INNOVATIVE SOLUTIONS & SUPPORT INC
Form 10-Q
February 06, 2008

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, 2007

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 1, 2008, there were 16,898,354 shares of the Registrant s Common Stock, with par value of $.001 per share, outstanding.

INNOVATIVE SOLUTIONS AND SUPPORT, INC.

FORM 10-Q December 31, 2007

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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 December 31, 2007	As of September 30, 2007
Current Assets:		
Cash and cash equivalents	$ 43,819,458	$ 49,151,078
Accounts receivable	5,109,240	6,248,606
Inventories	9,637,230	9,363,795
Deferred income taxes	1,033,030	899,895
Prepaid expenses and other current assets	7,749,392	6,208,804
Total current assets	67,348,350	71,872,178
Property and Equipment:		
Computers and test equipment	5,579,698	5,444,737
Corporate airplane	3,058,627	3,058,627
Furniture and office equipment	1,033,542	1,016,954
Manufacturing facility	5,557,048	5,557,048
Land	1,021,245	1,021,245
	16,250,160	16,098,611
Less - Accumulated depreciation and amortization	(6,951,713)	(6,721,274)
Net property and equipment	9,298,447	9,377,337
Deferred income taxes	643,511	328,060
Other assets	3,006,590	3,008,210
Total assets	$ 80,296,898	$ 84,585,785
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current Liabilities		
Current portion of capitalized lease obligations	$ 9,908	$ 9,908
Accounts payable	5,092,254	4,077,789
Accrued expenses	3,099,201	4,670,832
Deferred revenue	272,549	660,415
Total current liabilities	8,473,912	9,418,944
Note payable	4,335,000	4,335,000
Long-term portion of capitalized lease obligations	45,128	47,542
Deferred revenue	32,902	50,520
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, 2007 and September 30, 2007				
Common stock, $.001 par value: 75,000,000 shares authorized, 18,166,734 and 18,161,172 shares issued at December 31, 2007 and September 30, 2007		18,167		18,161
Additional paid-in capital		44,818,781		44,607,993
Retained earnings		40,659,436		44,194,053
Treasury stock, at cost, 1,272,510, shares at December 31, 2007 and September 30, 2007		(18,086,428)		(18,086,428)
Total shareholders' equity		67,409,956		70,733,779
Total liabilities and shareholders' equity	$	80,296,898	$	84,585,785

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 2007		Three Months Ended December 31 2006
Net sales:				
Product	$	3,899,788	$	3,182,028
Engineering - modification & development		835,859		246,620
Total net sales		4,735,647		3,428,648
Cost of sales				
Product		2,770,099		1,747,216
Engineering - modification & development		888,960		286,729
Total cost of sales		3,659,059		2,033,945
Gross profit		1,076,588		1,394,703
Operating expenses:				
Research and development		1,740,668		1,324,354
Selling, general and administrative		5,935,906		3,059,015
Total operating expenses		7,676,574		4,383,369
Operating loss		(6,599,986)		(2,988,666)
Interest income		589,361		816,273
Interest expense		(50,539)		(50,760)
Loss before income taxes		(6,061,164)		(2,223,153)
Income tax benefit		(1,939,223)		(1,124,709)
Net loss	$	(4,121,941)	$	(1,098,444)
Net loss per common share:				
Basic	$	(0.24)	$	(0.07)
Diluted	$	(0.24)	$	(0.07)
Weighted average shares outstanding:				
Basic		16,893,547		16,824,933
Diluted		16,893,547		16,824,933

