plan

The 2009 Plan authorizes the grant of Stock Appreciation Rights, Restricted Stock, Options and other equity-based awards under the 2009 Plan (collectively referred to as Awards). Options granted under the 2009 Plan may be either incentive stock or nonqualified stock options, as determined by the Compensation Committee of the Company's Board of Directors (the Committee).

Subject to an adjustment necessary upon a stock dividend, recapitalization, forward split or reverse split, reorganization, merger, consolidation, spin-off, combination, repurchase or share exchange, extraordinary or unusual cash distribution or other similar corporate transaction or event, the maximum number of shares of common stock available for awards under the 2009 Plan are 1,200,000, all of which may be issued pursuant to awards of incentive stock options. In addition, the Plan provides that no more than 300,000 shares may be awarded to any employee as a performance-based award under Section 162(m) of the Internal Revenue Code.

The 2009 Plan will terminate on the tenth anniversary of the 2009 Plan's adoption by the Board, unless earlier terminated by the Board. Termination will not affect awards outstanding at the time of termination. The Board may amend, alter, suspend, discontinue or terminate the 2009 Plan without shareholder approval, provided that shareholder approval is required for any amendment which (i) would increase the number of shares subject to the 2009 Plan; (ii) would decrease the price at which Awards may be granted, or (iii) would require shareholder approval by law, regulation, or the rules of any stock exchange or automated quotation system.

No options were granted under the 2009 Plan during the nine months ended June 30, 2009.

Stock repurchase program

On February 21, 2008, the Company's Board of Directors approved a common stock repurchase program to acquire up to 1,000,000 shares of the Company's outstanding common stock. Purchases of the stock were to be made from time to time, subject to market conditions and at prevailing market prices. The program expired on February 21, 2009. During the current fiscal year no shares were purchased under the plan prior to its expiration date.

On February 22, 2009 the Company's Board of Directors approved a common stock repurchase program to acquire up to 1,000,000 shares of the Company's outstanding common stock. Under the repurchase program, the Company may purchase shares of its common stock through open market transactions or in privately negotiated block purchases or other private transactions (either solicited or unsolicited). The timing and amount of repurchase transactions under this program will depend on market conditions and corporate and regulatory considerations. The plan will expire on February 22, 2010, unless extended by the Board of Directors; however, the program may be discontinued or suspended at any time. During the nine months ended June 30, 2009 the Company purchased 25,000 shares of common stock under the program at a cost of \$108,250, or an average market price of \$4.33 per share. The Company financed these purchases through available cash. The following table sets forth the purchases made under this new plan for each month since its inception through June 30, 2009:

Period

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| | Total Number of Shares Purchased | Average Price Paid per Share | Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs | Maximum Number of Shares that May Yet Be Purchased Under the Program |
|---------------|---|---|---|---|
| January 2009 | | | | (a) |
| February 2009 | | | | 1,000,000 |
| March 2009 | 25,000 | \$ 4.33 | 25,000 | 975,000 |
| April 2009 | | | | 975,000 |
| May 2009 | | | | 975,000 |
| June 2009 | 25,000 | \$ 4.33 | 25,000 | 975,000 |

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5. Income (Loss) per Share

Income (loss) per share (EPS) is calculated using the principles of SFAS No. 128, *Earnings Per Share*.

For the three and nine month periods ended June 30, 2009, there were 425,000 and 426,000 options to purchase common stock outstanding, respectively, excluded from the computations of diluted earnings per share as the effect would be anti-dilutive.

For both the three and nine month periods ended June 30, 2008, there were 928,000 options to purchase common stock outstanding excluded from the computations of diluted earnings per share as the effect would be anti-dilutive.

6. Subsequent Event

The Company has evaluated subsequent events and transactions for potential recognition or disclosure in the financial statements through August 7, 2009.

On August 3, 2009 the Company repaid in full its loan from the Chester County, Pennsylvania Industrial Development Authority for an aggregate payment of \$4,335,000.

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

CAUTIONARY STATEMENT REGARDING FORWARD-LOOKING STATEMENTS

This report contains forward looking statements within the meaning of Section 21E of the Securities Exchange Act of 1934. We have based these forward looking statements largely on our current expectations and projections about future events and trends affecting our business. In this report, the words believe, may, will, estimate, continue, anticipate, intend, forecast, expect, plan, should, is likely and similar expressions, as they relate to our business or our management, are intended to identify forward looking statements, but they are not exclusive means of identifying them.

