

INNOVATIVE SOLUTIONS & SUPPORT INC  
Form 10-Q  
May 06, 2010  
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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 March 31, 2010**

**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)

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**PENNSYLVANIA**  
(State or Other Jurisdiction  
of Incorporation)

**23-2507402**  
(I.R.S. 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 the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 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 May 5, 2010, there were 16,760,759 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 March 31, 2010**



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**INNOVATIVE SOLUTIONS AND SUPPORT, INC.**  
**CONDENSED CONSOLIDATED BALANCE SHEETS**  
**(Unaudited)**

|  | March 31,<br>2010    | September 30,<br>2009 |
|--|----------------------|-----------------------|
| <b><u>ASSETS</u></b>   |                      |                       |
| Current Assets   |                      |                       |
| Cash and cash equivalents  | \$ 35,654,687        | \$ 35,565,694         |
| Accounts receivable, net   | 4,004,698            | 6,188,706             |
| Inventories  | 5,054,422            | 5,306,985             |
| Deferred income taxes  | 473,000              | 503,993               |
| Prepaid expenses and other current assets  | 1,362,383            | 1,227,413             |
| <b>Total current assets</b>  | <b>46,549,190</b>    | <b>48,792,791</b>     |
| Property and equipment, net  | 8,092,015            | 8,343,701             |
| Other assets   | 260,910              | 399,520               |
| <b>Total Assets</b>  | <b>\$ 54,902,115</b> | <b>\$ 57,536,012</b>  |
| <b><u>LIABILITIES AND SHAREHOLDERS' EQUITY</u></b>   |                      |                       |
| Current Liabilities  |                      |                       |
| Current portion of capitalized lease obligations   | \$ 9,908             | \$ 9,908              |
| Accounts payable   | 903,191              | 1,207,990             |
| Accrued expenses   | 2,152,236            | 2,785,560             |
| Deferred revenue   | 162,223              | 164,856               |
| <b>Total current liabilities</b>   | <b>3,227,558</b>     | <b>4,168,314</b>      |
| Long-term portion of capitalized lease obligations   | 21,374               | 26,991                |
| Deferred revenue   | 34,740               | 60,792                |
| Deferred income taxes  | 605,203              | 642,651               |
| Other liabilities  | 243,600              | 238,522               |
| <b>Total Liabilities</b>   | <b>4,132,475</b>     | <b>5,137,270</b>      |
| 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 March 31, 2010 |                      |                       |

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and September 30, 2009

|   |               |               |
|---|---------------|---------------|
| Common stock, \$.001 par value: 75,000,000 shares authorized, 18,226,469 and 18,206,839 issued at March 31, 2010 and September 30, 2009 | 18,226        | 18,207        |
| Additional paid-in capital  | 46,745,716    | 46,462,135    |
| Retained earnings   | 23,270,338    | 25,161,276    |
| Treasury stock, at cost, 1,476,000 and 1,470,510 shares at March 31, 2010 and September 30, 2009, respectively                          | (19,264,640)  | (19,242,876)  |
| Total Shareholders' Equity  | 50,769,640    | 52,398,742    |
| Total Liabilities and Shareholders' Equity  | \$ 54,902,115 | \$ 57,536,012 |

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 Ending March 31, |              | Six Months Ending March 31, |               |
|---|-------------------------------|--------------|-----------------------------|---------------|
|   | 2010                          | 2009         | 2010                        | 2009          |
| <b>Net sales:</b>                           |                               |              |                             |               |
| Product                                     | \$ 4,985,736                  | \$ 9,365,306 | \$ 8,822,313                | \$ 18,254,424 |
| Engineering - modification and development  | 387,221                       | 1,100,420    | 1,157,883                   | 2,786,648     |
| Total net sales                             | 5,372,957                     | 10,465,726   | 9,980,196                   | 21,041,072    |
| <b>Cost of sales</b>                        |                               |              |                             |               |
| Product                                     | 2,816,054                     | 4,915,652    | 5,181,395                   | 9,910,746     |
| Engineering - modification and development  | 126,442                       | 301,961      | 597,874                     | 562,040       |
| Total cost of sales                         | 2,942,496                     | 5,217,613    | 5,779,269                   | 10,472,786    |
| Gross profit                                | 2,430,461                     | 5,248,113    | 4,200,927                   | 10,568,286    |
| <b>Operating expenses:</b>                  |                               |              |                             |               |
| Research and development                    | 1,404,705                     | 1,610,687    | 2,569,410                   | 2,891,188     |
| Selling, general and administrative         | 1,876,326                     | 2,272,080    | 4,027,465                   | 4,631,387     |
| Total operating expenses                    | 3,281,031                     | 3,882,767    | 6,596,875                   | 7,522,575     |
| Operating income (loss)                     | (850,570)                     | 1,365,346    | (2,395,948)                 | 3,045,711     |
| Interest income                             | 27,636                        | 97,227       | 50,610                      | 298,313       |
| Interest (expense)                          | (614)                         | (19,241)     | (1,278)                     | (54,715)      |
| Other income                                |                               |              | 50,000                      | 50,073        |
| Income (loss) before income taxes           | (823,548)                     | 1,443,332    | (2,296,616)                 | 3,339,382     |
| Income tax expense (benefit)                | (77,783)                      | 95,802       | (405,678)                   | 168,466       |
| Net income (loss)                           | \$ (745,765)                  | \$ 1,347,530 | \$ (1,890,938)              | \$ 3,170,916  |
| <b>Net (loss) income per common share:</b>  |                               |              |                             |               |
| Basic                                       | \$ (0.04)                     | \$ 0.08      | \$ (0.11)                   | \$ 0.19       |
| Diluted                                     | \$ (0.04)                     | \$ 0.08      | \$ (0.11)                   | \$ 0.19       |
| <b>Weighted Average Shares Outstanding:</b> |                               |              |                             |               |
| Basic                                       | 16,752,563                    | 16,718,209   | 16,749,080                  | 16,718,209    |
| Diluted                                     | 16,752,563                    | 16,718,215   | 16,749,080                  | 16,735,645    |

