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

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

x QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended December 31, 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 February 2, 2007, there were 16,866,193 shares of the Registrant s Common Stock, with par value of $.001 per share, outstanding.

INNOVATIVE SOLUTIONS & SUPPORT, INC.

FORM 10-Q December 31, 2006

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PART I FINANCIAL INFORMATION

Item 1 Financial Statements

INNOVATIVE SOLUTIONS AND SUPPORT, INC.

CONDENSED CONSOLIDATED BALANCE SHEET

(unaudited)

	As of December 31, 2006	As of September 30, 2006
ASSETS		
Current Assets:		
Cash and cash equivalents	$ 62,608,952	$ 62,984,829
Accounts receivable, less allowance for doubtful accounts of $100,000 at December 31, 2006 and September 30, 2006	1,760,747	3,333,131
Inventories	6,211,280	6,466,156
Deferred income taxes	911,822	1,082,931
Prepaid expenses and other current assets	5,442,347	4,065,696
Total current assets	76,935,148	77,932,743
Property and Equipment:		
Computers and test equipment	4,616,087	4,592,410
Corporate airplane	3,027,502	3,027,502
Furniture and office equipment	748,827	748,827
Manufacturing facility	5,426,761	5,426,761
Land	1,021,245	1,021,245
	14,840,422	14,816,745
Less- Accumulated depreciation and amortization	(6,037,516)	(5,846,272)
Net property and equipment	8,802,906	8,970,473
Deposits and other assets	324,264	329,664
Total assets	$ 86,062,318	$ 87,232,880
LIABILITIES AND SHAREHOLDERS EQUITY		
CURRENT LIABILITIES:		
Current portion of notes payable	$ 100,000	$ 100,000
Current portion of capitalized lease obligations	8,231	7,891
Accounts payable	497,140	358,818
Accrued expenses	2,731,834	3,122,542
Deferred revenue	211,418	591,626
Total current liabilities	3,548,623	4,180,877
Note payable	4,235,000	4,235,000
Long-term portion of capitalized lease obligations	2,222	4,587
Deferred revenue	103,374	120,991
Deferred income taxes	575,626	490,072
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 December 31, 2006 and September 30, 2006		
Common stock, $.001 par value: 75,000,000 shares authorized, 18,124,938 and 18,088,121 shares issued at December 31, 2006 and September 30,2006	18,125	18,088
Additional paid-in capital	43,724,879	43,230,352
Retained earnings	51,940,897	53,039,341
Treasury stock, at cost, 1,272,510, shares at December 31. 2006 and September 30, 2006	(18,086,428)	(18,086,428)
Total shareholders equity	77,597,473	78,201,353
Total liabilities and shareholders equity	$ 86,062,318	$ 87,232,880

The accompanying notes are an integral part of these statements.

INNOVATIVE SOLUTIONS AND SUPPORT, INC.
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(unaudited)

	Three Months Ended December 31 2006	Three Months Ended December 31 2005
Net sales	$ 3,428,648	$ 5,405,387
Cost of sales	2,033,945	2,702,018
Gross profit	1,394,703	2,703,369
Operating expenses:		
Research and development	1,324,354	1,535,001
Selling, general and administrative	3,059,015	1,896,836
	4,383,369	3,431,837
Operating (loss)	(2,988,666)	(728,468)
Interest income	816,273	781,445
Interest expense	(50,760)	(43,512)
Income (loss) before income taxes	(2,223,153)	9,465
Income tax expense (benefit)	(1,124,709)	3,340
Net income (loss)	$ (1,098,444)	$ 6,125
Net income (loss) per common share:		
Basic	$ (0.07)	$ 0.00
Diluted	$ (0.07)	$ 0.00
Weighted average shares outstanding:		
Basic	16,824,933	18,055,243
Diluted	16,824,933	18,272,423

The accompanying notes are an integral part of these statements.

INNOVATIVE SOLUTIONS AND SUPPORT, INC.
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(unaudited)