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 Three Months Ended December 31, 2007	For the Three Months Ended December 31, 2006
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net loss	$ (4,121,941)	$ (1,098,444)
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities:		
Depreciation and amortization	245,239	199,178
Share-based compensation expense:		
Stock options	129,136	111,871
Nonvested stock awards	50,000	49,943
Tax benefit (expense) from share-based arrangements:		
Stock options	10,439	129,994
Nonvested stock awards	6,286	(1,036)
Excess tax benefits from share-based payments arrangements	(9,685)	(122,811)
(Gain) loss on disposal of fixed assets	(3,000)	551
Deferred income taxes	(448,586)	256,663
(Increase) decrease in:		
Accounts receivable	1,139,366	1,572,384
Inventories	(273,435)	254,876
Prepaid expenses and other current assets	(1,540,588)	(1,376,651)
Other non current assets	(6,180)	
Increase (decrease) in:		
Accounts payable	1,014,465	138,322
Accrued expenses	(984,307)	(390,708)
Deferred revenue	(405,484)	(397,825)
Net cash used in operating activities	(5,198,275)	(673,693)
CASH FLOWS FROM INVESTING ACTIVITIES:		
Purchases of property and equipment	(158,549)	(26,762)
Proceeds on sale of fixed assets	3,000	
Net cash used in investing activities	(155,549)	(26,762)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Proceeds from exercise of stock options	14,933	203,792
Repayment of capitalized lease obligations	(2,414)	(2,025)
Excess tax benefits from share-based payments arrangements	9,685	122,811
Net cash provided by financing activities	22,204	324,578
Net decrease in cash and cash equivalents	(5,331,620)	(375,877)
Cash and cash equivalents, beginning of year	49,151,078	62,984,829
Cash and cash equivalents, end of year	$ 43,819,458	$ 62,608,952
SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION		
Cash paid for interest	$ 40,439	$ 40,529
Cash received from income tax refund	$ (4,593)	$

The accompanying notes are an integral part of these statements.

Innovative Solutions and 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 flat panel display systems, flight information computers and advanced monitoring systems for military, government, commercial air transport and corporate aviation markets.

The balance sheet as of December 31, 2007, the statement of operations for the three months ended December 31, 2007 and 2006 and the statements of cash flows for the three months ended December 31, 2007 and 2006 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, 2007 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 10-K for the year ended September 30, 2007 as filed with the Securities and Exchange Commission. The results of operations for the three months ended December 31, 2007 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.

For each of the three month periods ended December 31, 2007 and 2006, there were 569,000 options to purchase common stock 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, 2007, one customer accounted for 70% of net sales. 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.

4. Inventories

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

	December 31 2007	September 30 2007
Raw materials	$ 6,297,344	$ 6,420,184
Work-in-process	2,262,207	2,216,111
Finished goods	1,077,679	727,500
	$ 9,637,230	$ 9,363,795

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, 2007 is highlighted below:

Warranty accrual at September 30, 2007	$	592,524
Accrued expense for the three months ended December 31, 2007		71,509
Warranty costs for the three months ended December 31, 2007		(39,552)
Warranty accrual at December 31, 2007	$	624,481

6. Share-Based Compensation

Effective October 1, 2005 the Company adopted the provisions of SFAS No.123(R), Share-Based Payment (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.

Total share-based compensation expense was $179,000 and $162,000 for the three months ended December 31, 2007 and 2006, respectively. The total income tax benefit recognized in the statement of operations for share-based compensation arrangements was $57,000 and $82,000 for the three months ended December 31, 2007 and 2006, 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, 2007 no stock options have been granted to independent contractors or consultants under this Plan. Total compensation expense was $129,000 and $112,000 for the three months ended December 31, 2007 and 2006, 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 3,389,000 shares of Common Stock for awards under the plan. As of December 31, 2007 there were 1,686,000 shares remaining and available for grant under the Plan.

A summary of option activity under the Plan as of December 31, 2007 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, 2007	572,959	$	10.30			
Granted						
Exercised	(2,097)		7.12			
Cancelled	(2,000)		11.72			
Outstanding at December 31, 2007	568,862	$	10.31	5.85	$	
Exercisable at December 31, 2007	392,962	$	7.31	4.95	$	934,939

There were no options granted during the three months ended December 31, 2007. The weighted-average grant date fair value of individual options granted during the three months ended December 31, 2006 was $16.30. The total intrinsic value of options exercised during the three months ended December 31, 2007 and 2006 was $27,000 and $388,000, respectively.