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 Six Months Ended March 31, |               |
|--|------------------------------------|---------------|
|  | 2010                               | 2009          |
| <b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>   |                                    |               |
| Net (Loss) income  | \$ (1,890,938)                     | \$ 3,170,916  |
| Adjustments to reconcile net (loss) income to net cash provided by operating activities: |                                    |               |
| Depreciation and amortization  | 411,275                            | 521,097       |
| Deposit forfeiture, installation kits  | 118,660                            |               |
| Share-based compensation expense:  |                                    |               |
| Stock options  | 186,751                            | 277,026       |
| Nonvested stock awards   | 99,966                             | 100,099       |
| Tax benefit from share-based compensation:   |                                    |               |
| Nonvested stock awards   | (3,115)                            | 3,735         |
| Loss on disposal of property and equipment   | 2,888                              | 260           |
| Excess and obsolete inventory cost   |                                    | 603,916       |
| (Increase) decrease in:  |                                    |               |
| Accounts receivable  | 2,184,008                          | (1,546,177)   |
| Inventories  | 252,563                            | 2,811,529     |
| Prepaid expenses and other current assets  | 270,735                            | 127,708       |
| Other non-current assets   |                                    | (80,534)      |
| Increase (decrease) in:  |                                    |               |
| Accounts Payable   | (304,799)                          | (711,683)     |
| Accrued expenses   | (633,324)                          | (1,759,631)   |
| Income taxes payable   | (400,627)                          | (519,521)     |
| Deferred income tax  | (6,455)                            |               |
| Deferred revenue   | (28,685)                           | (236,645)     |
| Net cash provided by operating activities  | 258,903                            | 2,762,095     |
| <b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>   |                                    |               |
| Purchases of property and equipment  | (142,529)                          | (161,557)     |
| Net cash (used in) investing activities  | (142,529)                          | (161,557)     |
| <b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>   |                                    |               |
| Purchase of treasury stock   | (21,764)                           | (108,250)     |
| Repayment of capitalized lease obligations   | (5,617)                            | (5,230)       |
| Net cash (used in) financing activities  | (27,381)                           | (113,480)     |
| Net increase in cash and cash equivalents  | 88,993                             | 2,487,058     |
| Cash and cash equivalents, beginning of year   | 35,565,694                         | 35,031,932    |
| Cash and cash equivalents, end of period   | \$ 35,654,687                      | \$ 37,518,990 |
| <b>SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION</b>                                  |                                    |               |
| Cash paid for interest   | \$ 1,227                           | \$ 34,700     |
| Cash paid for income tax   | \$ 110,667                         | \$ 704,486    |
| Cash received from income tax refund   | \$ 1,000                           | \$ 25,115     |

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, 2009 is derived from audited financial statements. Operating results for the three and six months ended March 31, 2010 are not necessarily indicative of the results that may be expected for the fiscal year ending September 30, 2010. 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 for the fiscal year ended September 30, 2009.

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. Estimates are used in accounting for, among other items, allowance for doubtful accounts, inventory obsolescence, product warranty cost liability, income taxes and contingencies. 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 March 31, 2010 and September 30, 2009 consist of funds invested in money market accounts with financial institutions.

***Property and Equipment***

Property and equipment are 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 Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC) Topic 360-10, *Property, Plant and Equipment* (ASC Topic 360-10). 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

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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 six months ended March 31, 2010 or 2009.

***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 FASB ASC Topic 605-25, *Multiple-Element Arrangements* (ASC Topic 605-25), 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 FASB ASC Topic 605-35, *Construction-Type and Production-Type Contracts* (ASC Topic 605-35). 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 FASB ASC Topic 605, *Revenue Recognition* (ASC Topic 605).

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 ASC Topic 605. 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 -*

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 ASC Topic 605-35. The Company considers the nature of these service arrangements (including term, size of contract and 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.

***Income Taxes***

Income taxes are recorded in accordance with FASB ASC Topic 740, *Income Taxes* (ASC Topic 740), 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 and expected benefits of utilizing net operating loss and tax credit 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. The Company files a consolidated United States federal income tax return (see Note 3).

Effective October 1, 2007 (the first day of fiscal 2008), income tax contingencies are accounted for in accordance with ASC Topic 740, which 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 or expects to take on a tax return. Significant judgment is required in

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determining our provision for income taxes and recording the related assets and liabilities. In the normal course of our business, there are transactions and calculations where the ultimate tax determination is less than certain. The Company and its subsidiaries are subject to examination by Federal and State tax authorities. The Company regularly assesses the potential outcomes of these examinations and any future examinations for the current or prior years in determining the adequacy of the provision for income taxes. The Company continually assesses the likelihood and amount of potential adjustments and records any necessary adjustments in the period in which the facts that give rise to a revision become known. The Company has elected to record any interest or penalties from the uncertain tax position as income tax expense.

A valuation allowance is established when it is more likely than not that all or a portion of the net deferred tax asset will not be realized. The Company continues to maintain a full valuation allowance against its net deferred tax assets, as of the quarter ended March 31, 2010. In accordance with ASC Topic 740, the Company will continue to evaluate the need for a full or partial valuation allowance in future periods.

***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 EMD as the revenue related to the agreements is recognized.

***Comprehensive Income***

Pursuant to FASB ASC Topic 220, *Comprehensive Income* (ASC Topic 220), 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. For the six months ended March 31, 2010 and 2009, comprehensive income consists of net income (loss) and there were no items of other comprehensive income for any of the periods presented.

***Fair Value of Financial Instruments***

The Company adopted FASB ASC Topic 820, *Fair Value Measurements and Disclosures* (ASC Topic 820) 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 ASC Topic 820 and directly related to the amount of subjectivity associated with the inputs to fair valuation of these assets and liabilities, are as follows:

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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;
- 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 March 31, 2010, according to the valuation techniques the Company used to determine their fair values.