	For the Three Months Ended December 31 2006	For the Three Months Ended December 31 2005
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income (loss)	$ (1,098,444)	$ 6,125
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities:		
Depreciation and amortization	199,178	201,838
Stock-based compensation expense	111,871	174,009
Compensation expense for stock issued to directors	49,943	60,048
Loss on disposal of fixed assets	551	156
Excess and obsolete inventory expense		85,129
Deferred income taxes	256,663	200,308
Tax benefit from exercise of stock options	128,958	21,378
Excess tax benefits from share-based payment arrangements	(122,811)	(8,689)
(Increase) decrease in:		
Accounts receivable	1,572,384	163,102
Inventories	254,876	178,004
Prepaid expenses and other current assets	(1,376,651)	(285,769)
Increase (decrease) in:		
Accounts payable	138,322	31,749
Accrued expenses	(390,708)	(1,088,554)
Deferred revenue	(397,825)	15,343
Net cash used in operating activities	(673,693)	(245,823)
CASH FLOWS FROM INVESTING ACTIVITIES:		
Cash paid for property and equipment	(26,762)	(96,351)
Purchases of other assets		(253,333)
Net cash used in investing activities	(26,762)	(349,684)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Proceeds from exercise of stock options	203,792	48,702
Repayment of capitalized lease obligation	(2,025)	(2,576)
Excess tax benefits from share-based payment arrangements	122,811	8,689
Net cash provided by financing activities	324,578	54,815
Net decrease in cash and cash equivalents	$ (375,877)	$ (540,692)
Cash and cash equivalents, beginning of year	$ 62,984,829	$ 83,172,582
Cash and cash equivalents, end of period	$ 62,608,952	$ 82,631,890
SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION:		
Cash paid for interest	$ 40,529	$ 31,101
Cash paid for income taxes		$ 435,000

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 displays and advanced monitoring systems for the military, government, commercial air transport and corporate aviation markets.

The balance sheet as of December 31, 2006, the statement of operations for the three months ended December 31, 2006 and 2005 and the statements of cash flows for the three months ended December 31, 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 December 31, 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, 2006 as filed with the Securities and Exchange Commission. The results of operations for the three months ended December 31, 2006 are not necessarily indicative of the operating results for the full year.

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 December 31, 2006	Three Months Ended December 31, 2005
Weighted average number of shares-basic	16,824,933	18,055,243
Effect of dilutive securities:		
Employee stock options		217,180
Weighted average number of shares-diluted	16,824,933	18,272,423

For the three-month periods ended December 31, 2006 and 2005, there were 282,000 and 206,000 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 December 31, 2006, three customers accounted for 15%, 12% and 10% of net sales or 37% on a combined basis. For the three months ended December 31, 2005, three customers accounted for 28%, 10%, and 9% of net sales or 47% 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:

	December 31 2006	September 30 2006
Raw materials	$ 3,553,089	$ 3,006,088
Work-in-process	1,063,842	2,237,489
Finished goods	1,594,349	1,222,579
	$ 6,211,280	$ 6,466,156

5. Warranty

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

Warranty cost and accrual information for the three months ended December 31, 2006 is highlighted below:

Warranty accrual at September 30, 2006	$ 617,116
Accrued expense for the three months ended December 31, 2006	22,629
Warranty costs for the three monts ended December 31, 2006	(66,864)
Warranty accrual at December 31, 2006	$ 572,881

6. Share-Based Compensation

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 and non-vested stock awards. Accordingly, total share-based compensation expense was $162,000 and $234,057 for the three months ended December 31, 2006 and 2005 respectively. The total income tax benefit recognized in the statement of operations for share-based compensation arrangements was $81,956 and $82,622 for the three months ended December 31, 2006 and 2005 respectively. Compensation expense related to share-based awards is recorded as a component of general and administrative expense.

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

Stock Options

The Plan provides for the granting of incentive and nonqualified stock options to employees, officers, directors and independent contractors and consultants. Through December 31, 2006 no stock options have been granted to independent contractors or consultants under this plan. Total compensation expense was $112,000 and $174,009 for the three months ended December 31, 2006 and 2005, respectively.

Incentive stock options granted under the Plan have exercise prices that must be at least equal to the fair value of the common stock on the date of grant. Nonqualified stock options granted under the Plan have exercise prices that may be less than, equal to or greater than the fair value of the common stock on the date of grant. The Company has reserved 3,389,025 shares of Common Stock for awards under the Plan. As of December 31, 2006 there were 1,713,119 remaining and available for granting.

A summary of option activity under the Plan as of December 31, 2006 and changes during the period then ended is as follows:

	Options	Weighted Average Exercise Price	Weighted Average Remaining Contractual Life	Aggregate Intrinsic Value
Outstanding at September 30, 2006	701,854	$ 9.93		
Granted	9,000	16.30		
Exercised	(33,542)	6.08		
Cancelled	(108,700)	14.50		
Outstanding at December 31, 2006	568,612	$ 9.39	6.64	$ 4,345,213
Exercisable at December 31, 2006	363,712	$ 6.74	5.69	$ 3,743,312

The weighted-average grant date fair value of individual options granted during the three month ended December 31, 2006 and 2005 was $9.64 and $7.46, respectively. The total intrinsic value of options exercised during the three months ended December 31, 2006 and 2005 was $388,401 and $59,419, respectively.

