GSE SYSTEMS INC
Form 10-Q
August 09, 2011

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, 2011.
or

[ ] Transition Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934 for the Transition Period from to .

Commission File Number: 001-14785

GSE SYSTEMS, INC.
(Exact name of registrant as specified in its charter)

Delaware	52-1868008
(State of incorporation)	(I.R.S. Employer Identification No.)

1332 Londontown Blvd., Suite 200, Sykesville, MD 21784
(Address of principal executive office and zip code)

Registrant's telephone number, including area code: (410) 970-7800

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Sections 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 [ ]

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such period that the registrant was required to submit and post such files). Yes [X] No [ ]

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of “large accelerated filer”, “accelerated filer” and “smaller reporting

company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer [ ]	Accelerated filer [ ]	Non-accelerated filer [ ] (Do not check if a smaller reporting company)	Smaller reporting company [X]

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

There were 18,959,652 shares of common stock, with a par value of $.01 per share outstanding as of August 5, 2011.

GSE SYSTEMS, INC.

QUARTERLY REPORT ON FORM 10-Q

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PART I - FINANCIAL INFORMATION
Item 1. Financial Statements

GSE SYSTEMS, INC. AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS
(in thousands, except share data)

	Unaudited June 30, 2011	December 31, 2010
ASSETS		
Current assets:		
Cash and cash equivalents	$ 18,634	$ 26,577
Restricted cash	4,350	179
Contract receivables, net	19,460	17,201
Prepaid expenses and other current assets	2,939	1,992
Total current assets	45,383	45,949
Equipment and leasehold improvements	5,361	4,727
Accumulated depreciation	(4,162)	(3,667)
Equipment and leasehold improvements, net	1,199	1,060
Software development costs, net	1,782	1,790
Goodwill	4,494	2,609
Intangible assets, net	1,744	637
Long-term restricted cash	1,054	794
Other assets	1,528	775
Total assets	$ 57,184	$ 53,614
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	$ 3,396	$ 4,945
Accrued expenses	1,660	1,753
Accrued compensation and payroll taxes	2,182	2,053
Billings in excess of revenue earned	4,340	4,268
Accrued warranty	1,900	1,680
Other current liabilities	3,271	1,210
Total current liabilities	16,749	15,909
Other liabilities	2,275	799
Total liabilities	19,024	16,708
Commitments and contingencies	-	-
Stockholders' equity:		
Preferred stock $.01 par value, 2,000,000 shares authorized, shares issued and outstanding none in 2011 and 2010	-	-
Common stock $.01 par value, 30,000,000 shares authorized, shares issued 19,239,681 in 2011 and 19,171,855 in 2010	192	192
Additional paid-in capital	69,803	69,298

Accumulated deficit	(31,095)		(31,864)
Accumulated other comprehensive loss	(404)		(720)
Treasury stock at cost, 150,881 shares in 2011, 0 in 2010	(336)		-
Total stockholders' equity	38,160		36,906
Total liabilities and stockholders' equity	$ 57,184		$ 53,614

The accompanying notes are an integral part of these consolidated financial statements.

GSE SYSTEMS, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF OPERATIONS
(in thousands, except per share data)
(Unaudited)

	Three Months ended June 30,		Six months ended June 30,	
	2011	2010	2011	2010
Contract revenue	$ 11,257	$ 11,773	$ 23,579	$ 22,981
Cost of revenue	7,500	8,125	16,347	16,188
Gross profit	3,757	3,648	7,232	6,793
Operating expenses:				
Selling, general and administrative	3,198	2,731	6,618	5,292
Depreciation	103	141	228	272
Amortization of definited-lived intangible assets	208	25	425	25
Total operating expenses	3,509	2,897	7,271	5,589
Operating income (loss)	248	751	(39)	1,204
Interest income, net	29	21	62	19
Gain (loss) on derivative instruments, net	(410)	(374)	178	(678)
Other income (expense), net	(26)	19	39	38
Income (loss) before income taxes	(159)	417	240	583
Provision (benefit) for income taxes	85	47	(529)	(236)
Net income (loss)	$ (244)	$ 370	$ 769	$ 819
Basic income (loss) per common share	$ (0.01)	$ 0.02	$ 0.04	$ 0.04
Diluted income (loss) per common share	$ (0.01)	$ 0.02	$ 0.04	$ 0.04

The accompanying notes are an integral part of these consolidated financial statements.