The following table summarizes information about stock options under the Plan at December 31, 2007:

				Options Outstanding				Options Exercisable		
Range of Exercise Prices				**Outstanding As of December 31, 2007**	**Weighted-Average Remaining Contractual Life**		**Weighted-Average Exercise Price**	**As of December 31, 2007**		**Weighted-Average Exercise Price**
$	0.00	-	5.00	204,963	4.98	$	4.18	203,763	$	4.18
$	5.01	-	10.00	140,699	3.97		7.70	118,199		7.60
$	10.01	-	15.00	110,000	7.62		14.03	37,600		13.89
$	15.01	-	20.00	48,200	7.35		16.81	23,400		16.77
$	20.01	-	26.97	65,000	8.54		24.16	10,000		20.84
				568,862	5.85		10.31	392,962		7.31

The fair value of each option grant is estimated on the date of grant using the Black-Scholes option pricing model. 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. Compensation expense for employee stock options also includes an estimate for forfeitures and is recognized ratably over the vesting term. The table below sets forth the fair value assumptions used to record compensation expense for the period identified:

	Three Months Ended December 31, 2007	**Three Months Ended December 31, 2006**
Expected lives (years)	8.6	8.8
Weighted average risk-free interest rate	2.3%	2.1%
Expected volatility	64.4%	64.7%
Expected dividend rate	%	%

As of December 31, 2007, there was approximately $1.3 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 quarterly installments during the fiscal year provided the director is still serving on the board on the quarterly issue date. Total expense was $50,000 for each of the three month periods ended December 31, 2007 and 2006. As of December 31, 2007, there was 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. The following table outlines restricted stock awards for the three months ended December 31, 2007:

	Non-vested Stock Awards		Weighted Average Share Price
Balance at September 30, 2007	3,465	$	14.43
Granted	10,525		19.00
Issued	(3,465)		14.43
Cancelled			
Balance at December 31, 2007	10,525	$	19.00

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 December 31, 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 includes an optional redemption schedule that allows the Company the option of forgoing any principal pay-down of the outstanding balance and, accordingly, the balance of the notes payable will be due in 2015.

The loan agreement required 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 December 31, 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.

In November 2007 the Company and the lender signed an amendment to the loan agreement which deleted existing financial covenants and replaced them with only one restrictive covenant that requires the Company to maintain at all times unencumbered cash and marketable securities having a market value of at least $20 million. The Company was in compliance with this covenant as of December 31, 2007.

9. New Accounting Pronouncements

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

10. Income Taxes

The Company adopted the provisions of FASB Interpretation 48, Accounting for Uncertainty in Income Taxes (FIN 48), on October 1, 2007. Previously, the Company had accounted for tax contingencies in accordance with SFAS No. 5, Accounting for Contingencies. At the adoption date of October 1, 2007, the Company applied FIN 48 to all tax positions for which the statute of limitations remained open. As a result of the implementation of FIN 48, the Company recognized a decrease of approximately $587,000 in the liability for unrecognized tax benefits, which was accounted for as an increase to the October 1, 2007 balance of retained earnings

The amount of unrecognized tax benefits as of October 1, 2007 was approximately $330,000, all of which, if ultimately recognized, would reduce the Company s annual effective tax rate. There have been no material changes in unrecognized tax benefits since October 1, 2007.

The Company is subject to income taxes in the U.S. federal and various state jurisdictions. Tax regulations within each jurisdiction are subject to the interpretation of the related tax laws and regulations and require significant judgment to apply. With few significant exceptions, the Company is no longer subject to U.S. federal or state and local examinations by tax authorities for the years ending before September 30, 2004.

The Company does not expect the total amount of unrecognized tax benefits to significantly change in the next twelve months.

The Company recognizes interest accrued and penalties related to unrecognized tax benefits in income tax expense for all periods presented. The Company had accrued approximately $30,000 for the payment of interest and penalties, net of deferred tax benefits, at October 1, 2007. Subsequent changes to accrued interest and penalties have not been significant.

For the three months ended December 31, 2007, we recognized $11,814 of interest and penalties, net of cash benefit, within income tax expense.

11. Prepaid Expenses and Other Current Assets

Prepaid expenses consist of the following:

		December 31, 2007		December 31, 2006
Prepaid income taxes	$	6,629,938	$	5,017,794
Other		1,119,454		1,191,010
	$	7,749,392	$	6,208,804

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

Overview

We design, manufacture and sell flat panel display systems, flight information computers 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 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. Sales to defense contractors are on commercial terms, although some of the termination and other provisions of government contracts are applicable to these contracts.