The forward looking statements in this report are only predictions and actual events or results may differ materially. In evaluating such statements, a number of risks, uncertainties and other factors could cause our actual results, performance, financial condition, cash flows, prospects, and opportunities to differ materially from those expressed in, or implied by, the forward looking statements. These risks, uncertainties and other factors include the following:

- *market acceptance of our flat panel display systems, or COCKPIT/IP system or other planned products or product enhancements;*
- *difficulties in developing and producing our COCKPIT/IP system or other planned products or product enhancements;*
- *continued market acceptance of our air data systems and products;*
- *the availability of government funding;*
- *our ability to gain regulatory approval of our products in a timely manner;*
- *delays in receiving components from third party suppliers;*
- *the competitive environment;*

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- *the impact of general economic trends on our business;*
- *the bankruptcy or insolvency of one or more key customers;*
- *the deferral or 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.*

Except as expressly required by the federal securities laws, we undertake no obligation to publicly update or revise any forward looking statements, whether as a result of new information, future events or otherwise after the date of this report. Our results of operations in any past period should not be considered indicative of the results to be expected for future periods. Fluctuations in operating results may also result in fluctuations in the price of our common stock.

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, 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 discussions of Risk Factors contained in the Company's Annual Report on Form 10-K for the fiscal year ended September 30, 2008.

Investors should also be aware that while we do, from time to time, communicate with securities analysts, it is against our policy to disclose any material non-public information or other confidential commercial information. Accordingly, shareholders should not assume that we agree with

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*any statement or report issued by any analyst irrespective of the content of the statement or report. Furthermore, we have a policy against issuing or confirming financial forecasts or projections issued by others. Thus, to the extent that reports issued by securities analysts contain any projections, forecasts or opinions, such reports are **not** the responsibility of Innovative Solutions and Support, Inc.*

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Company Overview

Innovative Solutions and Support was founded in 1988. The Company designs, develops, manufactures and sells flight information computers, large flat-panel displays, and advanced monitoring systems that measure and display critical flight information, including data relative to aircraft separation, airspeed, altitude as well as engine and fuel data measurements.

Our sales are derived from the sale of our products to the retrofit market and, to a lesser extent, original equipment manufacturers (OEMs). Our customers include the United States Department of Defense (DoD) and their commercial contractors, aircraft operators, aircraft modification centers and various OEMs. Although we occasionally sell our products directly to the DoD, we primarily have sold our products to commercial customers for end use in DoD programs. Sales to defense contractors are on commercial terms, although some of the termination and other provisions of government contracts are applicable to these contracts.

Our cost of sales related to product sales is comprised of material and components 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, material control and quality departments, and warranty costs.

Our cost of sales related to Engineering modification and development (EMD) is comprised of engineering labor, consulting services, and other cost associated with specific design and development projects that are billable under specific customer agreements.

We intend to continue investing in the development of new products that complement our current product offerings and will expense associated research and development costs as they are incurred.

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

We sell our products to agencies of the United States and foreign governments, aircraft operators, aircraft modification centers and original equipment manufacturers. Our customers have been and may continue to be affected by the ongoing adverse economic conditions that currently exist both in the United States and abroad. Such conditions may cause our customers to curtail or delay their spending on both new and existing aircraft. Factors that can impact general economic conditions and the level of spending by our customers include but are not limited to general levels of consumer spending, increases in fuel and energy costs, conditions in the real estate and mortgage markets, labor and healthcare costs, access to credit, consumer confidence and other macroeconomic factors affecting spending behavior. In addition, spending by government agencies may in the future be further reduced due to declining tax revenues associated with this economic downturn. If our customers curtail or delay their spending or are forced to declare bankruptcy or liquidate their operations due to continuing adverse economic conditions, our revenues and results of operations will be adversely affected. However, we believe that in a declining economic environment a customer that may have otherwise elected to purchase newly manufactured aircraft will instead be interested in retrofitting existing aircraft as a cost effective alternative, which will create a market opportunity for our products.

Critical Accounting Policies and Estimates

Our discussion and analysis of our financial condition and consolidated results of operations are based upon our condensed consolidated financial statements, which have been prepared in accordance with generally accepted accounting principles in the United States. The preparation of our condensed consolidated financial statements requires us to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenue and expenses and related disclosure of contingent assets and liabilities. On an on-going basis, we evaluate our estimates based upon historical experience and various other assumptions that we believe to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Our actual results may differ from these estimates.