GSE SYSTEMS, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (LOSS)
(in thousands)
(Unaudited)

	Three Months ended June 30,		Six months ended June 30,	
	2011	2010	2011	2010
Net income (loss)	$(244)	$370	$769	$819
Foreign currency translation adjustment	(66)	(253)	316	(281)
Comprehensive income (loss)	$(310)	$117	$1,085	$538

The accompanying notes are an integral part of these consolidated financial statements.

GSE SYSTEMS, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENT OF CHANGES IN STOCKHOLDERS' EQUITY
(in thousands)
(Unaudited)

	Common Stock		Additional Paid-in	Accumulated	Accumulated Other Comprehensive	Treasury Stock		
	Shares	Amount	Capital	Deficit	Loss	Shares	Amount	Total
Balance, December 31, 2010	19,172	$ 192	$ 69,298	$ (31,864)	$ (720)	-	$ -	$ 36,906
Stock-based compensation expense	-	-	386	-	-	-	-	386
Common stock issued for options exercised	62	-	109	-	-	-	-	109
Common stock issued for warrants exercised	6	-	10	-	-	-	-	10
Foreign currency translation adjustment	-	-	-	-	316	-	-	316
Treasury stock purchased	-	-	-	-	-	(151)	(336)	(336)
Net income	-	-	-	769	-	-	-	769
Balance, June 30, 2011	19,240	$ 192	$ 69,803	$ (31,095)	$ (404)	(151)	$ (336)	$ 38,160

The accompanying notes are an integral part of these consolidated financial statements.

GSE SYSTEMS, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS
(in thousands)
(Unaudited)

	Six Months ended June 30,	
	2011	2010
Cash flows from operating activities:		
Net income	$769	$819
Adjustments to reconcile net income to net cash provided by (used in) operating activities:		
Depreciation	228	272
Amortization of definite-lived intangible assets	425	25
Capitalized software amortization	394	282
Amortization of deferred financing costs	-	19
Change in fair value of contingent consideration	284	32
Stock-based compensation expense	386	423
Equity loss on investment in GSE-UNIS Simulation Technology Co. Ltd.	(25)	-
(Gain) loss on derivative instruments	(178)	678
Changes in assets and liabilities:		
Contract receivables	(685)	(6,056)
Prepaid expenses and other assets	(416)	(310)
Accounts payable, accrued compensation and accrued expenses	(2,079)	2,789
Billings in excess of revenue earned	3	2,610
Accrued warranty reserves	220	101
Other liabilities	(889)	(645)
Net cash provided by (used in) operating activities	(1,563)	1,039
Cash flows from investing activities:		
Capital expenditures	(329)	(201)
Capitalized software development costs	(386)	(475)
Investment in GSE-UNIS Simulation Technology Co. Ltd.	(456)	-
Acquisitions, net of cash acquired	(830)	(432)
Restrictions of cash as collateral under letters of credit	(4,939)	-
Release of cash as collateral under letters of credit	587	683
Drawdown of cash collateral on Emirates Simulation Academy, LLC line of credit	(79)	(146)
Proceeds from sale/leaseback transaction	-	377
Net cash used in investing activities	(6,432)	(194)
Cash flows from financing activities:		
Deferred financing costs	-	(82)
Treasury stock purchases	(336)	-
Proceeds from issuance of common stock	119	68
Net cash used in financing activities	(217)	(14)
Effect of exchange rate changes on cash	269	(182)
Net increase (decrease) in cash and cash equivalents	(7,943)	649
Cash and cash equivalents at beginning of year	26,577	25,270
Cash and cash equivalents at end of period	$18,634	$25,919

Supplemental cash flow disclosures		
Non-cash financing activities		
Issuance of 122,617 shares of common stock to acquire TAS Holdings Ltd.	$-	$682

The accompanying notes are an integral part of these consolidated financial statements.