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|                            | Fair Value Measurement on March 31, 2010                               |  |  |
|----------------------------|--|--|--|
|                            | Quoted Price in<br>Active Markets for<br>Identical Assets<br>(Level 1) | Significant Other<br>Observable<br>Inputs<br>(Level 2) | Significant<br>Unobservable<br>Inputs<br>(Level 3) |
| Assets                     |  |  |  |
| Cash and cash equivalents: |  |  |  |
| Money market funds         | \$ 35,127,440  | \$   | \$   |

|                            | Fair Value Measurement on September 30, 2009                           |  |  |
|----------------------------|--|--|--|
|                            | Quoted Price in<br>Active Markets for<br>Identical Assets<br>(Level 1) | Significant Other<br>Observable<br>Inputs<br>(Level 2) | Significant<br>Unobservable<br>Inputs<br>(Level 3) |
| Assets                     |  |  |  |
| Cash and cash equivalents: |  |  |  |
| Money market funds         | \$ 34,793,543  | \$   | \$   |

***Stock-Based Compensation***

The Company accounts for stock-based compensation under FASB ASC Topic 505-50, *Equity-Based Payments to Non-Employees* (ASC Topic 505-50) and FASB ASC Topic 718, *Stock Compensation* (ASC Topic 718), which require 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.

***Warranty***

We offer warranties on some products of various lengths. At the time of shipment, we establish a reserve for costs 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 actual warranty costs differ from our estimated amounts, future results of operations could be adversely affected.

***Concentrations******Major Customers and Products***

For the three months ended March 31, 2010, three of the Company's customers, Lockheed Martin, FedEx and American Airlines, accounted for 18%, 17% and 13% of net sales, respectively. During the six months ended March 31, 2010, four of the Company's customers, Lockheed Martin, BAE Systems, FedEx and L3 Communications, accounted for 17%, 12%, 11% and 11% of net sales, respectively.

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For the three months ended March 31, 2009, two of the Company's customers, American Airlines and the United States Department of Defense accounted for 34% and 11% of net sales, respectively. During the six months ended March 31, 2009, two of the Company's customers, American Airlines and Boeing accounted for 32% and 10% of net sales, respectively.

### *Major Suppliers*

The Company, for strategic purposes such as timeliness and favorable pricing, currently buys several 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. For the three months ended March 31, 2010 the Company's two largest suppliers accounted for 14.2% and 13.5% of the Company's total inventory purchases, respectively. For the six months ended March 31, 2010 the Company's four largest suppliers accounted for 22.0%, 12.0%, 10.4% and 10.0% of the Company's total inventory purchases, respectively.

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*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 \$0.2 and \$0.2 million, as of March 31, 2010 and September 30, 2009, respectively

*Recent Accounting Pronouncements*

In May 2009, the FASB issued ASC Topic 855 (ASC Topic 855), *Subsequent Events* which 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. ASC Topic 855 is effective for interim or annual financial periods ending after June 15, 2009. In February 2010, the FASB amended its guidance removing the requirement for SEC filers to disclose the date through which an entity has evaluated subsequent events. The Company adopted ASC Topic 855 on April 1, 2009 and the adoption had no impact on the condensed consolidated financial statements.

In October 2009, the FASB issued Accounting Standards Update (ASU) No. 2009-13 (ASU 2009-13), *Multiple-Deliverable Revenue Arrangements* which updates ASC Topic 605-25, *Multiple Elements Arrangements*, of the FASB codification. ASU 2009-13 provides new guidance on how to determine if an arrangement involving multiple deliverables contains more than one unit of accounting, and if so allows companies to allocate arrangement considerations in a manner more consistent with the economics of the transaction. ASU 2009-13 is effective for the Company, prospectively, for revenue arrangements entered into or materially modified in fiscal years beginning on or after June 15, 2010 (the Company's fiscal year 2011); early application is permitted. The Company is currently evaluating the impact of adopting ASU 2009-13 on its financial statements.

In October 2009, the FASB issued ASU No. 2009-14 (ASU 2009-14), *Revenue Arrangements That include Software Elements* which amends ASC Topic 985-605, *Software Revenue Recognition* in regard to the scope of software guidance. ASU 2009-14 excludes software components of tangible products that function together to provide the tangible product's essential functionality. While ASU 2009-14 does not create any new methods of revenue recognition, it could significantly affect the Company's recognition of revenue from period to period. ASU 2009-14 is effective for the Company, prospectively, for revenue arrangements entered into or materially modified in fiscal years beginning on or after June 15, 2010 (the Company's fiscal year 2011); early application is permitted as long as the guidance from ASU 2009-13 is applied. The Company is currently evaluating the impact of adopting ASU 2009-14 on its financial statements.

In January 2010, the FASB issued ASU No. 2010-06 (ASU 2010-06), *Fair Value Measurements and Disclosures* which amends ASC Topic 820, adding new requirements for disclosures for Levels 1 and 2, separate disclosures of purchases, sales, issuances, and settlements relating to Level 3 measurements and clarification of existing fair value disclosures. ASU 2010-06 is effective for interim and annual periods beginning after December 15, 2009, except for the requirement to provide Level 3 activity of purchases, sales, issuances, and settlements on a gross basis,

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which will be effective for fiscal years beginning after December 15, 2010 (the Company's fiscal year 2012); early adoption is permitted. The Company is currently evaluating the impact of adopting ASU 2009-14 on its financial statements.

