INNOVATIVE SOLUTIONS & SUPPORT INC
Form 10-Q
August 07, 2006

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, 2006

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	**23-2507402**
(State or other jurisdiction of incorporation)	(IRS Employer Identification No.)
720 Pennsylvania Drive, Exton, Pennsylvania	**19341**
(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 days.

Yes x No o

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

o Large accelerated filer x Accelerated filer o Non-accelerated filer

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

Yes o No x

As of August 2, 2006, there were 16,812,269 shares of the Registrant s Common Stock, with par value of $.001 per share, outstanding.

INNOVATIVE SOLUTIONS & SUPPORT, INC.

FORM 10-Q June 30, 2006

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PART I FINANCIAL INFORMATION

Item 1 Financial Statements

INNOVATIVE SOLUTIONS AND SUPPORT, INC.

CONDENSED CONSOLIDATED BALANCE SHEET

(unaudited)

ASSETS	As of June 30, 2006	As of September 30, 2005
Current Assets:		
Cash and cash equivalents	$ 66,679,719	$ 83,172,582
Accounts receivable, less allowance for doubtful accounts of $100,000 at June 30, 2006 and September 30, 2005	1,651,487	5,479,936
Inventories	5,888,956	3,911,626
Deferred income taxes	1,000,604	956,070
Prepaid expenses and other current assets	3,287,000	4,028,498
Total current assets	78,507,766	97,548,712
Property and Equipment:		
Computers and test equipment	4,616,382	4,278,748
Corporate airplane	3,027,502	2,998,161
Furniture and office equipment	748,827	734,038
Manufacturing facility	5,420,741	5,420,741
Land	1,021,245	1,021,245
	14,834,697	14,452,933
Less- Accumulated depreciation and amortization	(5,691,721)	(5,091,881)
Net property and equipment	9,142,976	9,361,052
Deposits and other assets	339,864	125,114
Total assets	$ 87,990,606	$ 107,034,878
LIABILITIES AND SHAREHOLDERS EQUITY		
CURRENT LIABILITIES:		
Current portion of notes payable	$ 100,000	$ 100,000
Current portion of capitalized lease obligations	7,891	7,257
Accounts payable	631,503	305,516
Accrued expenses	2,798,295	3,503,814
Deferred revenue	592,288	176,650
Total current liabilities	4,129,977	4,093,237
Note payable	4,235,000	4,235,000
Long-term portion of capitalized lease obligations	6,591	13,113
Deferred revenue	138,609	191,463
Deferred income taxes	521,388	635,967
Commitments and contingencies		
Shareholders Equity:		
Preferred stock, 10,000,000 shares authorized, $.001par value, of which 200,000 shares are authorized as Class A Convertible stock. No shares issued and outstanding at June 30, 2006 and September 30, 2005.	--	---
Common stock, $.001 par value: 75,000,000 shares authorized, 18,080,879 and 18,047,425 shares issued and outstanding at June 30, 2006 and September 30, 2005	18,081	18,047
Additional paid-in capital	43,038,800	41,926,318
Retained earnings	53,988,588	55,921,733
Treasury stock, at cost, 1,272,510 and 0 shares at June 30, 2006 and September 30, 2005	(18,086,428)	---
Total shareholders equity	78,959,041	97,866,098
Total liabilities and shareholders equity	$ 87,990,606	$ 107,034,878

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 2006	Three Months Ended June 30 2005	Nine Months Ended June 30 2006	Nine Months Ended June 30 2005
Net sales	$ 2,991,022	$ 17,101,620	$ 12,141,161	$ 55,081,445
Cost of sales	1,667,301	5,846,912	6,564,037	17,806,327
Gross profit	1,323,721	11,254,708	5,577,124	37,275,118
Operating expenses:				
Research and development	1,695,304	1,501,475	5,147,093	4,321,474
Selling, general and administrative	2,543,635	2,489,287	6,641,121	6,821,682
	4,238,939	3,990,762	11,788,214	11,143,156
Operating income (loss)	(2,915,218)	7,263,946	(6,211,090)	26,131,962
Interest income	848,601	543,857	2,449,672	1,255,431
Interest expense	(50,068)	(48,796)	(138,063)	(127,930)
Income (loss) before income taxes	(2,116,685)	7,759,007	(3,899,481)	27,259,463
Income tax expense (benefit)	(955,071)	2,860,294	(1,966,336)	9,894,108
Net income (loss)	$ (1,161,614)	$ 4,898,713	$ (1,933,145)	$ 17,365,355
Net income (loss) per common share:				
Basic	$ (0.07)	$ 0.27	$ (0.11)	$ 0.97
Diluted	$ (0.07)	$ 0.27	$ (0.11)	$ 0.95
Weighted average shares outstanding:				
Basic	17,013,737	17,909,270	17,582,519	17,814,504
Diluted	17,013,737	18,360,921	17,582,519	18,314,568