GSE SYSTEMS, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
For the Three and Six Months ended June 30, 2011 and 2010
(Unaudited)

1. Basis of Presentation and Revenue Recognition

Basis of Presentation

The consolidated financial statements included herein have been prepared by GSE Systems, Inc. (the "Company" or "GSE") without independent audit. In the opinion of the Company's management, all adjustments and reclassifications of a normal and recurring nature necessary to present fairly the financial position, results of operations and cash flows for the periods presented have been made. Certain information and footnote disclosures normally included in financial statements prepared in accordance with U.S. generally accepted accounting principles ("GAAP") have been condensed or omitted. The results of operations for interim periods are not necessarily an indication of the results for the full year. These consolidated financial statements should be read in conjunction with the consolidated financial statements and notes thereto included in the Company's Annual Report on Form 10-K for the period ended December 31, 2010 filed with the Securities and Exchange Commission on March 14, 2011.

The Company has only one reportable segment. The Company has a wide range of knowledge of simulation systems and the processes those systems are intended to control and model. The Company's knowledge is concentrated heavily in simulation technology and model development. The Company is primarily engaged in simulation for the power generation industry and the process industries. Contracts typically range from 12 months to three years.

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements as well as reported amounts of revenues and expenses during the reporting period. The Company's most significant estimates relate to revenue recognition, capitalization of software development costs, valuation of intangible assets acquired, contingent consideration issued in business acquisitions, and the recoverability of deferred tax assets. Actual results could differ from these estimates and those differences could be material.

Revenue Recognition

The majority of the Company's revenue is derived through the sale of uniquely designed systems containing hardware, software and other materials under fixed-price contracts. Revenue under these fixed-price contracts is accounted for on the percentage-of-completion method. This methodology recognizes revenue and earnings as work progresses on the contract and is based on an estimate of the revenue and earnings earned to date, less amounts recognized in prior periods. The Company bases its estimate of the degree of completion of the contract by reviewing the relationship of costs incurred to date to the expected total costs that will be incurred on the project. Estimated contract earnings are reviewed and revised periodically as the work progresses, and the cumulative effect of any change in estimate is recognized in the period in which the change is identified. Estimated losses are charged against earnings in the period such losses are identified. The Company recognizes revenue arising from contract claims either as income or as an offset against a potential loss only when the amount of the claim can be estimated reliably and realization is probable and there is a legal basis for the claim.

Uncertainties inherent in the performance of contracts include labor availability and productivity, material costs, change order scope and pricing, software modification and customer acceptance issues. The reliability of these cost

estimates is critical to the Company's revenue recognition as a significant change in the estimates can cause the Company's revenue and related margins to change significantly from the amounts estimated in the early stages of the project.

As the Company recognizes revenue under the percentage-of-completion method, it provides an accrual for estimated future warranty costs based on historical experience and projected claims. The Company's long-term contracts generally provide for a one-year warranty on parts, labor and any bug fixes as it relates to software embedded in the systems.

The Company's system design contracts do not normally provide for "post customer support service" ("PCS") in terms of software upgrades, software enhancements or telephone support. In order to obtain PCS, the customers must normally purchase a separate contract. Such PCS arrangements are generally for a one-year period renewable annually and include customer support, unspecified software upgrades, and maintenance releases. The Company recognizes revenue from these contracts ratably over the life of the agreements.

Revenue from the sale of software licenses which do not require significant modifications or customization for the Company's modeling tools are recognized when the license agreement is signed, the license fee is fixed and determinable, delivery has occurred, and collection is considered probable.

Revenue from certain consulting or training contracts is recognized on a time-and-material basis. For time-and-material type contracts, revenue is recognized based on hours incurred at a contracted labor rate plus expenses.

