GSE SYSTEMS INC
Form 10-Q
November 14, 2006

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-Q

[X] Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934 for the Quarterly Period Ended September 30, 2006.

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: 0-26494

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

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

7133 Rutherford Rd., Suite 200, Baltimore, MD 21244
(Address of principal executive office and zip code)

Registrant's telephone number, including area code: (410) 277-3740

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 is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of “accelerated filer and large accelerated filer” in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer [ ]   Accelerated filer [ ]   Non-accelerated filer [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]

The number of shares outstanding of each of the registrant’s Common Stock and Series A Cumulative Convertible Preferred Stock as of November 1, 2006:

Common Stock, par value $.01 per share	9,462,046 shares
Series A Cumulative Convertible Preferred Stock, par value $.01 per share	42,500 shares

1

GSE SYSTEMS, INC.

QUARTERLY REPORT ON FORM 10-Q

INDEX

PART I - FINANCIAL INFORMATION
Item 1. Financial Statements

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

	Unaudited September 30, 2006		December 31, 2005	
ASSETS				
Current assets:				
Cash and cash equivalents	$	1,007	$	1,321
Contract receivables		9,278		6,896
Prepaid expenses and other current assets		576		376
Total current assets		10,861		8,593
Equipment and leasehold improvements, net		349		329
Software development costs, net		893		940
Goodwill		1,739		1,739
Restricted cash		2,291		56
Other assets		1,077		325
Total assets	$	17,210	$	11,982
LIABILITIES AND STOCKHOLDERS' EQUITY				
Current liabilities:				
Current portion of long-term debt	$	2,841	$	1,182
Accounts payable		2,603		3,019
Due to GP Strategies Corporation		198		542
Accrued expenses		1,448		1,612
Accrued compensation and payroll taxes		1,463		1,226
Billings in excess of revenue earned		2,061		1,177
Accrued warranty		698		754
Other current liabilities		28		6
Total current liabilities		11,340		9,518
Long-term debt		-		869
Other liabilities		147		698
Total liabilities		11,487		11,085
Commitments and contingencies				
Stockholders' equity:				
Series A convertible preferred stock $.01 par value, 2,000,000 shares authorized, shares issued and outstanding 42,500 in 2006 and none in 2005		-		-
Common stock $.01 par value, 18,000,000 shares authorized,				

shares issued and outstanding 9,462,046 in 2006 and 8,999,706 in 2005		95		90
Additional paid-in capital		36,405		30,915
Accumulated deficit - at formation		(5,112)		(5,112)
Accumulated deficit - since formation		(24,615)		(23,839)
Accumulated other comprehensive loss		(1,050)		(1,157)
Total stockholders' equity		5,723		897
Total liabilities and stockholders' equity	$	17,210	$	11,982

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 September 30,		Nine months ended September 30,	
	2006	**2005**	**2006**	**2005**
Contract revenue	$ 7,292	$ 4,607	$ 19,432	$ 17,617
Cost of revenue	5,111	4,228	13,944	14,543
Gross profit	2,181	379	5,488	3,074
Operating expenses:				
Selling, general and administrative	1,279	1,395	3,502	5,001
Administrative charges from GP Strategies	171	171	513	513
Depreciation	45	243	136	387
Total operating expenses	1,495	1,809	4,151	5,901
Operating income (loss)	686	(1,430)	1,337	(2,827)
Interest expense, net	(234)	(180)	(607)	(251)
Loss on extinguishment of debt	-	-	(1,428)	-
Other income (expense), net	(30)	593	(50)	439
Income (loss) before income taxes	422	(1,017)	(748)	(2,639)
Provision for income taxes	-	30	28	6
Net income (loss)	422	(1,047)	(776)	(2,645)
Preferred stock dividends	(85)	-	(200)	-
Net income (loss) attributed to common shareholders	$ 337	$ (1,047)	$ (976)	$ (2,645)
Basic income (loss) per common share	$ 0.04	$ (0.12)	$ (0.11)	$ (0.29)
Diluted income (loss) per common share	$ 0.03	$ (0.12)	$ (0.11)	$ (0.29)

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 September 30,				Nine months ended September 30,			
	2006		2005		2006		2005	
Net income (loss)	$	422	$	(1,047)	$	(776)	$	(2,645)
Foreign currency translation adjustment		4		10		107		(332)
Comprehensive income (loss)	$	426	$	(1,037)	$	(669)	$	(2,977)

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)