### **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:

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|                 | March 31,<br>2010 | September 30,<br>2009 |
|-----------------|-------------------|-----------------------|
| Raw materials   | \$ 3,140,522      | \$ 3,535,109          |
| Work-in-process | 669,811           | 315,179               |
| Finished goods  | 1,244,089         | 1,456,697             |
|                 | \$ 5,054,422      | \$ 5,306,985          |

*Prepaid expenses and other current assets*

Prepaid expenses and other current assets consist of the following:

|                                     | March 31,<br>2010 | September 30,<br>2009 |
|-------------------------------------|-------------------|-----------------------|
| Revenue recognized not yet invoiced | \$ 473,220        | \$ 491,417            |
| Prepaid insurance                   | 201,685           | 307,477               |
| Deferred engineering costs          | 14,014            | 81,957                |
| Income tax asset                    | 405,705           |                       |
| Other                               | 267,759           | 346,562               |
|                                     | \$ 1,362,383      | \$ 1,227,413          |

*Property and equipment*

Property and equipment, net consists of the following balances:

|   | March 31,<br>2010 | September 30,<br>2009 |
|---|-------------------|-----------------------|
| Computer equipment                              | \$ 2,034,077      | \$ 1,986,028          |
| Corporate airplane                              | 3,082,186         | 3,082,186             |
| Furniture and office equipment                  | 1,089,298         | 1,074,031             |
| Manufacturing facility                          | 5,576,466         | 5,558,553             |
| Equipment                                       | 4,097,202         | 4,037,689             |
| Land  | 1,021,245         | 1,021,245             |
|   | 16,900,474        | 16,759,732            |
| Less: Accumulated depreciation and amortization | (8,808,459)       | (8,416,031)           |
|   | \$ 8,092,015      | \$ 8,343,701          |

Depreciation and amortization related to property and equipment was approximately \$199,000 and \$221,000 for the three months ended March 31, 2010 and 2009, respectively.

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Depreciation and amortization related to property and equipment was approximately \$391,000 and \$438,000 for the six months ended March 31, 2010 and 2009, respectively.

### *Other assets*

Other assets consist of the following:

|  | March 31,<br>2010 | September 30,<br>2009 |
|--|-------------------|-----------------------|
| Intangible assets, net of accumulated amortization of \$218,090 and \$198,140 at March 31, 2010 and September 30, 2009 | \$ 260,910        | \$ 280,860            |
| Installation kits, deposit forfeiture  | \$ 260,910        | 118,660               |
|  | \$ 260,910        | \$ 399,520            |

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Intangible assets consist of licensing and certification rights which are amortized over a defined number of units. No impairment charge was recorded in the six months ended March 31, 2010.

Total intangible amortization expense was approximately \$18,950 and \$40,000 for the three months ended March 31, 2010 and 2009, respectively. Total amortization expense for the six months ended March 31, 2010 and 2009 was \$19,950 and \$83,000, 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:

|                                    | March 31,<br>2010 | September 30,<br>2009 |
|------------------------------------|-------------------|-----------------------|
| Warranty (a)                       | \$ 790,684        | \$ 808,544            |
| Salary, benefits and payroll taxes | 504,330           | 617,224               |
| Reduction in workforce / severance |                   | 166,453               |
| Professional fees                  | 259,213           | 188,349               |
| Income taxes payable               |                   | 112,449               |
| Materials on order                 | 34,578            | 108,210               |
| Other                              | 563,431           | 784,331               |
|                                    | \$ 2,152,236      | \$ 2,785,560          |

(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 is 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 March 31, 2010 is highlighted below:

|   |            |
|---|------------|
| Warranty Accrual at December 31, 2009                     | \$ 779,263 |
| Accrued expense for the three months ended March 31, 2010 | 68,931     |
| Warranty cost for the three months ended March 31, 2010   | (57,510)   |
| Warranty Accrual at March 31, 2010                        | \$ 790,684 |

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Warranty cost and accrual information for the six months ended March 31, 2010 is highlighted below:

|   |    |           |
|---|----|-----------|
| Warranty Accrual at September 30, 2009                  | \$ | 808,544   |
| Accrued expense for the six months ended March 31, 2010 |    | 119,071   |
| Warranty cost for the six months ended March 31, 2010   |    | (136,930) |
| Warranty Accrual at March 31, 2010                      | \$ | 790,685   |

### *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 was scheduled to mature in 2015 and carried an interest rate set by the remarketing agent that was consistent with 30-day tax-exempt commercial paper. The Company exercised its option to pay-down the outstanding balance during August, 2009.

The interest cost related to this debt for the three months ended March 31, 2010 and 2009 was \$0 and \$9,000, respectively. The interest cost related to this debt for the six months ended March 31, 2010 and 2009 was \$0 and \$33,000 respectively. The Company was required to maintain a letter of credit in the amount of \$5,000,000 covering the debt, prior to the August, 2009 redemption.



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**3. Income Taxes**

The income tax benefit for the three and six months ended March 31, 2010 was \$78,000 and \$406,000, respectively, as compared to an expense of \$96,000 and \$168,000, respectively, for the three and six months ended March 31, 2009. The income tax benefit for the three and six months ended March 31, 2010 was the result of the actual pre-tax loss for both periods, as compared to the actual pre-tax income from the same periods in the prior year.

The effective tax rates for the three months ended March 31, 2010 and 2009 were 9% and 7%, respectively. The effective tax rate differs from the statutory rate for the three months ended March 31, 2010 primarily due to a decrease in the overall forecast effective tax rate for the year from the previous quarter, in conjunction with a smaller pretax loss in the current quarter as compared to the quarter ended December 31, 2009. The effective tax rate differs from the statutory rate for the three months ended March 31, 2009 due to the reversal of certain deductible temporary differences, which were fully offset by a valuation allowance, that were deductible for income tax purposes in the fiscal year ended September 30, 2009.

The effective tax rates for the six months ended March 31, 2010 and 2009 were 18% and 5%, respectively. The effective tax rate differs from the statutory rate for the six months ended March 31, 2010 primarily due to the forecasted utilization of research and experimentation tax credit carry forwards and the forecasted net reversal of various deductible temporary differences which are fully offset by a valuation allowance, based on the forecasted level of pretax income. The effective tax rate differs from the statutory rate for the six months ended March 31, 2009 due to the reversal of certain deductible temporary differences, which were fully offset by a valuation allowance, that were deductible for income tax purposes in the fiscal year ended September 30, 2009.