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 2006	For the Nine Months Ended June 30 2005
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income (loss)	$ (1,933,145)	$ 17,365,355
Adjustments to reconcile net income to net cash provided by (used in) operating activities:		
Depreciation and amortization	628,750	565,876
Stock-based compensation expense	539,635	
Compensation expense for stock issued to directors	239,919	145,525
Loss (Gain) on disposal of fixed assets	156	(14,000)
Excess and obsolete inventory expense	47,817	52,340
Deferred income taxes	(159,113)	
Tax benefit from exercise of stock options	201,826	1,628,562
Excess tax benefits from share-based payment arrangements	(12,335)	
(Increase) decrease in:		
Accounts receivable	3,828,449	(2,493,776)
Inventories	(2,025,147)	1,478,696
Prepaid expenses and other current assets	743,348	(679,366)
Increase (decrease) in:		
Accounts payable	325,987	(1,286,829)
Accrued expenses	(705,519)	(989,931)
Deferred revenue	362,784	156,587
Net cash provided by operating activities	2,083,412	15,929,039
CASH FLOWS FROM INVESTING ACTIVITIES:		
Purchases of property and equipment	(387,430)	(315,221)
Purchases of other assets	(240,000)	
Net cash used in investing activities	(627,430)	(315,221)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Proceeds from exercise of stock options	131,136	1,744,370
Purchase of treasury stock	(18,086,428)	
Repayment of capitalized lease obligation	(5,888)	(5,646)
Excess tax benefits from share-based payment arrangements	12,335	
Net cash provided by (used in) financing activities	(17,948,845)	1,738,724
Net increase (decrease) in cash and cash equivalents	$ (16,492,863)	$ 17,352,542
Cash and cash equivalents, beginning of year	$ 83,172,582	$ 65,867,167
Cash and cash equivalents, end of period	$ 66,679,719	$ 83,219,709
SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION:		
Cash paid for interest	$ 108,938	$ 72,932
Cash paid for income taxes	$ 440,338	$ 10,046,772
Cash received from income tax refund	$ (3,267,575)	$

The accompanying notes are an integral part of these statements.

Innovative Solutions & Support Inc.

Notes to Condensed Consolidated Financial Statements

1. Basis of Presentation:

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

The balance sheet as of June 30, 2006, the statement of operations for the three months and nine months ended June 30, 2006 and 2005 and the statements of cash flows for the nine months ended June 30, 2006 and 2005 have been prepared by the Company without audit. In the opinion of management, all adjustments, consisting of normal and recurring adjustments, necessary to present fairly the financial position, results of operations and cash flows at June 30, 2006 and for all periods presented have been made.

Certain information and footnote disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States of America have been condensed or omitted. It is suggested that these financial statements be read in conjunction with the financial statements and notes thereto included in the Company s Form 10K for the year ended September 30, 2005 as filed with the Securities and Exchange Commission. The results of operations for the three months and nine months ended June 30, 2006 are not necessarily indicative of the operating results for the full year.

On June 13, 2005, the Company s Board of Directors approved a three-for-two split of the Company s common stock. The stock split was effected in the form of a fifty (50%) stock dividend that was paid on July 7, 2005 to shareholders of record on June 23, 2005. The issued and outstanding common stock and all the share and per share amounts have been retroactively restated in this report to give effect to this three-for-two stock split.

2. Net income per Share

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

A reconciliation of weighted average shares outstanding appears below:

	Three Months Ended June 2006	**Three Months Ended June 2005**	**Nine Months Ended June 2006**	**Nine Months Ended June 2005**
Weighted average number of shares-basic	17,013,737	17,909,270	17,582,519	17,814,504
Effect of dilutive securities:				
Employee stock options		451,651		500,064
Weighted average number of shares-diluted	17,013,737	18,360,921	17,582,519	18,314,568

For the three month periods ended June 30, 2006 and 2005, there were 371,272 and 0 options outstanding that were excluded from the computation of diluted earnings per share as the effect would have been antidilutive. For the nine month periods ended June 30, 2006 and 2005, there were 418,559 and 16,841 options outstanding that were excluded from the computation of diluted earnings per share as the effect would be antidilutive.