We believe that our critical accounting policies affect our more significant estimates and judgments used in the preparation of our consolidated financial statements. Our Annual Report on Form 10-K for the year ended September 30, 2008 contains a discussion of these critical accounting policies. There have been no significant changes in our critical accounting policies since September 30, 2008. See also Note 1 to our unaudited condensed consolidated financial statements for the three and nine month periods ended June 30, 2009 as set forth herein.

Table of Contents**RESULTS OF OPERATIONS FOR THE THREE AND NINE MONTHS ENDED****JUNE 30, 2009 AND 2008**

The following table sets forth statement of operations data expressed as a percentage of total net sales for the periods indicated (some items may not add due to rounding):

| | Three Months Ending June 30, | | Nine Months Ending June 30, | |
|--|-------------------------------------|-------------|------------------------------------|-------------|
| | 2009 | 2008 | 2009 | 2008 |
| Net sales: | | | | |
| Product | 85.6% | 82.0% | 86.5% | 85.1% |
| Engineering - modification and development | 14.4% | 18.0% | 13.5% | 14.9% |
| Total net sales | 100.0% | 100.0% | 100.0% | 100.0% |
| Cost of sales | | | | |
| Product | 42.6% | 44.0% | 45.9% | 50.9% |
| Engineering - modification and development | 4.1% | 8.2% | 3.1% | 8.3% |
| Total cost of sales | 46.7% | 52.2% | 48.9% | 59.2% |
| Gross profit | 53.3% | 47.8% | 51.1% | 40.8% |
| Operating expenses: | | | | |
| Research and development | 16.6% | 36.8% | 14.5% | 38.1% |
| Selling, general and administrative | 23.7% | 37.5% | 22.5% | 68.7% |
| Asset impairment | 0.0% | 28.3% | 0.0% | 12.2% |
| Total operating expenses | 40.3% | 102.6% | 37.0% | 119.0% |
| Operating income (loss) | 13.0% | (54.8)% | 14.1% | (78.1)% |
| Interest income | 0.8% | 3.2% | 1.3% | 6.5% |
| Interest expense | (0.3)% | (0.4)% | (0.3)% | (0.6)% |
| Other income | 0.0% | 0.0% | 0.2% | 1.5% |
| Income (loss) before income taxes | 13.6% | (51.9)% | 15.3% | (70.8)% |
| Income tax expense (benefit) | (2.6)% | (2.9)% | (0.1)% | 5.4% |
| Net income (loss) | 16.1% | (49.0)% | 15.4% | (76.2)% |

Three Months Ended June 30, 2009 Compared to the Three Months Ended June 30, 2008

Net sales. Net sales decreased \$1.0 million, or 11.3%, to \$7.8 million for the three months ended June 30, 2009 from \$8.8 million in the three months ended June 30, 2008. For the three months ended June 30, 2009, product sales decreased approximately \$0.6 million and EMD sales decreased approximately \$0.4 million from the same period in the prior year. The decrease in product sales was primarily the result of the impact of a demand of a large customer that we defer a portion of a delivery of flat panel displays that had originally scheduled for the third quarter. We have been informed that the customer plans to accelerate modification rates by 2010, consuming the balance of fifty ship-sets already delivered and restoring our delivery schedule. We are currently in discussions with the customer to determine all future delivery dates. The decrease in

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EMD sales was primarily a result of the timing of completion of several projects.

Cost of sales. Cost of sales decreased \$0.9 million or 20.7%, to \$3.6 million, or 46.7% of net sales in the three months ended June 30, 2009 from \$4.6 million, or 52.2% of net sales in the three months ended June 30, 2008. The decrease was primarily the result of the decrease in product sales during the quarter which accounted for \$0.5 million of the decrease, as well as by a \$0.4 million decrease in EMD related costs.

Research and development. Research and development expense decreased \$1.9 million or 60.0% to \$1.3 million or 16.6% of net sales in the three months ended June 30, 2009 from \$3.2 million or 36.8% of net sales in the three months ended June 30, 2008. The decrease in research and development expense in the quarter was primarily due to a reduction in headcount related costs and a decrease in cost from third-party subcontractors of \$1.0 million and \$1.1 million, respectively. This was offset by an increase in deferred EMD related direct costs of \$0.4 million. The significant research and development costs in the prior period primarily related to the Eclipse program that ended during the fourth quarter of fiscal year 2008. Since the termination of the Eclipse program the Company has reduced the total number of employees in the research and development department and has streamlined its research and development functions. However, the Company continues to invest in on-going research and development of our core products.