As of March 31, 2010, the Company recognized a \$406,000 current income tax asset resulting from current taxable losses that can be carried back to prior years to offset federal income tax paid. The Company maintains a full valuation allowance against its net deferred tax assets, which may not be carried back to prior taxable years, and consist primarily of deductible temporary differences and other carryforward items. The Company will continue to maintain this valuation allowance until an appropriate level of profitability is sustained to conclude that it is more likely than not that a portion of these net deferred tax assets would be realized in future periods. As such, improvements in pre-tax income in the future within the jurisdictions where the Company maintains a valuation allowance may result in these tax benefits ultimately being realized. However, there is no assurance that such improvements will be achieved.

**4. Capital Stock**

At March 31, 2010, the Company's Articles of Incorporation provides the Company authority to issue 75,000,000 shares of Common Stock and 10,000,000 shares of blank check Preferred Stock.

*Share-based compensation*

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The Company accounts for share-based compensation under the provisions of ASC Topic 505-50 and ASC Topic 718, using the modified prospective approach and 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 approximately \$136,000 and \$183,000 for the three months ended March 31, 2010 and 2009, respectively. The income tax impact is recognized as a (charge) credit to additional paid-in capital in the statement of shareholders' equity related to share-based compensation arrangements was approximately (\$1,000) and (\$13,000) for the three months ended March 31, 2010 and 2009, respectively.

Total share-based compensation expense was approximately \$287,000 and \$377,000 for the six months ended March 31, 2010 and 2009, respectively. The income tax impact is recognized as a (charge) credit to additional paid-in capital in the statement of shareholders' equity related to share-based compensation arrangements was approximately (\$3,000) and \$4,000 for the six months ended March 31, 2010 and 2009, 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"), the 2003 Restricted Stock Plan (the "Restricted Plan") and the 2009 Stock-Based Incentive Compensation Plan (the "2009 Plan"). These plans were approved by the Company's shareholders. The 1998 Plan expired on November 13, 2008.

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***1998 Stock Option Plan***

The 1998 Plan allowed the granting of incentive and nonqualified stock options to employees, officers, directors, and independent contractors and consultants. No stock options were granted to independent contractors or consultants under this Plan. Total compensation expense associated with awards under the 1998 plan was \$86,000 and \$133,000 for the three months ended March 31, 2010 and 2009, respectively. Total compensation expense associated with awards under the 1998 plan was \$187,000 and \$277,000 for the six months ended March 31, 2010 and 2009, respectively.

Incentive stock options granted under the 1998 Plan have exercise prices that are at least equal to the fair value of the common stock on the grant date. Nonqualified stock options granted under the 1998 Plan have exercise prices that are 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 1998 Plan. On November 13, 2008, the 1998 Plan expired and no additional shares were granted under the Plan after that date.

***Restricted Plan***

Total compensation expense under the Restricted Plan was \$50,000 for both the three months ended March 31, 2010 and 2009, respectively. Total compensation expense associated with the Restricted Plan was \$100,000 for both the six months ended March 31, 2010 and 2009, respectively. 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.

***2009 Stock-Based Incentive Compensation Plan***

The 2009 Plan authorizes the grant of Stock Appreciation Rights ( SARs ), 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 options as defined in section 422 of the Internal Revenue Code (the Code ), 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 shall be 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 Code. At March 31, 2010 there were 1,150,000 shares of Common Stock available for awards under the plan.

If any Award is forfeited, or if any Option terminates, expires or lapses without being exercised, shares of Common Stock subject to such Award will again be available for future grant. Any shares tendered by a participant in payment of the exercise price of an Option or the tax liability with respect to an Award (including, in any case, shares withheld from any such Award) will not be available for future grant under the 2009

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Plan. If there is any change in the Company's corporate capitalization, the Committee shall proportionately and equitably adjust the number and kind of shares of Common Stock which may be issued in connection with future Awards, the number and kind of shares of Common Stock covered by Awards then outstanding under the 2009 Plan, the number and kind of shares of Common Stock available under the 2009 Plan, the exercise or grant price of any Award, or if deemed appropriate, make provision for a cash payment with respect to any outstanding Award, provided that no adjustment may be made that would adversely affect the status of any Award that is intended to be a performance-based Award under Section 162(m) of the Code, unless otherwise determined by the Committee. In addition, the Committee may make adjustments in the terms and conditions of any Awards, including any performance goals, in recognition of unusual or nonrecurring events affecting the Company or any subsidiary, or in response to changes in applicable laws, regulations or accounting principles, provided that no adjustment may be made that would adversely affect the status of any Award that is intended to be a performance-based Award under Section 162(m) of the Code, unless otherwise determined by the Committee.

At March 31, 2010, there was no recognized compensation cost related to the 2009 Plan.

### *Stock repurchase program*

On February 23, 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. 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 March 31, 2010, and the program was extended as outlined below on February 16, 2010.

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On February 16, 2010, the Company's Board of Directors extended the 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. During the three months ended March 31, 2010 the Company purchased 5,200 shares of common stock under the program at a cost of \$21,661, or an average market price of \$4.17 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 of the three months ended March 31, 2010:

| Period        | Total<br>Number of<br>Shares<br>Purchased | Average<br>Price Paid<br>per Share | Total Number of<br>Shares Purchased as<br>Part of Publicly<br>Announced Plans or<br>Programs | Number of<br>Shares that May<br>Yet Be Purchased<br>Under the<br>Program |
|---------------|---|------------------------------------|--|--|
| January 2010  |   |                                    |  |  |
| February 2010 | 4,100                                     | \$ 4.16                            | 4,100  | 995,900  |
| March 2010    | 1,100                                     | \$ 4.20                            | 1,100  | 994,800  |
|               | 5,200                                     |                                    | 5,200  |  |

**5. Income (Loss) per Share**

Income (loss) per share (EPS) is calculated using the principles of FASB Accounting Standards Topic 260 (ASC 260), *Earnings Per Share*.