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The following table summarizes information about stock options under the Plan at December 31, 2006:

Options Outstanding				Options Exercisable	
Range of Exercise Prices	Outstanding As of December 31, 2006	Weighted-Average Remaining Contractual Life	Weighted-Average Exercise Price	As of December 31, 2006	Weighted-Average Exercise Price
$0.00 5.00	205,863	5.98	$ 4.18	203,163	$ 4.18
$5.01 10.00	152,549	4.93	7.68	113,249	7.58
$10.01 15.00	126,000	8.63	14.05	26,600	13.98
$15.01 20.00	53,700	8.43	16.70	14,600	16.68
$20.01 22.35	30,500	8.26	20.94	6,100	20.94
	568,612	6.64	$ 9.39	363,712	$ 6.74

The fair value of each option grant is estimated on the date of grant using the Black-Scholes option pricing model that uses the weighted average assumptions noted in the following table. Options are exercised over a maximum term of ten years from the date of grant and typically vest over periods of five years from the grant date. The expected term of options represents the period of time that the options granted are expected to be outstanding and is based on historical experience. Expected volatility is based on historical volatility of the Company s stock. The risk free interest rate is based on U.S. Treasuries with constant maturities in effect at the time of the grant.

	Three Months Ended December 31, 2006	Three Months Ended December 31, 2005
Expected lives (years)	8.8	9.3
Weighted average risk-free interest rate	2.1 %	1.8 %
Expected volatility	64.7 %	65.8 %
Expected dividend rate	%	%

As of December 31, 2006, there was approximately $1.4 million of unrecognized compensation cost, net of forfeitures, related to non-vested stock options, which is expected to be recognized over a period of approximately 5 years.

Non-vested Stock

The Restricted Plan for non-employee directors was approved by shareholders at the Company s February 26, 2004 Annual Meeting of Shareholders. The Plan calls for an annual award of non-vested stock having a fair market value of $40,000 as of the close of business on October 1 of the current fiscal year for all eligible non-employee directors. The stock is awarded in four installments quarterly during the fiscal year provided the director is still serving on the board on the quarterly issue date. As of December 31, 2006 and 2005 the Company recognized expense of $50,000 and $60,048, respectively. As of December 31, 2006, there is an estimated $150,000 of unrecognized compensation expense related to nonvested stock awards under the Company s Restricted Plan. That cost is expected to be recognized over the balance of the fiscal year or 9 months. The following table outlines restricted stock awards for the three months ended December 31, 2006:

	Non-vested Stock Awards	Weighted Average Share Price
Balance at September 30, 2006	3,275	$ 15.25
Granted	13,860	14.43
Issued	(3,275)	15.25
Cancelled		
Balance at December 31, 2006	13,860	$ 14.43

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7. Stock Repurchase Program

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

8. Notes Payable

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

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

9. New Accounting Pronouncements

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

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

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

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

Overview

We design, manufacture and sell flight information computers, flat panel displays 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 product line. In October 2005, the FAA awarded the Company a second Technical Standard Order (TSO) for our flat panel display system COCKPIT/IPTM. This TSO establishes our flat panel display system as meeting FAA requirements that have been put in place to ensure safe flight on a variety of aircraft types and, additionally, it addresses the most stringent Commercial Air Transport market requirements as provided in Title 14 of the Code of Federal Regulation, subpart 25, Commercial Air Transport. The TSO states It has been noted that this display system employs an integrity monitoring system that assures integrity to a

catastrophic/Level A design condition with the use of commercial graphic processors.

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

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

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 December 31, 2006 Compared to the Three Months Ended December 31, 2005

Net sales. Net sales decreased $2.0 million, or 37%, to $3.4 million for the three months ended December 31, 2006 from $5.4 million in the three months ended December 31, 2005. The decrease in net sales was primarily the result of a slower than expected start up of Flat Panel Display System deliveries.

Cost of sales. Cost of sales decreased $0.7 million or 26%, to $2.0 million, or 59% of net sales in the three months ended December 31, 2006 from $2.7 million, or 50 % of net sales in the three months ended December 31, 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 not being absorbed over lower net sales in the current period.

Research and development. Research and development expenses decreased $0.2 million or 13% to $1.3 million or 38% of net sales in the three months ended December 31, 2006 from $1.5 million or 28% of net sales in the three months ended December 31, 2005. The reduction is related to additional costs incurred during the three months ended December 31, 2005 in conjunction with obtaining the Supplement Type Certification on the PC-12. No certifications were obtained during the three months ended December 31, 2006.