3. Concentrations

For the three months ended June 30, 2006, two customers accounted for 16.1% and 10.4% of net sales or 26.5% of net sales on a combined basis. For the three months ended June 30, 2005, three customers accounted for 19%, 15% and 11% of net sales or 45% of net sales on a combined basis. For the nine months ended June 30, 2006, two customers accounted for 12.4% and 9.8% of net sales or 22.2% of net sales on a combined basis. For the nine months ended June 30, 2005, three customers accounted for 12%, 11% and 10% of net sales or 33% on a combined basis.

4. Inventories

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

	June 30 2006	September 30 2005
Raw materials	$ 3,103,347	$ 1,696,050
Work-in-process	1,777,700	1,151,828
Finished goods	1,007,909	1,063,748
	$ 5,888,956	$ 3,911,626

5. Warranty

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

Warranty cost and accrual information for the three months ended June 30, 2006 is highlighted below:

Warranty accrual at March 31, 2006	$ 708,952
Accrued expense for the three months ended June 30, 2006	12,861
Warranty costs for the three months ended June 30, 2006	(70,631)
Warranty accrual at June 30, 2006	$ 651,182

Warranty cost and accrual information for the nine months ended June 30, 2006 is highlighted below:

Warranty accrual at September 30, 2005	$ 770,845
Accrued expense for the nine months ended June 30, 2006	43,640
Warranty costs for the nine months ended June 30, 2006	(163,303)
Warranty accrual at June 30, 2006	$ 651,182

6. Stock Options

The Company s 1998 Stock Option Plan (the Plan) provides for the granting of incentive and nonqualified stock options to employees, officers, directors and independent contractors and consultants. Through June 30, 2006 no stock options have been granted to independent contractors or consultants under this plan.

Incentive stock options granted under the Plan have exercise prices that must be at least equal to the fair value of the common stock on the date of grant. Nonqualified stock options granted under the Plan have exercise prices that may be less than, equal to or greater than the fair value of the common stock on the date of grant. The Company has reserved 3,389,025 shares of Common Stock for awards under the Plan. As of June 30, 2006 there were 1,696,518 remaining and available for grant.

On December 16, 2004, the FASB finalized SFAS No. 123(R) Share-Based Payment (SFAS 123(R)). SFAS123(R) amends SFAS 123 and supersedes APB25. SFAS 123(R) requires that the cost of share-based payment transactions (including those with employees and non-employee directors) be recognized in the financial statements. SFAS 123(R) applies to all share-based payment transactions in which an entity acquires goods or services by issuing (or offering to issue) its shares, share options, or other equity instruments (except for those held by an Employee Stock Option Plan (ESOP)) or by incurring liabilities (1) in amounts based (even in part) on the price of the entity s shares or other equity instruments, or (2) that require (or may require) settlement by the issuance of an entity s shares or other equity instruments. This statement was effective as of the first annual reporting period beginning after June 15, 2005, which is the Company s period beginning October 1, 2005.

Effective October 1, 2005 the Company adopted the provisions of SFAS 123(R), using the modified prospective approach and now accounts for share-based compensation applying the fair value method for expensing stock options. Accordingly, the adoption of SFAS 123R s fair value method resulted in compensation costs for the Company s 1998 Stock Option Plan. The compensation cost that has been charged against income as a result of adoption of SFAS 123(R) for the plan was $184,128 and $539,635 for the three and nine month periods ended June 30, 2006, respectively . The total income tax benefit recognized in the statement of operations for share-based compensation arrangements was $74,498 and $218,336 for the three and nine month periods ended June 30, 2006, respectively.

Share-based compensation costs prior to October 1, 2005 were recognized using the intrinsic value method in accordance with Accounting Principles Board Opinion (APB) No. 25, Accounting for Stock Issued to Employees. For disclosure purposes, pro forma net income and net income per share data were provided in accordance with SFAS No. 123, Accounting for Stock-Based Compensation, as if the fair value method had been applied. Under SFAS No. 123, compensation cost related to stock options granted to employees was computed based on the fair value of the stock option at the date of grant using the Black-Scholes option pricing model. Prior to the adoption of SFAS 123(R) had compensation costs been determined based on the fair market value of the stock options, consistent with the provisions of SFAS 123, the Company s net income and earnings per share for the three and nine months ended June 30, 2005 would have been as follows:

	Three Months Ended June 30 2006	Three Months Ended June 30 2005	Nine Months Ended June 30 2006	Nine Months Ended June 30 2005
Net income (loss) as reported	$ (1,161,614)	$ 4,898,713	$ (1,933,145)	$ 17,365,355
Add back fair market value expense:				
Employee stock options (1)	109,630		321,299	
Deduct fair market value expense:				
Employee stock options (2)	(109,630)	(201,483)	(321,299)	(607,881)
Pro forma net income (loss)	$ (1,161,614)	$ 4,697,230	$ (1,933,145)	$ 16,757,474
Basic earnings (loss) per share				
As reported	$ (0.07)	$ 0.27	$ (0.11)	$ 0.97
Pro forma	$ (0.07)	$ 0.26	$ (0.11)	$ 0.94
Diluted earnings (loss) per share :				
As reported	$ (0.07)	$ 0.27	$ (0.11)	$ 0.95
Pro forma	$ (0.07)	$ 0.26	$ (0.11)	$ 0.91

(1) Amount represents compensation expense determined under the fair market value method included in reported net income, net of related tax effect.

(2) Amounts represent compensation expense if it had been determined under the fair market value based method, net of related tax effect.

The fair value of each option grant is estimated on the date of grant using the Black-Scholes option pricing model and the following weighted average assumptions:

	Nine Months Ended June 30 2006	Nine Months Ended June 30 2005
Expected lives (years)	9.0	8.8
Weighted average risk-free interest rate	1.9 %	1.7 %
Expected volatility	65.3 %	66.8 %
Expected dividend rate	%	%

7. Stock Repurchase Program

On December 28, 2005 the Company s Board of Directors approved a common stock repurchase program to acquire up to 2,000,000 shares of its outstanding common stock. Purchases of the stock may be made from time to time, subject to market conditions and at prevailing market prices. The program was in effect until June 30, 2006.

During the three months ended June 30, 2006, the Company repurchased 310,900 shares of its common stock at an average cost of $13.98 per share. Over the course of the program the Company repurchased 1,272,510 shares of its common stock at an average cost of $14.21 per share.

8. Notes Payable

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

The loan agreement requires the Company to maintain certain financial covenants including a ratio of liabilities to earnings before interest, taxes and depreciation and amortization (EBITDA), fixed charge ratio and a minimum tangible net worth.

As of June 30, 2006, the Company was in violation of these financial covenants. The defaults were subsequently waived and an amendment to the agreement was entered into with the lender whereby the existing covenants were suspended until the fiscal quarter ending on June 30, 2007.

New Accounting Pronouncements

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

In May 2005, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standard (SFAS) No. 154, Accounting Changes and Error Corrections a replacement of APB Opinion No. 20 and FASB Statement No. 3. SFAS No. 154 requires retrospective application to prior periods financial statements of changes in accounting principle, unless it is impracticable to determine either the period-specific effects or the cumulative effect of the change. SFAS No. 154 also requires that retrospective application of a change in accounting principle be limited to the direct effects of the change. Indirect effects of a change in accounting principle, such as a change in nondiscretionary profit-sharing payments resulting from an accounting change, should be recognized in the period of the accounting change. SFAS No. 154 also requires that a change in depreciation, amortization, or depletion method for long-lived, non-financial assets be accounted for as a change in accounting estimate effected by a change in accounting principle. SFAS No. 154 is effective for accounting changes and corrections of errors made in fiscal years beginning after December 15, 2005. Early adoption is permitted for accounting changes and corrections of errors made in fiscal years beginning after the date this Statement is issued. The Company will adopt the provisions of SFAS No. 154 as applicable beginning in fiscal 2007.

In December 2004, the FASB issued FASB Staff Position (FSP) FAS 109-1, Application of FASB Statement No. 109, Accounting for Income Taxes, to the Tax Deduction on Qualified Production Activities Provided by the American Jobs Creation Act of 2004 . This FSP provides guidance on the application of Statement 109 to the provisions within the American Jobs Creation Act of 2005 (the Act), which provides tax relief to U.S. domestic manufacturers. The FSP states that a manufacturer s deduction provided for under the Act should be accounted for as a special deduction in accordance with Statement 109 and not as a tax rate reduction. The FSP also reminds preparers that the special deduction should be considered by an enterprise in (a) measuring deferred taxes when the enterprise is subjected to graduated tax rates, and (b) assessing whether a valuation allowance is necessary as required by Statement 109. This statement is effective immediately. The Company has adopted this statement during fiscal year 2005 and it did not have a material impact on the Company s financial position or results of operations.