	Preferred Stock		Common Stock		Additional Paid-in Capital	Accumulated Deficit		Accumulated Other Comprehensive Loss	Total
	Shares	Amount	Shares	Amount		At Formation	Since Formation		
Balance, January 1, 2006	-	$ -	9,000	$ 90	$ 30,915	$ (5,112)	$ (23,839)	$ (1,157)	$ 897
Foreign currency translation adjustment	-	-	-	-	-	-	-	107	107
Issuance of preferred stock	43	-	-	-	3,386	-	-	-	3,386
Stock-based compensation expense	-	-	-	-	135	-	-	-	135
Employee stock option exercises	-	-	81	1	177	-	-	-	178
Issuance of warrants	-	-	-	-	1,941	-	-	-	1,941
Warrant exercises	-	-	367	4	(4)	-	-	-	-
Issuance of restricted stock	-	-	14	-	55	-	-	-	55
Preferred stock dividends paid or payable	-	-	-	-	(200)	-	-	-	(200)
Net loss	-	-	-	-	-	-	(776)	-	(776)
Balance, September 30, 2006	43	$ -	9,462	$ 95	$ 36,405	$ (5,112)	$ (24,615)	$ (1,050)	$ 5,723

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)

	Nine months ended September 30, 2006	2005
Cash flows from operating activities:		
Net loss	$ (776)	$ (2,645)
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation and amortization	515	844
Change in fair market value of liabilities for conversion option and warrants	-	(577)
Loss on extinguishment of debt	1,428	-
Employee stock based compensation expense	135	-
Changes in assets and liabilities:		
Contract receivables	(2,382)	807
Prepaid expenses and other assets	23	374
Accounts payable, accrued compensation and accrued expenses	(262)	(1,407)
Due to GP Strategies Corporation	(344)	130
Billings in excess of revenues earned	884	(231)
Accrued warranty reserves	(56)	44
Other liabilities	138	(5)
Net cash used in operating activities	(697)	(2,666)
Cash flows from investing activities:		
Capital expenditures	(150)	(120)
Capitalized software development costs	(274)	(329)
Releases (restrictions) of cash as collateral under letters of credit	(2,344)	29
Net cash used in investing activities	(2,768)	(420)
Cash flows from financing activities:		
Increase in borrowings under lines of credit	1,659	1,182
Net proceeds from issuance of preferred stock and warrants	3,856	-
Paydown of note payable	(2,000)	-
Proceeds from issuance of common stock	178	100
Deferred financing costs	(448)	(212)
Payment of preferred stock dividends	(115)	-
Issuance of subordinated convertible note payable	-	2,000
Other financing activities, net	-	(9)
Net cash provided by financing activities	3,130	3,061
Effect of exchange rate changes on cash	21	(39)
Net decrease in cash and cash equivalents	(314)	(64)

Cash and cash equivalents at beginning of period		1,321		868
Cash and cash equivalents at end of period	$	1,007	$	804

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

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 an 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. 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, 2005 filed with the Securities and Exchange Commission on March 31, 2006.

On June 21, 2005, the Board of Directors of GP Strategies Corporation ("GP Strategies") approved plans to spin-off its 57% interest in GSE through a special dividend to the GP Strategies' stockholders. On September 30, 2005, the GP Strategies' stockholders received 0.283075 share of GSE common stock for each share of GP Strategies common stock or Class B stock held on the record date of September 19, 2005. Following the spin-off, GP Strategies ceased to have any ownership interest in GSE. GP Strategies continues to provide corporate support services to GSE, including accounting, finance, human resources, legal, network support and tax pursuant to a Management Services Agreement which expires on December 31, 2006.

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, the process industries, and the U.S. Government. Contracts typically range from 18 months to three years.

On February 28, 2006, the Company and Dolphin Equity Partners, LP ("Dolphin") entered into a Cancellation and Warrant Exchange Agreement (the "Cancellation Agreement") under which Dolphin agreed to cancel its Senior Subordinated Secured Convertible Promissory Note and cancel its outstanding warrant to purchase 380,952 shares of GSE common stock at an exercise price of $2.22 per share. In exchange for Dolphin's agreement to enter into the Cancellation Agreement and for the participation of Dolphin Offshore Partners, LP in the Preferred Stock transaction discussed below, the Company repaid the Dolphin Note and agreed to issue a new warrant to purchase 900,000 shares of GSE common stock at an exercise price of $0.67 per share (the "Dolphin Warrant"). At the date of issuance, the fair value of the Dolphin Warrant was $868,000, as established using the Black-Scholes Model, and was recorded in paid-in capital with the offset recorded as loss on extinguishment of debt. In accordance with the terms of the warrant agreement, Dolphin exercised the Dolphin Warrant on November 8, 2006 upon the Company's certification that, among other things, the underlying shares of GSE common stock were registered with the Securities and Exchange Commission on October 31, 2006, that the current stock price was greater than $1.25 per share, and that the average of the current stock prices for each trading day of the prior 30 calendar day period was not less than $1.25 per share. The Company received cash proceeds of $603,000.