For the three and six month periods ended March 31, 2010, there were 380,000 options to purchase common stock outstanding excluded from the computations of diluted earnings per share as the effect would be anti-dilutive.

For the three and six month periods ended March 31, 2009, there were 638,000 and 438,000 options to purchase common stock outstanding, respectively, excluded from the computations of diluted earnings per share as the effect would be anti-dilutive.

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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 factors:*

- *the impact of general economic trends on our business;*
  
- *the deferral or termination of programs or contracts for convenience by customers;*
  
- *difficulties in developing and producing our COCKPIT/IP system or other planned products for product enhancements;*
  
- *market acceptance of our flat panel display systems, or COCKPIT/IP system or other planned products for product enhancements;*
  
- *our ability to gain regulatory approval of our products in a timely manner;*
  
- *failure to retain/recruit key personnel;*
  
- *continued market acceptance of our air data systems and products;*

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- *the availability of government funding;*
- *delays in receiving components from third party suppliers;*
- *the competitive environment;*
- *the bankruptcy or insolvency of one or more key customers;*
- *new product offerings from competitors;*
- *protection of intellectual property rights;*
- *our ability to service the international market;*
- *potential future acquisitions; 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, 2009.*

*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*



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*Innovative Solutions and Support, Inc.*

**Company Overview**

Innovative Solutions and Support, Inc. (The Company, IS&S or we) was founded in 1988. The Company designs, develops, manufactures and sells Flight Information Computers, Flat-Panel Display Systems, 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.

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 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.

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. Additionally, 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 should 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, revenues 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, 2009 contains a discussion of these critical accounting policies. There have been no significant changes in our critical accounting policies since September 30, 2009. See also Note 1 to our unaudited condensed consolidated financial statements for the three and six month period ended March 31, 2010 as set forth herein.

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**RESULTS OF OPERATIONS FOR THE THREE AND SIX MONTHS ENDED  
MARCH 31, 2010 AND 2009**

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):

|  | <b>Three Months Ending March 31,</b> |             | <b>Six Months Ending March 31,</b> |             |
|--|--------------------------------------|-------------|------------------------------------|-------------|
|  | <b>2010</b>                          | <b>2009</b> | <b>2010</b>                        | <b>2009</b> |
| <b>Net sales:</b>                          |                                      |             |                                    |             |
| Product                                    | 92.8%                                | 89.5%       | 88.4%                              | 86.8%       |
| Engineering - modification and development | 7.2%                                 | 10.5%       | 11.6%                              | 13.2%       |
| Total net sales                            | 100.0%                               | 100.0%      | 100.0%                             | 100.0%      |
| <b>Cost of sales</b>                       |                                      |             |                                    |             |
| Product                                    | 52.4%                                | 47.0%       | 51.9%                              | 47.1%       |
| Engineering - modification and development | 2.4%                                 | 2.9%        | 6.0%                               | 2.7%        |
| Total cost of sales                        | 54.8%                                | 49.9%       | 57.9%                              | 49.8%       |
| Gross profit                               | 45.2%                                | 50.1%       | 42.1%                              | 50.2%       |
| <b>Operating expenses:</b>                 |                                      |             |                                    |             |
| Research and development                   | 26.1%                                | 15.4%       | 25.7%                              | 13.7%       |
| Selling, general and administrative        | 34.9%                                | 21.7%       | 40.4%                              | 22.0%       |
| Total operating expenses                   | 61.0%                                | 37.1%       | 66.1%                              | 35.8%       |
| Operating income (loss)                    | -15.8%                               | 13.0%       | -24.0%                             | 14.5%       |
| Interest income                            | 0.5%                                 | 0.9%        | 0.5%                               | 1.4%        |
| Interest (expense)                         | 0.0%                                 | -0.2%       | 0.0%                               | -0.3%       |
| Other income                               | 0.0%                                 | 0.0%        | 0.5%                               | 0.2%        |
| Income (loss) before income taxes          | -15.3%                               | 13.8%       | -23.0%                             | 15.9%       |
| Income tax expense (benefit)               | -1.4%                                | 0.9%        | -4.1%                              | 0.8%        |
| Net income (loss)                          | -13.9%                               | 12.9%       | -18.9%                             | 15.1%       |

**Three Months Ended March 31, 2010 Compared to the Three Months Ended March 31, 2009**

*Net sales.* Net sales decreased \$5.1 million, or 48.6%, to \$5.4 million for the three months ended March 31, 2010 from \$10.5 million in the three months ended March 31, 2009. For the three months ended March 31, 2010, product sales decreased \$4.4 million and EMD sales decreased \$0.7 million from the same period in the prior year. The decrease in both product and EMD sales was primarily driven by customer delays in delivery schedules for backlog orders.

*Cost of sales.* Cost of sales decreased \$2.3 million or 43.6%, to \$2.9 million, or 54.8% of net sales in the three months ended March 31, 2010 from \$5.2 million, or 49.9% of net sales in the three months ended March 31, 2009. The decrease was primarily the result of the decrease in variable production costs during the quarter, resulting from lower product sales, which accounted for \$2.1 million of the decrease, with an

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additional decrease of \$0.2 million in EMD related costs. The reduced sales volume for the three months ended March 31, 2010 had a negative impact on gross margin as compared to the prior year period.

*Research and development.* Research and development expense decreased \$0.2 million or 12.8% to \$1.4 million or 26.1% of net sales in the three months ended March 31, 2010 from \$1.6 million or 15.4% of net sales in the three months ended March 31, 2009. The decrease in research and development expense in the quarter was primarily due to a reduction in departmental headcount.

*Selling, general, and administrative.* Selling, general and administrative expenses decreased \$0.4 million, or 17.4%, to \$1.9 million, or 34.9% of net sales in the three months ended March 31, 2010 from \$2.3 million or 21.7% of net sales in the three months ended March 31, 2009. The decrease in selling, general, and administrative expense in the quarter was primarily due to continued cost containment efforts.