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Selling, general, and administrative. Selling, general and administrative expenses decreased \$1.4 million, or 43.9%, to \$1.8 million, or 23.7% of net sales in the three months ended June 30, 2009 from \$3.2 million or 37.5% of net sales in the three months ended June 30, 2008. The decrease was primarily due to a reduction in professional fees, specifically legal costs, as well as a decrease in headcount related costs of \$0.5 million and \$0.5 million respectively. During the three months ended June 30, 2008 the Company incurred \$0.5 million of legal fees in connection with litigation related to protecting its Intellectual Property.

Interest income. Interest income was \$63,000 in the three months ended June 30, 2009 as compared to \$284,000 in the three months ended June 30, 2008. The decrease in interest income was primarily the result of our reduced average cash balance in the current quarter as compared to the same period in the prior year as well as lower interest rates in the quarter as compared to the same period in the prior year.

Interest expense. Interest expense was \$20,000 in the three months ended June 30, 2009 as compared to \$33,000 in the three months ended June 30, 2008. The reduction was primarily due to lower interest rates in effect during the period compared to the same period in the prior year.

Income tax expense (benefit). The income tax benefit for the three months ended June 30, 2009 was \$199,000 as compared to \$256,000 for the three months ended June 30, 2008. The decrease in the income tax benefit for the three months ended June 30, 2009 is due to a decrease in the FIN 48 liability upon the expiration of certain state statutes of limitations in the three months ended June 30, 2008. The Company continues to maintain a full valuation allowance as of the period ended June 30, 2009 on its net deferred tax assets. In accordance with FAS 109 the Company will continue to evaluate the need for a full or partial valuation allowance on a quarterly basis.

The effective tax rates for the three months ended June 30, 2009 and 2008 were (19%) and 6%, respectively. The effective tax rate differs from the statutory rate for the three months ended June 30, 2009 due to: 1) the reversal of certain deductible temporary differences which at September 30, 2008 were offset by a valuation allowance; such items will be deductible for income tax purposes in the current fiscal year based on forecasted earnings, and 2) the utilization of research and experimentation tax credits. The effective tax rate differs from the statutory rate for the three months ended June 30, 2008 due to the establishment of a full valuation allowance on net deferred tax assets during the preceding quarter.

Nine months ended June 30, 2009 Compared to the Nine months ended June 30, 2008

Net sales. Net sales increased \$8.5 million, or 41.8%, to \$28.8 million for the nine months ended June 30, 2009 from \$20.3 million in the nine months ended June 30, 2008. For the nine months ended June 30, 2009, product sales increased \$7.6 million and EMD sales increased \$0.9 million from the same period in the prior year. The increase in product sales was primarily related to growth in flat panel display sales to various customers. The increase in EMD sales was primarily a result of several projects for major customers that were completed during the nine months ended June 30, 2009. During the nine months ended June 30, 2008 \$10.6 million or 52% of net sales pertained to one OEM customer, which declared bankruptcy. Excluding these OEM sales the Company's net sales would have increased \$19.1 million or 197%.

Cost of sales. Cost of sales increased \$2.1 million or 17.3%, to \$14.1 million, or 48.9% of net sales in the nine months ended June 30, 2009 from \$12.0 million, or 59.2% of net sales in the nine months ended June 30, 2008. The increase was primarily the result of the additional product sales during the nine months ended June 30, 2009, which accounted for \$2.9 million of the increase and was offset by a \$0.8 million decrease in EMD related costs.

Research and development. Research and development expense decreased \$3.6 million or 46.0% to \$4.2 million or 14.5% of net sales in the nine months ended June 30, 2009 from \$7.7 million or 38.1% of net sales in the nine months ended June 30, 2008. The decrease in research and development expense in the nine months ended June 30, 2009 was primarily due to a reduction in headcount related costs and a decrease in costs from third-party subcontractors of \$2.3 million and \$2.0 million, respectively, offset by an increase in deferred EMD costs of \$1.1 million.