The following customers have provided more than 10% of the Company's consolidated revenue for the indicated periods:

	Three months ended June 30,		Six months ended June 30,	
	2011	2010	2011	2010
KSG Kraftwerks-Simulator-GmbH	11.4%	5.5%	9.1%	5.2%
Slovenské elektrárne, a.s.	10.1%	20.1%	12.3%	19.7%
Emerson Process Management	8.5%	10.4%	9.1%	12.8%
Westinghouse Electric Co.	7.0%	10.9%	7.1%	10.1%

2. Recently Adopted Accounting Pronouncements

On January 1, 2011 the Company adopted Accounting Standards Update ("ASU") 2009-13, Revenue Recognition (Topic 605), Multiple-Deliverable Arrangements. ASU 2009-13 amends the guidance that in the absence of vendor-specific objective and third-party evidence for deliverables in multiple-deliverable arrangements, companies will be required to develop a best estimate of the selling price to separate deliverables and allocate arrangements consideration using the relative selling price method. ASU 2009-13 expands the disclosure requirements for multiple-deliverable revenue arrangements. The adoption of ASU 2009-13 has not had a material impact on the financial statements.

On January 1, 2011 the Company adopted ASU 2009-14, Software (Topic 985), Certain Revenue Arrangements that Include Software Elements. ASU 2009-14 amends the guidance to exclude from the scope of software revenue accounting requirements tangible products if the product contains both software and non-software components that function together to deliver a product's essential functionality and factors to consider in determining whether a product is within the scope of the guidance. The adoption of ASU 2009-14 has not had a material impact on the financial statements.

3. Basic and Diluted Income (Loss) Per Common Share

Basic income (loss) per share is based on the weighted average number of outstanding common shares for the period. Diluted income (loss) per share adjusts the weighted average shares outstanding for the potential dilution that could occur if stock options or warrants were exercised into common stock. The number of common shares and common share equivalents used in the determination of basic and diluted income per share were as follows:

(in thousands, except for share amounts)	Three months ended June 30,		Six months ended June 30,	
	2011	2010	2011	2010
Numerator:				
Net income (loss)	$ (244)	$ 370	$ 769	$ 819
Denominator:				
Weighted-average shares outstanding for basic earnings per share	19,213,931	18,944,843	19,213,886	18,940,148
Effect of dilutive securities:				
Employee stock options and warrants	-	577,429	242,179	591,682
Adjusted weighted-average shares outstanding and assumed conversions for diluted earnings per share	19,213,931	19,522,272	19,456,065	19,531,830
Shares related to dilutive securities excluded because inclusion would be anti-dilutive	1,698,596	1,195,233	1,544,504	1,181,791

Conversion of outstanding stock options was not assumed for the three months ended June 30, 2011 because the impact was anti-dilutive. Included in the shares related to dilutive securities excluded from the diluted earnings per share calculation for the three months ended June 30, 2011 were in the money options totaling 153,396 shares.

4. Acquisition

EnVision Systems, Inc.

On January 4, 2011, (the "Closing Date") the Company completed the acquisition of all outstanding common stock of EnVision Systems, Inc. ("EnVision"), acquiring 100% ownership in EnVision. EnVision is headquartered in Madison, NJ and has an office in Chennai, India. EnVision's tutorials and simulation models serve the rapidly growing entry-level training market for the oil & gas, refining, and specialty chemicals industries. EnVision operates as a wholly-owned subsidiary of GSE and has been re-named GSE Envision, Inc. On the Closing Date, GSE paid $1.2 million in cash to the shareholders of EnVision. In addition, if EnVision attains certain revenue targets for the four year period ending December 31, 2014, the shareholders of EnVision could receive up to an additional $3.0 million payable over four years.

On the first anniversary of the Closing Date, the EnVision shareholders are entitled to receive $550,000. On the second, third and fourth anniversaries, EnVision shareholders are entitled to receive $500,000. These payments are contingent upon EnVision meeting or exceeding certain revenue targets during those periods, as defined in the purchase agreement. The EnVision shareholders are also entitled to the amount by which the aggregate payments received by the Company from Shell Global Solutions International, B.V. ("Shell") after the Closing Date and prior to March 31, 2014 exceed $3.0 million, provided that the amount payable to the EnVision shareholders will not exceed $1.0 million.