In conjunction with the early payoff of the Dolphin Note and the cancellation of the 380,952 warrants, the Company wrote off the remaining unamortized Original Issue Discount of $1.1 million, wrote off the remaining unamortized deferred financing charges of $185,000, recognized a credit of $698,000 from the write-off of the liabilities related to the Dolphin Note conversion feature and the related warrants, and took an $868,000 charge for the value of the 900,000 new warrants issued to Dolphin. The total loss on extinguishment of the Dolphin Note and the cancellation of the related warrants totaled $1.4 million.

On February 28, 2006, the Company raised $3.9 million, net of associated fees of $395,000, through the sale of 42,500 shares of Series A Cumulative Convertible Preferred Stock and Warrants by means of a private placement to “accredited investors”, as that term is used in rules and regulations of the Securities and Exchange Commission. The Convertible Preferred Stock is convertible at any time into a total of 2,401,130 shares of GSE common stock at a conversion price of $1.77 per share. The conversion price was equal to 110% of the closing price of the Company’s Common Stock on February 28, 2006, the date the sale of the Convertible Preferred Stock was completed. Each investor received a five-year warrant to purchase GSE common stock equal to 20% of the shares they would receive from the conversion of the Convertible Preferred Stock, at an exercise price of $1.77. In total, the Company issued warrants to purchase a total of 480,226 shares of GSE common stock. At the date of issuance, the fair value of the warrants was $342,000 and the fair value of the preferred stock was $3.9 million. The fair value of the warrants and the preferred stock was determined by the use of the relative fair value method, in which the $4.25 million gross proceeds was allocated based upon the fair values of the warrants, as determined by using the Black-Scholes Model, and the preferred stock, as determined by an independent appraisal. The Convertible Preferred Stockholders are entitled to an 8% cumulative dividend, payable on a semiannual basis every June 30 and December 30. If the Company does not make two consecutive dividend payments on the dates such payments are due, there will be an additional 30% warrant coverage of five-year warrants at a conversion price of $1.77 per share. On June 30, 2006, the Company paid dividends totaling $115,000 to the preferred stockholders. At any time after March 1, 2007, the Company has the right to convert the Preferred Stock into shares of GSE common stock when the average of the current stock price during the twenty trading days immediately prior to the date of such conversion exceeds 200% of the Series A Conversion Price. The holders of the Convertible Preferred Stock are entitled to vote on all matters submitted to the stockholders for a vote, together with the holders of the voting common stock, all voting together as a single class. The holders of the Convertible Preferred Stock are entitled to the number of votes equal to the number of GSE common stock that they would receive upon conversion of their Convertible Preferred Stock.

The Company paid the placement agent for the Convertible Preferred Stock and Warrants 6% of the gross proceeds received by the Company from the offering ($255,000) plus five-year warrants to purchase 150,000 shares of the Company’s common stock at an exercise price of $1.77 per share. In addition to the placement agent fee, the Company paid $140,000 of other transaction fees related to the offering. At the date of issuance, the fair value of the placement agent warrants was $128,000, as established using the Black-Scholes Model, and was recorded in paid-in capital, with the offset recognized as a reduction of the preferred stock proceeds.

The proceeds were used to payoff the Dolphin Note and the Company’s line of credit balance and for other working capital purposes.