*Interest income.* Interest income was \$28,000 in the three months ended March 31, 2010 as compared to \$97,000 in the three months ended March 31, 2009. The decrease in interest income was primarily the result of lower interest rates in the quarter as compared to the prior year period.

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*Interest expense.* Interest expense was \$1,000 in the three months ended March 31, 2010 as compared to \$19,000 in the three months ended March 31, 2009. The reduction was primarily due to the redemption of the Industrial Development Bond during August, 2009.

*Income tax expense (benefit).* The income tax benefit for the three months ended March 31, 2010 was \$78,000 as compared to an expense of \$96,000 for the three months ended March 31, 2009. The income tax benefit for the three months ended March 31, 2010 was the result of the actual pre-tax loss for the quarter as compared to the actual pre-tax income for the same period in the prior year.

The effective tax rate for the three months ended March 31, 2010 and 2009 were 9% and 7%, respectively. The effective tax rate differs from the statutory rate for the three months ended March 31, 2010 primarily due to the decrease in the overall forecast effective tax rate for the year from the previous quarter, in conjunction with a smaller pretax loss in the current quarter as compared to the quarter ended December 31, 2009. The effective tax rate differs from the statutory rate for the three months ended March 31, 2009 due to the reversal of certain deductible temporary differences, which were fully offset by a valuation allowance, that were deductible for income tax purposes in the fiscal year ended September 30, 2009.

*Net (Loss) Income.* As a result of the factors described above, our net loss for the three months ended March 31, 2010 was (\$0.7) million. Net income for the three months ended March 31, 2009 was \$1.3 million. The loss per share of (\$0.04) for the three months ended March 31, 2010 compares to income per share of \$0.08, on a fully diluted basis, for the three months ended March 31, 2009.

**Six Months Ended March 31, 2010 Compared to the Six Months Ended March 31, 2009**

*Net sales.* Net sales decreased \$11.0 million, or 52.6%, to \$10.0 million for the six months ended March 31, 2010 from \$21.0 million in the six months ended March 31, 2009. For the six months ended March 31, 2010, product sales decreased \$9.4 million and EMD sales decreased \$1.6 million from the same period in the prior year. The decrease in both product and EMD sales was primarily driven by customer delays in delivery schedules for backlog orders.

*Cost of sales.* Cost of sales decreased \$4.7 million or 44.8%, to \$5.8 million, or 57.9% of net sales in the six months ended March 31, 2010 from \$10.5 million, or 49.8% of net sales in the six months ended March 31, 2009. The decrease was the result of the decrease in variable production costs during the quarter which accounted for the entire \$4.7 million of decreased costs, as EMD related costs remained flat. The reduced sales volume for the six months ended March 31, 2010 had a negative impact on gross margin as compared to the prior year period.

*Research and development.* Research and development expense decreased \$0.3 million or 11.1% to \$2.6 million or 25.7% of net sales in the six months ended March 31, 2010 from \$2.9 million or 13.7% of net sales in the six months ended March 31, 2009. The decrease in research and development expense in the quarter was primarily due to a reduction in departmental headcount.

*Selling, general, and administrative.* Selling, general and administrative expenses decreased \$0.6 million, or 13.0%, to \$4.0 million, or 40.4% of net sales in the six months ended March 31, 2010 from \$4.6 million or 22.0% of net sales in the six months ended March 31, 2009. The decrease in selling, general, and administrative expense in the quarter was primarily due to continued cost containment efforts.

*Interest income.* Interest income was \$51,000 in the six months ended March 31, 2010 as compared to \$298,000 in the six months ended March 31, 2009. The decrease in interest income was primarily the result of lower interest rates in the quarter as compared to the prior year period.

*Interest expense.* Interest expense was \$1,000 in the six months ended March 31, 2010 as compared to \$55,000 in the six months ended March 31, 2009. The reduction was primarily due to the redemption of the Industrial Development Bond during August, 2009.

*Income tax expense.* The income tax benefit for the six months ended March 31, 2010 was \$406,000 as compared to an expense of \$168,000 for the six months ended March 31, 2009. The income tax benefit for the three and six months ended March 31, 2010 was the result of the actual pre-tax loss for the quarter as compared to the actual pre-tax income from the same periods in the prior year.

The effective tax rates for the six months ended March 31, 2010 and 2009 were 18% and 5%, respectively. The effective tax rate differs from the statutory rate for the six months ended March 31, 2010 due to the forecasted utilization of research and experimentation tax credit carryforwards, the forecasted net reversals of various deductible temporary differences which are fully offset by a valuation allowance and the forecasted level of pretax income. The effective tax rate differs from the statutory rate for the six months ended March 31, 2009 due to the reversal of certain deductible temporary differences, which were fully offset by a valuation allowance, that were deductible for income tax purposes in the fiscal year ended September 30, 2009.

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*Net (Loss) Income.* As a result of the factors described above, our net loss for the six months ended March 31, 2010 was \$(1.9) million. Net income for the six months ended March 31, 2009 was \$3.2 million.

**Liquidity and Capital Resources**

The following table highlights key financial measurements of the Company:

|  | <b>March 31,<br/>2010</b>                   | <b>September 30,<br/>2009</b> |
|--|---|-------------------------------|
| Cash and cash equivalents                        | \$ 35,654,687                               | \$ 35,565,694                 |
| Accounts receivable, net                         | 4,004,698                                   | 6,188,706                     |
| Current assets                                   | 46,549,190                                  | 48,792,791                    |
| Current liabilities                              | 3,227,558                                   | 4,168,314                     |
| Deferred revenue                                 | 196,963                                     | 225,648                       |
| Total debt and other non-current liabilities (1) | 880,085                                     | 918,072                       |
| Quick ratio (2)                                  | 12.29                                       | 10.02                         |
| Current ratio (3)                                | 14.42                                       | 11.71                         |
|  | <b>Six Months Ending March 31,<br/>2010</b> | <b>2009</b>                   |
| Cash flow activities:                            |   |                               |
| Net cash provided by operating activities        | \$ 258,903                                  | \$ 2,762,095                  |
| Net cash (used in) investing activities          | (142,529)                                   | (161,557)                     |
| Net cash (used in) financing activities          | (27,381)                                    | (113,480)                     |