Selling, general, and administrative. Selling, general and administrative expenses decreased \$7.5 million, or 53.6%, to \$6.5 million, or 22.5% of net sales in the nine months ended June 30, 2009 from \$14.0 million or 68.7% of net sales in the nine months ended June 30, 2008. The decrease was primarily due to a reduction in professional fees, specifically legal costs, as well as a decrease in headcount related costs of \$5.3 million and \$1.0 million respectively. During the nine months ended June 30, 2008 the Company incurred \$5.4 million of legal fees in connection with litigation related to protecting its intellectual property.

Interest income. Interest income was \$361,000 in the nine months ended June 30, 2009 as compared to \$1.3 million in the nine months ended June 30, 2008. The decrease in interest income was primarily the result of our reduced average cash balance during the nine months ended June 30, 2009 as compared to the same period in the prior year as well as lower interest rates during the nine months ended June 30, 2009 as compared to the same period in the prior year.

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Interest expense. Interest expense was \$75,000 in the nine months ended June 30, 2009 as compared to \$122,000 in the nine months ended June 30, 2008. The reduction was primarily due to lower interest rates in effect during the period compared to the same period in the prior year.

Other income. In March 2008, the Company received a payment of \$300,000 in settlement of a claim against a shareholder for short swing profit liability to the Company pursuant to Section 16(b) of the Securities Exchange Act of 1934, as amended.

Income tax expense (benefit). The income tax expense (benefit) for the nine months ended June 30, 2009 was (\$31,000) as compared to \$1.1 million for the nine months ended June 30, 2008. The decrease in the income tax expense is primarily due to the establishment of a full valuation allowance on deferred tax assets as of the period ended March 31, 2008. The establishment of the valuation allowance as of March 31, 2008 caused the Company to recognize income tax expense for the nine months ended June 30, 2008 relating to net deferred tax assets that are not likely to be realized. The Company continues to maintain a full valuation allowance as of the period ended June 30, 2009 on its net deferred tax assets. In accordance with FAS 109 the Company will continue to evaluate the need for a full or partial valuation allowance on a quarterly basis.

The effective tax rates for the nine months ended June 30, 2009 and 2008 were (1%) and (8%), respectively. The effective tax rate differs from the statutory rate for the nine months ended June 30, 2009 due to: 1) the reversal of certain deductible temporary differences which at September 30, 2008 were offset by a valuation allowance; such items will be deductible for income tax purposes in the current fiscal year based on forecasted earnings, and 2) the utilization of research and experimentation tax credits. The effective tax rate differs from the statutory rate for the nine months ended June 30, 2008 due to the establishment of a full valuation allowance on net deferred tax assets during the quarter ended March 31, 2008.

Liquidity and Capital Resources

The following table highlights key financial measurements of the Company:

| | June 30, 2009 | September 30, 2008 |
|--|--------------------------|-------------------------------|
| Cash and cash equivalents | \$ 39,307,938 | \$ 35,031,932 |
| Accounts receivable, net | \$ 4,747,604 | \$ 4,218,443 |
| Working capital | \$ 47,575,403 | \$ 42,491,253 |
| Deferred revenue | \$ 254,127 | \$ 564,998 |
| Total debt and other non-current liabilities | \$ 4,927,668 | \$ 5,047,146 |
| Quick ratio | 12.20 | 4.94 |
| Current ratio | 14.18 | 6.35 |

| | Nine Months Ended June 30, | |
|---|-----------------------------------|----------------|
| | 2009 | 2008 |
| Cash flow activities: | | |
| Net cash provided by (used in) operating activities | \$ 4,636,299 | \$ (7,514,973) |
| Net cash used in investing activities | (244,127) | (533,532) |
| Net cash used in financing activities | (116,166) | (31,677) |

Our main source of liquidity has been cash flow from operating activities. We require cash principally to finance inventory, accounts receivable and payroll.

Operating activities

Cash provided by operating activities was \$4.6 million for the nine months ended June 30, 2009 as compared to cash used in operating activities of \$7.5 million for the nine months ended June 30, 2008. The improvement was primarily due to net income of \$4.4 million for the nine months ended June 30, 2009 versus a net loss of \$15.5 million in the prior year period. Additionally, the cash provided by operating activities during the nine months ended June 30, 2009 was impacted by decreases in inventories and prepaid expenses of \$3.2 million and \$0.1 million, respectively. This was offset by increases in accounts receivable and decreases in accounts payable, accrued expenses, income taxes payable and deferred revenues of \$0.5 million, \$1.4 million, \$2.0 million, \$0.7 million, and \$0.3 million, respectively.