In November 2004, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards (SFAS) 151, Inventory Costs. This Statement amends the guidance in ARB No. 43, Chapter 4 Inventory Pricing, to clarify the accounting for abnormal amounts of idle facility expense, freight, handling costs, and wasted material (spoilage). Paragraph 5 of ARB 43, Chapter 4 previously stated that under some circumstances, items such as idle facility expense, excessive spoilage, double freight, and rehandling costs may be so abnormal as to require treatment as current period charges . This Statement requires that those items be

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recognized as current-period charges regardless of whether they meet the criterion of so abnormal. In addition, this Statement requires that allocation of fixed production overheads to the costs of conversion be based on the normal capacity of the production facilities. This statement is effective for inventory costs incurred during fiscal years beginning after June 15, 2005. The Company has adopted this statement on October 1, 2005 and it did not have a material impact on the Company s financial position or results of operations.

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

Overview

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

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

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

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

In April 2006, the Company announced that the Federal Aviation Administration (FAA) granted a Supplemental Type Certificate (STC) for its Flat Panel Primary Flight/Navigation Display System for use on the Pilatus PC-12 Airplane.

Our cost of 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, customer service, material control and quality departments as well as warranty costs.

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

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

Three Months Ended June 30, 2006 Compared to the Three Months Ended June 30, 2005

Net sales. Net sales decreased $14.1 million, or 83%, to $3.0 million for the three months ended June 30, 2006 from $17.1 million in the three months ended June 30, 2005. This decrease in net sales was mainly due to a decrease in demand for RVSM systems. Sales for the three months ended June 30, 2005 reflected an industry wide response to a Federal Aviation Administration (FAA) mandate that required the installation of RVSM equipment on aircraft flying between 29,000 and 41,000 feet by January 20, 2005. The peak demand for the RVSM system declined soon after this date.

Cost of sales. Cost of sales decreased $4.1 million or 71%, to $1.7 million, or 56% of net sales in the three months ended June 30, 2006 from $5.8 million, or 34 % of net sales in the three months ended June 30, 2005. The absolute dollar decrease in cost of sales was related to our decrease in net sales. As a percentage, the increase was the result of fixed operating costs being absorbed over lower net sales in the current period.

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Research and development. Research and development expenses increased $0.2 million or 13% to $1.7 million or 57% of net sales in the three months ended June 30, 2006 from $1.5 million or 9% of net sales in the three months ended June 30, 2005. The increase in dollar spending reflects our sustained new product development effort. The percent increase was due to lower sales in the period.

Selling, general, and administrative. Selling, general, and administrative expenses increased $54,000, or 2%, to $2.5 million, or 85% of net sales in the three months ended June 30, 2006 from $2.5 million or 15% of net sales in the three months ended June 30, 2005. The increase in the dollar amount was primarily the result of legal and other fees relating to intellectual property matters and recognition of expenses related to stock options offset by lower commissions. The increase as a percent of net sales was the result of lower net sales in the period.

Interest income. Interest income was $849,000 in the three months ended June 30, 2006 as compared to interest income of $544,000 in the three months ended June 30, 2005. The increase in interest income in the three months ended June 30, 2006 was primarily the result of higher interest rates in the current period.

Interest expense. Interest expense was $50,000 in the three months ended June 30, 2006 as compared to interest expense of $49,000 in the three months ended June 30, 2005. The increase in interest expense in the three months ended June 30, 2006 was primarily the result of higher interest rates in the period.

Income tax expense. Income tax benefit for the three months ended June 30, 2006 was $1.0 million. The income tax expense for the three months ending June 30, 2005 was $2.9 million. The decrease in tax expense was primarily due to the loss for the current period generating a tax benefit.

The effective tax rate in the June 30, 2006 quarter was a benefit of 45.12%. In the June 30, 2005 quarter the effective tax rate was 36%. For the June 30, 2006 quarter, the effective tax rate differs from the statutory rate due to the benefit for state income taxes partially offset by the loss of benefit from the deduction for domestic production activities and the exclusion for extraterritorial income due to the anticipated taxable loss for the year. For the June 30, 2005 quarter, the effective tax rate differs from the statutory rate due to state tax expense, partially offset by the utilization of research and development tax credits.

Net income (loss). As result of the factors described above, our net loss in the three months ended June 30, 2006 was $1.2 million, a 124% decrease from the $4.9 million net income in the three months ended June 30, 2005.