EnVision's shareholders are entitled to receive an amount equal to 30% of the cash collected prior to March 31, 2013 from the billed receivables which were included on the Closing Date balance sheet related to Shell. Seventy percent of the cash collected prior to March 31, 2013 relating to the recoverable costs and accrued profit not billed amounts which appear on the Closing Date balance sheet will be paid to the EnVision shareholders. Payments to the EnVision shareholders for cash collections relating to the billed receivables and recoverable costs and accrued profit not billed amounts will occur in three yearly payments ending in 2013. EnVision shareholders could receive up to approximately $687,000 of the trade receivables and recoverable costs and accrued profit not billed amounts included on the Closing Date balance sheet, contingent on the collection of cash. In the second quarter of 2011, the Company made payments of $74,000 to EnVision's shareholders related to billed receivables included on the Closing Date balance sheet. Since the Closing Date, the Company has made total payments of $74,000 related to billed receivables included on the Closing Date balance sheet.

At Closing, the EnVision shareholders were entitled to receive all the cash of the business except for $400,000. Additionally, the EnVision shareholders were credited for any prepaid expenses and assumed any existing liabilities from the Closing Date balance sheet. Based on the Closing Date balance sheet, a $109,000 payment was made to the EnVision shareholders in the second quarter of 2011.

Of the $4.0 million gross purchase price, the Company accrued approximately $2.0 million of contingent consideration based on its estimate of the fair value of the potential contingent consideration payable to the EnVision shareholders for the four year period ending December 31, 2014. The Company will estimate the fair value of the recorded amount of contingent consideration on a quarterly basis and any subsequent adjustments based on actual payments or revised estimates are recognized in the selling, general, and administrative expenses of the consolidated statement of operations during the period of adjustment. The contingent consideration is valued using significant inputs that are not observable in the market which are defined as Level 3 inputs pursuant to fair value measurement accounting.

The estimated fair value of the purchase price recorded by the Company consisted of the following (in thousands):

Cash paid at closing	$	1,200
Present value of estimated future payments		1,998
Payable to EnVision Shareholders - contracts receivable		687
Working capital retained by EnVision Shareholders - cash		109
Total estimated purchase price	$	3,994

The Company's purchase price allocation for the net assets acquired was as follows (in thousands):

	January 4, 2011 (unaudited)	
Cash	$	553
Contract receivables		1,124
Prepaid expenses and other current assets		62
Property, plant and equipment, net		22
Receivable from EnVision shareholders		321
Intangible assets		1,509
Goodwill		1,854
Total assets		5,445
Accounts payable, accrued expenses and other liabilities		429
Billings in excess of revenue earned		46
Deferred tax liability		976
Total liabilities assumed		1,451
Net assets acquired	$	3,994

The Company recorded intangible assets as a result of the acquisition, which included $871,000 relating to contractual and non-contractual customer relationships. Contractual customer relationships acquired totaled $438,000 and are being amortized in proportion to the projected revenue streams of the related contracts over three years. Non-contractual customer relationships acquired totaled $433,000 and are being amortized in proportion to the projected revenue streams of the related relationships over eight years. The Company acquired intangible assets of $471,000 related to developed technology which are being amortized using the straight line method over an eight year period. The Company also acquired $152,000 of in-process research and development intangible assets which are being amortized over eight years in proportion to the projected revenue streams of the related in-process research and development. Additionally, $15,000 related to domain names and other marketing related intangibles were obtained and are being amortized using the straight line method over an estimated useful life of three years. The intangible assets and accrued contingent consideration for EnVision were recorded at estimated fair value.

EnVision's results of operations are included in the consolidated financial statements for the period beginning January 4, 2011.

Pro forma results. Our consolidated financial statements include the operating results of EnVision as of the date of acquisition. For the three and six months ended June 30, 2011 and 2010, the unaudited pro forma financial information below assumes that our material business acquisition of EnVision occurred on January 1, 2010.