Selling, general, and administrative. Selling, general, and administrative expenses increased $1.2 million, or 63%, to $3.1 million, or 91% of net sales in the three months ended December 31, 2006 from $1.9 million or 35% of net sales in the three months ended December 31, 2005. The increase in the dollar amount was primarily the result of increased legal and other fees relating to intellectual property matters and increased selling cost related to trade show expenses.

Interest income. Interest income was $816,000 in the three months ended December 31, 2006 as compared $781,000 in the three months ended December 31, 2005. The increase in interest income in the three months ended December 31, 2006 was primarily the result of higher interest rates offsetting our reduced cash position in the current period.

Interest expense. Interest expense was $51,000 in the three months ended December 31, 2006 as compared to $44,000 in the three months ended December 31, 2005. The increase in interest expense in the three months ended December 31, 2006 was primarily the result of higher interest rates in the period.

Income tax expense. The income tax benefit for the three months ended December 31, 2006 was $1.1 million. The income tax expense for the three months ending December 31, 2005 was $3,000. The decrease in the amount of tax from a tax expense to a tax benefit was due to recording a loss before taxes for the three months ended December 31, 2006.

The effective tax rate for the three months ended December 31, 2006 was a benefit of 50.6 %. The effective tax rate for the three months ended December 31, 2005 was 35.3%. In each quarter the effective tax rate differs from the statutory rate due to the utilization of research and experimentation tax credits.

In December of 2006, an additional two-year extension of the Research and Experimentation (R&E) Tax Credit was enacted into law. This retroactive extension is for amounts paid or incurred after December 31, 2005, and before January 1, 2008. The entire impact of

this retroactive extension has been recognized in the first quarter ended December 31, 2006, as required by SFAS 109, Accounting for Income Taxes. For the quarter ending December 31, 2006, the overall benefit recorded, including the impact of the R&E credit was 50.6% and would have been 43.7% without this discrete item.

Net income. As a result of the factors described above, our net loss in the three months ended December 31, 2006 was $1.1 million a decrease of $1.1 million from net income of $6,125 for the three months ended December 31, 2005.

Liquidity and Capital Resources

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

Our cash used in operating activities was $674,000 for the three months ended December 31, 2006 as compared to $246,000 for the three months ended December 31, 2005. The increase was due primarily to lower net income ($1.1 million) and increased prepaid expenses ($1.1 million) which were partially offset by reduced accounts receivable ($1.4 million).

Our cash used in investing activities was $27,000 for the three months ended December 31, 2006. This primarily consisted of spending for production and laboratory test equipment. Cash used in investing activities was $350,000 for the three months ended December 31, 2005 and primarily consisted of production certification, production equipment and, laboratory test equipment.

Net cash flow from financing activities was $325,000, for the three months ended December 31, 2006 as compared to $55,000 in the three months ended December 31, 2005. 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), a fixed charge ratio and a minimum tangible net worth.

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

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 December 31, 2006 and 2005, our backlog was $32.3 million and $18.2 million, respectively. The period over period increase in backlog principally reflects the increase in Flat Panel Display System orders. The Flat Panel Display System component as of December 31, 2006 is $23.5 million, an increase of $11.4 million over the December 31, 2005 balance of $12.1 million.

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.

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 displays and advanced monitoring systems to the Department of Defense, government agencies, commercial air transport carriers and corporate/general aviation markets. We currently derive virtually all our net sales from the sale of this equipment. Almost all of the net sales, operating results and identifiable assets are in the United States.

New Accounting Pronouncements

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

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

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

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

FORWARD-LOOKING STATEMENTS

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

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

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

Readers are cautioned not to place undue reliance on these forward-looking statements, which speak only as of the date of this Form

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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, 2006.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

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

Item 4. Controls and Procedures

(a) An evaluation was performed under the supervision and with the participation of the Company s management, including its Chief Executive Officer, or CEO, and Chief Financial Officer, or CFO, of the effectiveness of the Company s disclosure controls and procedures, as such term is defined under Rule 13a-15e under the Securities Exchange Act of 1934, as amended (the Exchange Act) as of December 31, 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 and that such information is accumulated and communicated to the Company s management, including the CEO and CFO, or persons performing similar functions, as appropriate to allow timely decisions regarding required disclosure.

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

PART II OTHER INFORMATION

Item 1. Legal Proceedings

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, 2006.

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

None

Item 3. Defaults upon Senior Securities

None

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

No matters were submitted to a vote of our shareholders during the three months ended December 31, 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

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 & SUPPORT, INC.

Date: February 5, 2007 By: /s/ JAMES J. REILLY
James J. Reilly Chief Financial Officer

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