Nine months Ended June 30, 2006 Compared to the Nine months Ended June 30, 2005

Net sales. Net sales decreased $43.0 million, or 78%, to $12.1 million for the nine months ended June 30, 2006 from $55.1 million in the nine months ended June 30, 2005. This decrease in net sales was mainly due to a decrease in demand for RVSM systems. Sales for the nine months ended June 30, 2005 reflected an industry wide response to a Federal Aviation Administration (FAA) mandate that required the installation of RVSM equipment on aircraft flying between 29,000 and 41,000 feet by January 20, 2005. The peak demand for the RVSM system declined soon after this date.

Cost of sales. Cost of sales decreased $11.2 million or 63%, to $6.6 million, or 54% of net sales in the nine months ended June 30, 2006 from $17.8 million, or 32 % of net sales in the nine months ended June 30, 2005. The absolute dollar decrease in cost of sales was related to our decrease in net sales. As a percentage, the increase was the result of fixed operating costs being absorbed over lower net sales in the current period.

Research and development. Research and development expenses increased $0.8 million or 19% to $5.1 million or 42% of net sales in the nine months ended June 30, 2006 from $4.3 million or 8% of net sales in the nine months ended June 30, 2005. The increase in dollar spending reflects our sustained new product development effort. The percent increase was mostly due to lower sales in the period.

Selling, general, and administrative. Selling, general, and administrative expenses decreased $0.2 million, or 3%, to $6.6 million, or 55% of net sales in the nine months ended June 30, 2006 from $6.8 million or 12% of net sales in the nine months ended June 30, 2005. The decrease in the dollar amount was primarily the result of lower commissions offset by the recognition of expenses related to stock options. The increase as a percent of net sales was the result of lower net sales in the period.

Interest income. Interest income was $2.4 million in the nine months ended June 30, 2006 as compared to interest income of $1.3 million in the nine months ended June 30, 2005. The increase in interest income in the nine months ended June 30, 2006 was primarily the result of higher interest rates in the current period.

Interest expense. Interest expense was $138,000 in the nine months ended June 30, 2006 as compared to interest expense of $128,000 in the nine months ended June 30, 2005. The increase in interest expense in the nine months ended June 30, 2006 was primarily the result of higher interest rates in the period.

Income tax expense. Income tax benefit for the nine months ended June 30, 2006 was $2.0 million. The income tax expense for the nine months ending June 30, 2005 was $9.9 million. The decrease in tax expense was primarily due to the loss for the current period generating a tax benefit.

The effective tax rate for the nine months ended June 30, 2006 was a benefit of 50.43%. For the nine months ended June 30, 2005 the effective tax rate was 36.3%. For the nine months ended June 30, 2006, the effective tax rate differs from the statutory rate due to the benefit for state income taxes and an adjustment to the tax payable accounts, partially offset by the loss of benefit from the deduction for domestic production activities and the exclusion for extraterritorial income due to the anticipated taxable loss for the year. For the June 30, 2005 quarter, the effective tax rate differs from the statutory rate due to state tax expense, partially offset by the utilization of research and development tax credits.

Net income (loss). As a result of the factors described above, our net loss in the nine months ended June 30, 2006 was $1.9 million, a 111% decrease from the $17.4 million net income in the nine months ended June 30, 2005.

Liquidity and Capital Resources

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

Our cash flow from operating activities was $2.1 million for the nine months ended June 30, 2006, as compared to $15.9 million for the nine months ended June 30, 2005. The decrease was due primarily to lower net income ($19.3 million) and increased inventories ($3.5 million) which were partially offset by reduced accounts receivable ($6.3 million) and a decrease in prepaid expenses ($1.4 million).

Our cash used in investing activities was $627,000 for the nine months ended June 30, 2006. This primarily consisted of spending for product certification, production equipment and laboratory test equipment. Cash used in investing activities was $315,000 for the nine months ended June 30, 2005 and primarily consisted of spending for production equipment, laboratory test equipment, computer equipment and office furniture.

Net cash used in financing activities was $17.9 million for the nine months ended June 30, 2006 as compared to net cash provided by financing activities of $1.7 million in the nine months ended June 30, 2005. The primary use of cash for financing activities was attributable to the Company purchasing 1,272,510 shares of our stock at a total cost of $18.1 million. In both periods the primary source of cash was from proceeds from the exercise of stock options.

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

The loan agreement requires the Company to maintain certain financial covenants including a ratio of liabilities to earnings before interest, taxes and depreciation and amortization (EBITDA), fixed charge ratio and a minimum tangible net worth.

As of June 30, 2006, the Company was in violation of these financial covenants. The defaults were subsequently waived and an amendment to the agreement was entered into with the lender whereby the existing covenants were suspended until the fiscal quarter ending on June 30, 2007.