(in thousands except per share data)	(unaudited)	(unaudited)

	Three Months ended June 30,		Six Months ended June 30,	
Pro forma financial information including the acquisition of EnVision	2011	2010	2011	2010
Revenue	$11,257	$12,572	$23,579	$24,579
Operating income	484	1,026	222	1,419
Net income (loss)	(8)	768	1,030	1,040
Earnings per common share — basic	$0.00	$0.04	$0.05	$0.05
Earnings per common share — diluted	$0.00	$0.04	$0.05	$0.05

5. Contract Receivables

Contract receivables represent balances due from a broad base of both domestic and international customers. All contract receivables are considered to be collectible within twelve months. Recoverable costs and accrued profit not billed represent costs incurred and associated profit accrued on contracts that will become billable upon future milestones or completion of contracts. The components of contract receivables are as follows:

(in thousands)		June 30, 2011		December 31, 2010
Billed receivables	$	5,884	$	7,733
Recoverable costs and accrued profit not billed		13,942		11,508
Allowance for doubtful accounts		(366)		(2,040)
Total contract receivables, net	$	19,460	$	17,201

Recoverable costs and accrued profit not billed totaled $13.9 million and $11.5 million as of June 30, 2011 and December 31, 2010, respectively. In July 2011, the Company invoiced $3.2 million of the unbilled amounts; the balance of the June 30, 2011 unbilled amounts is expected to be invoiced and collected within one year.

During the first quarter of 2011, the Company wrote off $1.6 million of billed receivables related to the Emirates Simulation Academy LLC that had been fully reserved as of December 31, 2010.

The following customers account for more than 10% of the Company's consolidated net billed receivables for the indicated periods:

	June 30, 2011	December 31, 2010
Westinghouse Electric Company	19.7%	0.0%
Emerson Process Management	13.9%	11.4%
KSG Kraftwerks-Simulator-GmbH	13.0%	2.8%
Exelon Generation Company, LLC	1.2%	23.8%

In July 2011, the Company collected 36.3% of the June 30, 2011 billed receivables; the balance of the net billed receivables is expected to be collected within one year.

6. Software Development Costs

Certain computer software development costs are capitalized in the accompanying consolidated balance sheets. Capitalization of computer software development costs begins upon the establishment of technological feasibility. Capitalization ceases and amortization of capitalized costs begins when the software product is commercially available for general release to customers. Amortization of capitalized computer software development costs is included in cost of revenue and is determined using the straight-line method over the remaining estimated economic life of the product, typically three years.

Software development costs capitalized were $207,000 and $386,000 for the three and six months ended June 30, 2011, respectively, and $269,000 and $475,000 for the three and six months ended June 30, 2010, respectively. Total amortization expense was $203,000 and $394,000 for the three and six months ended June 30, 2011, respectively, and $144,000 and $282,000 for the three and six months ended June 30, 2010, respectively.

7. Fair Value of Financial Instruments

Accounting Standards Codification ("ASC") 820, Fair Value measurements and Disclosures, defines fair value as the exchange price that would be received for an asset or paid to transfer a liability (an exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date. ASC 820 also establishes a fair value hierarchy which requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value.

The levels of the fair value hierarchy established by ASC 820 are:

Level 1: inputs are quoted prices, unadjusted, in active markets for identical assets or liabilities that the reporting entity has the ability to access at the measurement date.

Level 2: inputs are other than quoted prices included within Level 1 that are observable for the asset or liability, either directly or indirectly. A Level 2 input must be observable for substantially the full term of the asset or liability.

Level 3: inputs are unobservable and reflect the reporting entity's own assumptions about the assumptions that market participants would use in pricing the asset or liability.

The Company considers the recorded value of certain of its financial assets and liabilities, which consist primarily of cash, accounts receivable and accounts payable, to approximate the fair value of the respective assets and liabilities at June 30, 2011 and December 31, 2010 based upon the short-term nature of the assets and liabilities. The Company values goodwill, intangible assets, and contingent consideration using significant inputs which are not observable in the market which are defined as Level 3 inputs pursuant to fair value measurement accounting.