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Investing activities

Cash used in investing activities was \$244,000 for the nine months ended June 30, 2009 and \$534,000 for the nine months ended June 30, 2008, which primarily consisted of the purchase of production and laboratory test equipment.

Financing activities

Net cash used in financing activities was \$116,000 for the nine months ended June 30, 2009 which consisted of \$108,000 for the repurchase of common stock and \$8,000 for the repayment of capitalized lease obligations. Net cash used in financing activities of \$32,000 for the nine months ended June 30, 2008 primarily consisted of \$57,000 for the repurchase of common stock and a \$7,000 repayment for capitalized lease obligations, offset by proceeds from the exercise of stock options of \$33,000.

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 includes an optional redemption schedule allowing the Company the option of forgoing any principal pay-down until such time the bonds expire in 2015. The Company has exercised its option not to pay-down the outstanding balance and accordingly, the balance of the notes payable will be due in 2015.

Effective November 30, 2007 the loan covenants require the Company to maintain at all times unencumbered cash and marketable securities having a market value of at least \$20.0 million and a minimum tangible net worth of \$65.0 million. On January 10, 2008 the lender agreed to discontinue the tangible net worth covenant. As of June 30, 2009 the Company was in compliance with the remaining loan covenant.

The Company repaid this loan in full on August 3, 2009 for an aggregate payment of \$4,335,000.

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 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

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As of June 30, 2009 and September 30, 2008, our backlog was \$39.0 million and \$57.3 million, respectively. The subsequent decrease in backlog reflects steps taken by management during the nine months ended June 30, 2009 to re-evaluate certain customer bookings in light of the current economic environment and likelihood that these bookings would result in actual revenues. Although we had no customer cancellations, we have de-booked approximately \$6.5 million during the nine months ended June 30, 2009. As noted earlier, a large customer deferred delivery of flat panel displays that had originally been scheduled for delivery in the third and fourth quarter of fiscal year 2009. The backlog associated with this customer has not been changed. In consideration of the continually changing economic environment the Company's management will continue to evaluate the realizability of the backlog.

Backlog activity for the nine months ended June 30, 2009 (in thousands):

| Balance at September 30, 2008 | Additional Bookings | Recognized in Revenue | Adjustments | Balance at June 30, 2009 |
|--|--------------------------------|----------------------------------|--------------------|---|
| \$ 57,373 | \$ 16,490 | \$ (28,800) | \$ (6,475) | \$ 38,588 |

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Backlog activity for the three months ended June 30, 2009 (in thousands):

| Balance at March 31, 2009 | Additional Bookings | Recognized in Revenue | Adjustments | Balance at June 30, 2009 |
|---------------------------------|------------------------|--------------------------|-------------|--------------------------------|
| \$ 39,423 | \$ 6,929 | \$ (7,759) | \$ (5) | \$ 38,588 |

Off-Balance Sheet Arrangements

We do not participate in transactions that generate relationships with unconsolidated entities or financial partnerships, such as special purpose entities (SPEs) or variable interest entities (VIEs), which would have been established for the purpose of facilitating off-balance sheet arrangements or other limited purposes. As of June 30, 2009 and September 30, 2008, we were not involved with any unconsolidated SPEs or VIEs.

As of June 30, 2009, we had a standby letter of credit of \$4.4 million with PNC Bank, N.A. The stand by letter of credit is one of the requirements of the loan agreement with Chester County, Pennsylvania Industrial Development Authority (PIDA). Upon the repayment of the PIDA bond (see Note 6 to the condensed consolidated financial statements) we will no longer need to maintain this letter of credit.

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. Assuming that the balances during the three and nine months ending June 30, 2009 were to remain constant and no actions were taken to alter the existing interest rate sensitivity, a hypothetical 1% increase in our variable interest rates would have affected interest income by approximately \$97,000 and \$182,000, respectively, and interest expense by approximately \$70,000 and \$85,000, respectively. This would result in a net impact on cash flows of approximately \$27,000 and \$97,000 for the three and nine months ended June 30, 2009, respectively.

As the interest rates are variable, 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

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(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, 2009. 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.

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PART II OTHER INFORMATION

Item 1. Legal Proceedings

In the ordinary course of business, we are at times subject to various legal proceedings. Except with respect to the fees incurred in connection with the matters described below, we do not believe any current legal proceedings will have a material adverse effect on our results of operations or financial position.