We continue to invest in and seek additional opportunities for our Flat Panel Display System 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.

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.

In January 2007, the Company in a teaming arrangement with ABX Air received another STC from the FAA on its Flat Panel Display System for use on B-757 aircraft. Similar to the prior STC awarded by the FAA, this one provides B-757 operators with the same 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.

Our cost of sales related to product sales is comprised of product material 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.

Our cost of sales related to Engineering-modification and development (EMD) is comprised of engineering labor, consulting services and other cost associated with specific design and development projects.

We intend to continue to invest in the development of new products and the enhancement of our existing product line and will expense research and development costs 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, 2007 Compared to the Three Months Ended December 31, 2006

Net sales. Net sales increased $1.3 million, or 38%, to $4.7 million for the three months ended December 31, 2007 from $3.4 million in the three months ended December 31, 2006. For the three months ended December 31, 2007, product sales increased $0.7 million and EMD sales increased $0.6 million from the same period in the prior year. The increase in product sales and EMD was primarily related to our order with Eclipse Aviation. The first production units for Eclipse Aviation were shipped during the quarter.

Cost of sales. Cost of sales increased $1.6 million or 76%, to $3.7 million, or 79% of net sales in the three months ended December 31, 2007 from $2.1 million, or 62 % of net sales in the three months ended December 31, 2006. The overall dollar increase consists of $1.0 million in cost of sales related to product sales and an increase of $0.6 million related to EMD sales. The $1.0 million increase in cost related to product sales is attributable to increased sales and additional costs associated with the first production units for the Eclipse Aviation order. The increase in cost related to EMD was primarily related to increased EMD sales.

Research and development. Research and development expense increased $0.4 million or 31% to $1.7 million or 37% of net sales in the three months ended December 31, 2007 from $1.3 million or 38% of net sales in the three months ended December 31, 2006.

The increase in research and development expense in the quarter was mainly due to less cost being allocated to EMD cost of sales for the period. This allocation was necessary to match non- recurring engineering cost with corresponding non-recurring engineering sales in the period. Overall, when you combine research and development expenses with EMD cost of sales, combined engineering, research and development related cost has increased $1.0 million for the same period in the prior year and reflects the Company s continued commitment to product development, research and engineering.

Selling, general, and administrative. Selling, general and administrative expenses increased $2.9 million, or 94%, to $5.9 million, or 125% of net sales in the three months ended December 31, 2007 from $3.1 million or 89% of net sales in the three months ended December 31, 2006. The increase in the dollar amount was primarily the result of $3.5 million of legal fees in the quarter that the Company incurred in connection with litigation related to protecting its Intellectual Property.

Interest income. Interest income was $589,000 in the three months ended December 31, 2007 as compared $816,000 in the three months ended December 31, 2006. The decrease in interest income was primarily the result of our reduced average cash balance in the current quarter as opposed to the same period in the prior year.

Interest expense. Interest expense was $51,000 in the three months ended December 31, 2007 and 2006 respectively.

Income tax benefit. The income tax benefit for the three months ended December 31, 2007 was $1.9 million as compared to $1.1 million for the three months ended December 31, 2006. The increase in the amount of tax benefit was the result of a higher loss before income tax in the three months ended December 31, 2007 then the same period, in the prior year.

The effective tax rate for the three months ended December 31, 2007 was a benefit of 32%. The effective tax rate for the three months ended December 31, 2006 was a benefit of 51%. 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 covered amounts paid or incurred from January 1, 2006 to December 31, 2006. 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 51% and would have been 44% without this discrete item.

Net loss. As a result of the factors described above, our net loss in the three months ended December 31, 2007 was $4.1 million, an increase of $3.0 million from the net loss of $1.1 million for the three months ended December 31, 2006.

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 $5.2 million for the three months ended December 31, 2007 as compared to $0.7 million for the three months ended December 31, 2006. The increase was due primarily to higher net loss ($3.0 million), increased deferred tax benefit ($0.7 million) and increased accrued expenses ($0.6 million) which were partially offset by increased accounts payable ($0.9 million).