At June 30, 2011 and December 31, 2010 the Company had approximately $10.2 million and $17.0 million, respectively, deposited in a money market account with Bank of America.

The following table presents assets and liabilities measured at fair value at June 30, 2011:

(in thousands)	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Total
Money market fund	$ 10,161	$ -	$ -	$ 10,161
Certificates of deposit	4,596	-	-	4,596
Foreign exchange contracts	-	1,104	-	1,104
Total assets	$ 14,757	$ 1,104	$ -	$ 15,861
Foreign exchange contracts	$ -	$ (1,159)	$ -	$ (1,159)
Total liabilities	$ -	$ (1,159)	$ -	$ (1,159)

8. Derivative Instruments

The Company utilizes forward foreign currency exchange contracts to manage market risks associated with the fluctuations in foreign currency exchange rates. It is the Company's policy to use such derivative financial instruments to protect against market risk arising in the normal course of business in order to reduce the impact of these exposures. The Company minimizes credit exposure by limiting counterparties to nationally recognized financial institutions.

As of June 30, 2011, the Company had foreign exchange contracts outstanding of approximately 1.6 million Pounds Sterling, 12.8 million Euro, and 617.9 million Japanese Yen at fixed rates. The contracts expire on various dates through February 2014. At December 31, 2010, the Company had contracts outstanding of approximately 1.6 million Pounds Sterling, 10.6 million Euro, and 865.2 million Japanese Yen at fixed rates. The Company has not designated any of the foreign exchange contracts outstanding as hedges and has recorded the estimated fair value of the contracts in the consolidated balance sheets as follows:

(in thousands)	June 30, 2011	December 31, 2010
Asset derivatives		
Prepaid expenses and other current assets	$ 1,012	$ 208
Other assets	92	117
	1,104	325
Liability derivatives		
Other current liabilities	(1,092)	(204)
Other liabilities	(67)	(40)
	(1,159)	(244)
Net fair value	$ (55)	$ 81

The changes in the fair value of the foreign exchange contracts are included in net gain (loss) on derivative instruments in the consolidated statements of operations.

The foreign currency denominated contract receivables, billings in excess of revenue earned and subcontractor accruals that are related to the outstanding foreign exchange contracts are remeasured at the end of each period into the functional currency using the current exchange rate at the end of the period. The gain or loss resulting from such remeasurement is also included in net gain (loss) on derivative instruments in the consolidated statements of operations.

For the three and six months ended June 30, 2011 and 2010, the Company recognized a net gain (loss) on its derivative instruments as outlined below:

	Three months ended June 30,		Six months ended June 30,	
(in thousands)	2011	2010	2011	2010
Foreign exchange contracts- change in fair value	$ (716)	$ 6	$ (155)	$ (58)
Remeasurement of related contract receivables, billings in excess of revenue earned and subcontractor accruals	306	(380)	333	(620)
Gain (loss) on derivatives, net	$ (410)	$ (374)	$ 178	$ (678)

9. Stock-Based Compensation

The Company recognizes compensation expense for all equity-based compensation awards issued to employees, directors and non-employees that are expected to vest. Compensation cost is based on the fair value of awards as of the grant date. The Company recognized $183,000 and $205,000 of pre-tax stock-based compensation expense for the three months ended June 30, 2011 and 2010, respectively, under the fair value method and recognized $386,000 and $423,000 of pre-tax stock-based compensation expense for the six months ended June 30, 2011 and 2010,

respectively. The Company granted 0 and 42,000 stock options for the three and six months ended June 30, 2011, respectively, and the Company granted a total 60,000 stock options for the three and six months ended June 30, 2010.

10. Long-Term Debt

At June 30, 2011 and December 31, 2010, the Company had no long-term debt.