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

Backlog

As of June 30, 2006 and 2005, our backlog was $34.3 million and $13.7 million, respectively. The components of the backlog from period-to-period have shown a distinct transformation. Flat Panel Display Systems (FPDS) comprise $22.1 million, or 64% of the June 30, 2006 backlog, an increase of $17.0 million from the June 30, 2005 FPDS backlog of $5.1 million.

Bookings of FPDS for the nine months ended June 30, 2006 increased $17.3 million or 400% to $21.6 million from $4.3 million for the nine months ended June 30, 2005.

Critical Accounting Policies

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

The Company recognizes sales for products when the following revenue recognition criteria are met: persuasive evidence of an arrangement exists, product delivery and acceptance has occurred, pricing is fixed or determinable and collection is reasonably assured. The Company recognizes sales upon shipment of products to customers.

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

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

The Company enters into certain sales arrangements that include multiple deliverables as defined in Emerging Issues Task Force (EITF) Issue No. 00-21, *Accounting for Revenue Arrangements with Multiple Deliverables*. Effective July 1, 2003, the Company identifies all goods and/or services that are to be delivered separately under a sales arrangement and allocates revenue to each deliverable based on fair value that is established with the customer during contract negotiations. In general, revenues are separated between product sales and non-recurring engineering services. The allocated revenue for each deliverable is then recognized using appropriate revenue recognition methods. Effective for transactions entered into after October 1, 2003, the Company accounts for transactions with software and non-software components under EITF Issue 03-5, Applicability of AICPA Statement of Position 97-2, Software Revenue Recognition, to Non-Software Deliverables in an Arrangement Containing More-Than-Incidental Software.

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

We maintain an allowance for doubtful accounts for estimated losses resulting from the inability of our customers to make required payments. These allowances are determined by analyzing historical data and trends. If actual losses are greater than estimated amounts or if the financial condition of our customers were to deteriorate, resulting in an impairment of their ability to make payments, future results from operations could be adversely affected.

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

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

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

Business Segments

We operate in one principal business segment which designs, manufactures and sells flight information computers, flat panel display systems and advanced monitoring systems to the Department of Defense, government agencies, commercial air transport carriers and corporate/general aviation markets. We currently derive virtually all our net sales from the sale of this equipment. Almost all of the net sales, operating results and identifiable assets are in the United States. Net sales, operating results, and identifiable assets outside of the U.S. are not significant.

New Accounting Pronouncements

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

In May 2005, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standard (SFAS) No. 154, Accounting Changes and Error Corrections a replacement of APB Opinion No. 20 and FASB Statement No. 3. SFAS No. 154 requires retrospective application to prior periods financial statements of changes in accounting principle, unless it is impracticable to determine either the period-specific effects or the cumulative effect of the change. SFAS No. 154 also requires that retrospective application of a change in accounting principle be limited to the direct effects of the change. Indirect effects of a change in accounting principle, such as a change in nondiscretionary profit-sharing payments resulting from an accounting change, should be recognized in the period of the accounting change. SFAS No. 154 also requires that a change in depreciation, amortization, or depletion method for long-lived, non-financial assets be accounted for as a change in accounting estimate effected by a change in accounting principle. SFAS No. 154 is effective for accounting changes and corrections of errors made in fiscal years beginning after December 15, 2005. Early adoption is permitted for accounting changes and corrections of errors made in fiscal years beginning after the date this Statement is issued. The Company will adopt the provisions of SFAS No. 154 as applicable beginning in fiscal 2007.

In December 2004, the FASB issued FASB Staff Position (FSP) FAS 109-1, Application of FASB Statement No. 109, Accounting for Income Taxes, to the Tax Deduction on Qualified Production Activities Provided by the American Jobs Creation Act of 2004. This FSP provides guidance on the application of Statement 109 to the provisions within the American Jobs Creation Act of 2005 (the Act), which provides tax relief to U.S. domestic manufacturers. The FSP states that a manufacturer s deduction provided for under the Act should be accounted for as a special deduction in accordance with Statement 109 and not as a tax rate reduction. The FSP also reminds preparers that the special deduction should be considered by an enterprise in (a) measuring deferred taxes when the enterprise is subjected to graduated tax rates, and (b) assessing whether a valuation allowance is necessary as required by Statement 109. This statement is effective immediately. The Company has adopted this statement during fiscal year 2005 and it did not have a material impact on the Company s financial position or results of operations.