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, and 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 IS&S.

On November 7, 2007 the Company received a favorable jury verdict in its trade secret misappropriation case against Kollsman, Inc. (a subsidiary of Elbit Systems Ltd.), J2 Inc., Joseph Caesar, James Zachary and Zachary Technologies, Inc. in the United States District Court for the Western District of Tennessee. The jury unanimously found that each of the defendants had misappropriated IS&S's air data computer technology. The jury found that IS&S had suffered damages of just over \$4.4 million in lost profits and \$1.6 million in defendants' net profits, for a total of over \$6 million. The jury also found in favor of IS&S's claims for breach of duty and contract, and unfair competition against J2 Inc., Joseph Caesar, James Zachary and Zachary Technologies, Inc.

On December 18, 2007, the court entered a temporary injunction aimed at preventing further use of the Company's trade secret and proprietary information. On March 14, 2008, the judge presiding over the case heard the Company's claims for a permanent injunction as well as punitive and exemplary damages and attorneys' fees against Kollsman and the other defendants.

On July 7, 2008, the court issued several rulings in the case. In the rulings, the court awarded damages, interest and fees in addition to the more than \$6 million in compensatory damages awarded by the jury when it rendered its verdict in the case in November 2007. The additional awards brought the damages assessed against Kollsman, Inc. to more than \$23 million. The court also entered an order granting the Company's request for permanent injunctive relief.

On August 27, 2008, the Company entered into a Settlement Agreement (the Settlement Agreement) with Kollsman, Inc. On August 29, 2008, the settlement became effective with respect to all claims filed by the Company and Kollsman against each other in the United States District Court for the Western District of Tennessee and a Consent Order was entered. Under the Settlement Agreement, all claims between the Company and Kollsman have been dismissed with prejudice, a final agreed injunction has been entered and the matter has been fully and finally mutually settled without any admission of guilt by either party. In addition, an agreed settlement payment of \$17 million has been made by Kollsman to the Company.

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On October 9, 2008, Zachary and ZTI consented to the entry of judgment against and to a permanent injunction, which resulted in the conclusion of all claims with respect to those parties. On November 17, 2008, the court granted the Company's motion to dismiss its patent infringement claims against Caesar and J2, and dismissed Caesar and J2's counterclaims for noninfringement, invalidity and unenforceability because there was no longer a justifiable claim or controversy with respect to those counterclaims.

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. The case is ongoing.

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, 2008.

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

Stock repurchase program

On February 21, 2008, the Company's Board of Directors approved a common stock repurchase program to acquire up to 1,000,000 shares of the Company's outstanding common stock. Purchases of the stock were to be made from time to time, subject to market conditions and at prevailing market prices. There were no shares purchased under this plan during the three months ended June 30, 2008. The program expired on February 21, 2009.

On February 22, 2009, the Company's Board of Directors approved a common stock repurchase program to acquire up to 1,000,000 shares of the Company's outstanding common stock. Under the repurchase program, the Company may purchase shares of its

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common stock through open market transactions or in privately negotiated block purchases or other private transactions (either solicited or unsolicited). The timing and amount of repurchase transactions under this program will depend on market conditions and corporate and regulatory considerations. The plan will expire on February 22, 2010, unless extended by the Board of Directors; however, the program may be discontinued or suspended at any time. During the nine months ending June 30, 2009, the Company purchased 25,000 shares of common stock under the program at a cost of \$108,250, or an average market price of \$4.33 per share. We financed these purchases through available cash. The following table sets forth the purchases made under this new plan for each month since adoption ended June 30, 2009:

| Period | Total Number of Shares Purchased | Average Price Paid per Share | Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs | Maximum Number of Shares that May Yet Be Purchased Under the Program |
|---------------|---|-------------------------------------|---|---|
| January 2009 | | | | (a) |
| February 2009 | | | | 1,000,000 |
| March 2009 | 25,000 | \$ 4.33 | 25,000 | 975,000 |
| April 2009 | | | | 975,000 |
| May 2009 | | | | 975,000 |
| June 2009 | 25,000 | \$ 4.33 | 25,000 | 975,000 |

(a) The plan was not approved until February 2009.

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

* Filed herewith

Furnished herewith

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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: August 7, 2009

By: /s/ JOHN C. LONG
JOHN C. LONG
CHIEF FINANCIAL OFFICER