(1) Excludes deferred revenue

(2) Calculated as: (Cash and cash equivalents and Accounts receivable, net) divided by Current liabilities

(3) Calculated as: Current assets divided by Current liabilities

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

***Operating activities***

Cash provided by operating activities was \$0.3 million for the six months ended March 31, 2010 as compared to cash provided by operating activities of \$2.8 million for the six months ended March 31, 2009. The decrease was primarily due to a net loss of \$1.9 million for the six months ended March 31, 2010 versus net income of \$3.2 million in the prior year period. The cash provided by operating activities during the six months ended March 31, 2010 was primarily due to decreases in accounts receivable, pre-paid expenses and inventory of \$2.2 million, \$0.3

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million and \$0.3 million, respectively. This was partially offset by the net loss experienced for the period, a decrease in accrued expenses and a decrease in accounts payable of \$1.9 million, \$0.6 million and \$0.3 million, respectively.

### *Investing activities*

Cash used in investing activities was \$143,000 for the six months ended March 31, 2010 and \$162,000 for the six months ended March 31, 2009, which primarily consisted of the purchase of production and laboratory test equipment.

### *Financing activities*

Net cash used in financing activities was \$27,000 for the six months ended March 31, 2010 which consisted of approximately \$22,000 for the repurchase of common stock and \$5,000 for the repayment of capitalized lease obligations. Net cash used in financing activities of \$113,000 for the six months ended March 31, 2009, which consisted of \$108,000 for the repurchase of common stock, and a \$5,000 repayment of capitalized lease obligations.

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 construction of the Company's new office and manufacturing facility.



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The loan was scheduled to mature in 2015 and carried an interest rate set by the remarketing agent that is consistent with 30-day tax-exempt commercial paper. The Company exercised its option to pay-down the outstanding balance during August, 2009.

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 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 March 31, 2010 and September 30, 2009, our backlog was \$35.0 million and \$34.1 million, respectively. The \$0.9 million increase in backlog was the result of \$10.9 million in new business orders offset by \$10.0 million of recognized revenue. Air Data product backlog as of March 31, 2010 increased \$1.1 million from September 30, 2009; while Flat Panel Display Systems backlog, as of March 31, 2010, decreased \$0.2 million from September 30, 2009. To the extent new business orders do not continue to equal or exceed recognized revenue from the Company's existing backlog, future operating results may be negatively impacted.

Backlog activity for the six months ended March 31, 2010 (in thousands):

| Balance at<br>September 30,<br>2009 | Additional<br>Bookings | Recognized<br>in Revenue | Balance at<br>March 31,<br>2010 |
|-------------------------------------|------------------------|--------------------------|---------------------------------|
| \$ 34,142                           | \$ 10,876              | \$ 9,980                 | \$ 35,038                       |

Backlog activity for the three months ended March 31, 2010 (in thousands):

| Balance at<br>December 31,<br>2009 | Additional<br>Bookings | Recognized<br>in Revenue | Balance at<br>March 31,<br>2010 |
|------------------------------------|------------------------|--------------------------|---------------------------------|
| \$ 34,321                          | \$ 6,090               | \$ 5,373                 | \$ 35,038                       |

**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 March 31, 2010 and September 30, 2009, we were not involved with any unconsolidated SPEs or VIEs.

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

The Company's operations are exposed to market risks primarily as a result of changes in interest rates. The Company does not use derivative financial instruments for speculative or trading purposes. The Company's exposure to market risk for changes in interest rates relates to its cash equivalents. The Company's cash equivalents consist of funds invested in money market accounts, which bear interest at a variable rate. As the interest rates are variable, and we do not engage in hedging activities, a change in interest rates earned on the cash equivalents would impact interest income and cash flows, but would not impact the fair market value of the related underlying instruments. Assuming that the balances during the three and six months ending March 31, 2010 were to remain constant and no actions were taken to alter the existing interest rate sensitivity, a hypothetical 1% increase or decrease in our variable interest rates would have affected interest income by approximately \$90,000 and \$183,000, respectively, with a resulting impact on cash flows of approximately \$90,000 and \$183,000 for the three and six months ended March 31, 2010, respectively.

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**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 March 31, 2010. 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 and claims. We do not believe any such matters that are currently pending will have a material adverse effect on our results of operations or financial position.

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, 2009.

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

*Stock repurchase program*

On February 23, 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. 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 March 31, 2010. The program was scheduled to expire on February 21, 2010; on February 16, 2010 the Company's Board of Directors approved the extension of this program.

On February 16, 2010, the Company's Board of Directors extended the 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. During the three months ended March 31, 2010 the Company purchased 5,200 shares of common stock under the program at a cost of \$21,661, or an average market price of \$4.17 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 of the three months ended March 31, 2010:

|              | <b>Total Number of<br/>Shares Purchased as</b> | <b>Number of<br/>Shares that May</b> |
|--------------|--|--------------------------------------|
| <b>Total</b> |  |                                      |

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| Period        | Number of Shares Purchased | Average Price Paid per Share | Part of Publicly Announced Plans or Programs | Yet Be Purchased Under the Program |
|---------------|----------------------------|------------------------------|--|------------------------------------|
| January 2010  |                            |                              |  |                                    |
| February 2010 | 4,100                      | \$ 4.16                      | 4,100  | 995,900                            |
| March 2010    | 1,100                      | \$ 4.20                      | 1,100  | 994,800                            |
|               | 5,200                      |                              | 5,200  |                                    |

**Item 3. Defaults upon Senior Securities**

None

**Item 4.**

Removed and reserved

**Item 5. Other Information**

None

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**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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\* Filed herewith

Furnished herewith

**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: May 05, 2010

By:

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