In November 2004, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards (SFAS) 151, Inventory Costs. This Statement amends the guidance in ARB No. 43, Chapter 4 Inventory Pricing, to clarify the accounting for abnormal amounts of idle facility expense, freight, handling costs, and wasted material (spoilage). Paragraph 5 of ARB 43, Chapter 4 previously stated that under some circumstances, items such as idle facility expense, excessive spoilage, double freight, and rehandling costs may be so abnormal as to require treatment as current period charges This Statement requires that those items be recognized as current-period charges regardless of whether they meet the criterion of so abnormal. In addition, this Statement requires that allocation of fixed production overheads to the costs of conversion be based on the normal capacity of the production facilities. This statement is effective for inventory costs incurred during fiscal years beginning after June 15, 2005. The Company has adopted this statement on October 1, 2005 and it did not have a material impact on the Company s financial position or results of operations.

FORWARD-LOOKING STATEMENTS

This Form 10-Q contains statements, which, to the extent that they are not recitations of historical fact, constitute forward-looking statements within the meaning of the Securities Act of 1933 and the Securities Exchange Act of 1934. The words believe, estimate, anticipate, project, intend, expect, plan, outlook, forecast and similar expressions are intended to identify forward-looking statements. Numerous factors, includ potentially the following factors, could affect the Company s forward-looking statements and actual performance:

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continued market acceptance of our air data systems products;

our ability to obtain future contracts and awards;

availability of government funding and customer requirements;

difficulties in developing and producing our flat panel display systems (CIP) or other planned products or product enhancements;

market acceptance of our CIP system or other planned products or product enhancements;

our ability to gain regulatory approval of our products in a timely manner;

delays in receiving components from third party suppliers;

the competitive environment;

termination of programs or contracts for convenience by customers;

failure to retain key personnel;

new product offerings from competitors;

potential future acquisitions;

protection of intellectual property rights;

our ability to service the international market, and

other factors disclosed from time to time in our filings with the Securities and Exchange Commission.

Readers are cautioned not to place undue reliance on these forward-looking statements, which speak only as of the date of this Form 10-Q. The Company does not undertake any obligation to publicly release any revisions to these forward-looking statements to reflect events, 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, 2005.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

The Company s operations are exposed to market risks primarily as a result of changes in interest rates. The Company does not use derivative financial instruments for speculative or trading purposes. The Company s exposure to market risk for changes in interest rates relates to its cash equivalents and an industrial revenue bond. The Company s cash equivalents consist of funds invested in money market accounts, which bear interest at a variable rate, while the industrial revenue bond carries an interest rate that is consistent with 30-day, tax-exempt commercial paper. As the interest rates are variable, and we do not engage in hedging activities, a change in interest rates earned on the cash equivalents or paid on the industrial revenue bond would impact interest income and expense along with cash flows, but would not impact the fair market value of the related underlying instruments.

Item 4. Controls and Procedures

(a) An evaluation was performed under the supervision and with the participation of the Company s management, including its Chief Executive Officer, or CEO, and Chief Financial Officer, or CFO, of the effectiveness of the Company s disclosure controls and procedures, as such term is defined under Rule 13a-15e under the Securities Exchange Act of 1934, as amended (the Exchange Act) as of June 30, 2006. 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.

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

PART II OTHER INFORMATION

Item 1. Legal Proceedings

In the ordinary course of our business, we are at times subject to various legal proceedings. We do not believe that any current legal proceedings will have a material adverse effect on our results of operations or financial position.

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, 2005.

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

(a) The Company s purchases of its common stock during the third quarter of Fiscal 2006 were as follows:

Period	Total Number of Shares Purchased	Average Price Paid per Share	Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs (1)	Approximate Dollar Value of Shares that May Yet Be Purchased Under the Plans or Programs (1) (2)
April 1 to 30, 2006				$ 18,259,302
May 1 to 31, 2006				$ 18,259,302
June 1 to 30, 2006	310,900	$ 13.98	310,900	$ 0

(1) Effective December 28, 2005, the Company announced that the Board of Directors approved a $32 million share repurchase program, authorizing therepurchase of shares of its common stock. The Company was authorized to make repurchases through June 30, 2006.

(2) Includes brokerage commissions paid by the Company.

Item 3. Defaults upon Senior Securities

None

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

No matters were submitted to a vote of our shareholders during the three months ended June 30, 2006.

Item 5. Other Information

None

Item 6. Exhibits

(a) Exhibits

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

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

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

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SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

	INNOVATIVE SOLUTIONS AND SUPPORT, INC.	
Date: August 4, 2006	By:	/s/ JAMES J. REILLY **James J. Reilly Chief Financial Officer**

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