Lines of Credit

At December 31, 2010, the Company had two separate revolving credit agreements for revolving lines of credit with Bank of America ("BOA") which were to expire on May 31, 2012. The Company and its subsidiary, GSE Power Systems, Inc., were jointly and severally liable as co-borrowers. The credit facilities enabled the Company to borrow funds to support working capital needs and standby letters of credit. The first line of credit which was in the principal amount of up to $3.5 million was amended on March 29, 2010 to increase the principal amount to $5.0 million, but was terminated on March 14, 2011 (see below). The second line of credit was in the principal amount of up to $2.5 million. This line of credit enabled the Company to borrow funds up to 80% of domestic accounts receivable, 30% of domestic unbilled receivables and 100% of the principal balance of a $600,000 certificate of deposit issued by BOA and was amended on March 14, 2011 (see below). The interest rate on this line of credit was based on the daily LIBOR rate plus 225 basis points, with interest only payments due monthly. The credit agreements contained certain restrictive covenants regarding future acquisitions, incurrence of debt and the payment of dividends. In addition, both credit agreements contained financial covenants with respect to the Company's minimum tangible net worth, debt service coverage ratio, and funded debt to EBITDA ratio. At December 31, 2010, the Company was in default of the funded debt to EBITDA ratio.

Due to the Company's financial covenant default as of December 31, 2010, BOA made the following amendments to the Company's revolving credit agreements effective March 14, 2011:

- A written waiver was granted for the funded debt to EBITDA ratio default.
- The $5.0 million principal line of credit was terminated.
- The financial covenants for the $2.5 million principal line of credit were deleted. Going forward, there are no financial covenants.
- The Company was required to cash collateralize all outstanding standby letters of credit.
- All future letters of credit issued by BOA must be cash collateralized.
- Borrowings under the line of credit must be cash collateralized. Currently the Company has in place a $600,000 certificate of deposit as collateral for the line of credit.

As of June 30, 2011, the Company was contingently liable for seven standby letters of credit and three surety bonds totaling $6.4 million which represent performance and bid bonds on ten contracts. The Company has deposited the full value of seven of the standby letters of credit in certificates of deposit ($4.6 million) which have been restricted in that the Company does not have access to these funds until the related letters of credit have expired. The cash has been recorded on the Company's balance sheet at June 30, 2011 as restricted cash.

11. Product Warranty

As the Company recognizes revenue under the percentage-of-completion method, it provides an accrual for estimated future warranty costs based on historical experience and projected claims. The activity in the warranty account is as follows:

(in thousands)		
	$	1,680

Balance at December 31, 2010		
Warranty provision		444
Warranty claims		(248)
Currency adjustment		24
Balance at June 30, 2011	$	1,900

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12. Income Taxes

The Company files in the United States federal jurisdiction and in several state and foreign jurisdictions. Because of the net operating loss carryforwards, the Company is subject to U.S. federal and state income tax examinations from years 1997 forward and is subject to foreign tax examinations by tax authorities for years 2004 and forward. Open tax years related to state and foreign jurisdictions remain subject to examination but are not considered material to our financial position, results of operations or cash flows.

An uncertain tax position taken or expected to be taken in a tax return is recognized in the financial statements when it is more likely than not (i.e., a likelihood of more than fifty percent) that the position would be sustained upon examination by tax authorities that have full knowledge of all relevant information. A recognized tax position is then measured at the largest amount of benefit that is greater than fifty percent likely of being realized upon ultimate settlement. Interest and penalties related to income taxes are accounted for as income tax expense.

The Company, through its acquisition of EnVision on January 4, 2011, recognized deferred tax liabilities of $1.0 million. As a result of this acquisition, in accordance with ASC-805 Business Combinations, the Company reduced the valuation allowance on its U.S. net deferred tax assets and recognized the change in the valuation allowance ($1.0 million) through the income tax provision.

The Company, through its acquisition of EnVision on January 4, 2011, also recorded $320,000 of unrecognized tax benefits as well as a receivable from the EnVision shareholders for the same amount as indemnity for this tax position. The Company does not expect any material changes to its uncertain tax positions in the next twelve months.

The Company expects to pay income taxes in Sweden, India and England in 2011. In addition, the Company will pay foreign income tax w