Our cash used in investing activities was $155,000 for the three months ended December 31, 2007 and primarily consisted of the purchase of production and laboratory test equipment. Cash used in investing activities was $27,000 for the three months ended December 31, 2006 and consisted of the purchase of production equipment.

Net cash flow provided from financing activities was $22,000 for the three months ended December 31, 2007 as compared to $325,000 in the three months ended December 31, 2006. 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 includes an optional redemption schedule that allows the Company the option of forgoing any principal pay-down of the outstanding balance and, accordingly, the balance of the notes payable will be due in 2015

The loan agreement required 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 December 31, 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.

In November 2007 the Company and the lender signed an amendment to the loan agreement, which deleted existing financial covenants and replaced them with only one restrictive covenant that requires the Company to maintain at all times unencumbered cash and marketable securities having a market value of at least $20 million. The Company was in compliance with this covenant as of December 31, 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 December 31, 2007 and 2006, our backlog was $70.0 million and $32.3 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, 2007 is $61.1 million, an increase of $37.6 million over the December 31, 2006 balance of $23.5 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, inventory valuation, share-based compensation and warranty reserves.

Revenue recognition

The Company recognizes revenue under the provisions of Staff Accounting Bulletin (SAB) No. 104, Revenue Recognition (SAB 104).

The Company enters into certain sales arrangements that include multiple deliverables as defined in EITF Issue No. 00-21, Revenue Arrangements with Multiple Deliverables. 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. In general, revenues are separated between product sales and EDM sales. The allocated revenue for each deliverable is then recognized using appropriate revenue recognition methods.

The Company accounts for transactions with software that is more than incidental to the products under SOP 97-2. Software Revenue Recognition and 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. Accordingly, revenue is recognized when all of the following criteria are met: 1) there is persuasive evidence that an arrangement exists; 2) delivery has occurred or services have been rendered; 3) the seller s price to the buyer is fixed or determinable; and 4) collectibility is reasonably assured.

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.

Income taxes

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.

Inventories

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.

Share-based compensation

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.

Warranty reserves

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.

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

- market acceptance of our COCKPIT/IP™ system or other planned products or product enhancements;
- difficulties in developing and producing our flat panel systems, or COCKPIT/IP™, or other planned products or product enhancements;
- 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;
- 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 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 forwardlooking 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, 2007.

Investors should also be aware that while we do, from time to time, communicate with securities analysts, it is against our policy to disclose any material non-public information or other confidential commercial information. Accordingly, shareholders should not assume that we agree with any statement or report issued by an analyst irrespective of the content of the statement or report. Furthermore, we have a policy against issuing or confirming financial forecasts or projections issued by others. Thus, to the extent that reports issued by securities analysts contain any projections, forecasts or opinions, such reports are not the responsibility of Innovative Solutions and Support, Inc.

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, 2007. 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 business, we are at times subject to various legal proceedings. Except with respect to the fees incurred in connection with the matters described below, we do not believe that any of the current legal proceedings will have a material adverse effect on our results of operations or financial position. On September 13, 2005 the Company filed a lawsuit in the United States District Court for the Western District of Tennessee against J2, Inc., a company founded and jointly owned by Joseph Cesar, a former employee of the Company, and James Zachary, a former sales consultant for the Company. The complaint alleged that the J2/Kollsman/Air Data Computer then being marketed by J2 and manufactured by Kollsman, Inc. infringed a patent assigned to the Company.

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

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

On January 17, 2007 the Company filed suit in Pennsylvania state court against Strathman Associates, a former software consultant for the Company, alleging that Strathman had improperly used the Company s trade secret and proprietary information in assisting J2 and Kollsman in developing the J2/Kollsman Air Data Computer. The case is ongoing.

For the three months ended December 31, 2007 and 2006 the Company has incurred approximately $3.5 million and $1.1 million, respectively, in legal fees in connection with the two matters discussed above.

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, 2007.

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

None

Item 5. Other Information

None

Item 6. Exhibits

(a) Exhibits

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

31.2	Certification of Chief Financial Officer Pursuant to Rule 13a-14(a)
32.1	Certification Pursuant to U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

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: February 6, 2008	By:	/s/ JOHN C. LONG JOHN C. LONG CHIEF FINANCIAL OFFICER