On March 7, 2006, the Company entered into a new loan and security agreement with Laurus Master Fund, Ltd and terminated its $1.5 million bank line of credit. The new agreement established a $5.0 million line of credit for the Company. The line is collateralized by substantially all of the Company’s assets and provides for borrowings up to 90% of eligible accounts receivable and 40% of eligible unbilled receivables (up to a maximum of $1.0 million). The interest rate on this line of credit is based on the prime rate plus 200-basis points, with interest only payments due monthly (10.25% at September 30, 2006). There are no financial covenant requirements under the new agreement which expires on March 6, 2008. On May 18, 2006, Laurus Master Fund agreed to temporarily increase the Company’s borrowing capability by $2.0 million over and above the funds that were available to the Company based upon its normal borrowing base calculation. The over advance was used to collateralize a $2.1 million performance bond that the Company issued to the Emirates Simulation Academy, LLC (“ESA”) in the form of a standby letter of credit (See Note 4). One half of the increased borrowing capability expired on July 18, 2006, and the balance expires on February 12, 2007. The Company’s borrowings over and above the normal borrowing base calculation bear additional interest of 1.5% per month over and above the normal interest rate on the line of credit. At September 30, 2006, the Company’s available borrowing base was $3.9 million of which $2.8 million had been utilized. The Company issued to Laurus Master Fund, Ltd a warrant to purchase up to 367,647 shares of GSE common stock at an exercise price of $.01 per share. At the date of issuance, the fair value of the Laurus warrant, which was established using the Black-Scholes Model, was $603,000 and was recorded as paid-in capital with the offset recorded as deferred financing charges. Deferred financing charges are classified as an other asset and are amortized over the term of the credit facility through a charge to interest expense. On July 31, 2006, Laurus exercised the warrant through a cashless exercise procedure as defined in the warrant. Laurus received 366,666 shares of GSE common stock.

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, 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. In accordance with Statement of Position 81-1 *Accounting for Performance of Construction-Type and Certain Production-Type Contracts*, the 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 of the claim. In the third quarter 2006, the Company settled an outstanding claim with a customer for work performed through December 31, 2005 of approximately $265,000, of which $120,000 was recognized as revenue in 2005 and the balance was recognized as revenue in the third quarter 2006.

As the Company recognizes revenue under the percentage-of-completion method, it provides an accrual for estimated future warranty costs based on historical and projected claims experience. 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 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 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 in accordance with Statement of Position 97-2 *Software Revenue Recognition.*

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

Revenues from certain consulting or training contracts are 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.

One customer (the Emirates Simulation Academy, LLC) accounted for 26.3% and 17.9% of the Company's consolidated revenue for the three and nine months ended September 30, 2006, respectively. The Company had no revenue from ESA in 2005. Battelle's Pacific Northwest National Laboratory accounted for approximately 9.4% and 12.3%, respectively, of the Company's consolidated revenue. For the three and nine months ended September 30, 2005, this customer accounted for approximately 19.0% and 27.4%, respectively of the Company's consolidated revenue. The Pacific Northwest National Laboratory is the purchasing agent for the Department of Energy and the numerous projects GSE performs in Eastern and Central Europe.

Contract receivables unbilled totaled $3.1 million and $3.7 million as of September 30, 2006 and December 31, 2005, respectively. In October 2006, the Company billed $1.1 million of the unbilled amounts.

2. 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, warrants or convertible preferred stock were exercised or converted into common stock. The number of common shares and common share equivalents used in the determination of basic and diluted income (loss) per share were as follows:

(in thousands, except for share amounts)	Three Months Ended September 30,		Nine Months Ended September 30,	
	2006	2005	2006	2005
Numerator:				
Net income (loss)	$ 422	$ (1,047)	$ (776)	$ (2,645)
Preferred stock dividends	(85)	-	(200)	-
Net income (loss) attributed to common stockholders	$ 337	$ (1,047)	$ (976)	$ (2,645)
Denominator:				
Weighted-average shares outstanding for basic earnings per share	9,383,401	8,999,706	9,227,774	8,998,607
Effect of dilutive securities:				
Employee stock options, warrants, and convertible preferred stock	4,183,179	-	-	-
Adjusted weighted-average shares outstanding and assumed conversions for diluted earnings per share	13,566,580	8,999,706	9,227,774	8,998,607
Shares related to dilutive securities excluded because inclusion would be anti-dilutive	105,129	2,844,672	3,178,601	1,554,873

The net income (loss) for the three and nine months ended September 30, 2006 was adjusted by preferred stock dividends of $85,000 and $200,000, respectively, in calculating the basic per share amounts. There were no preferred stock dividends in 2005. Conversion of the stock options and warrants was not assumed for the nine months ended September 30, 2006 or for the three and nine months ended September 30, 2005 because the impact was anti-dilutive, with the exception of the warrant issued to Laurus Master Funds, Ltd to purchase up to 367,647 shares of GSE common stock which is included in basic weighted-average shares outstanding since the exercise price per share was $0.01. On July 31, 2006, Laurus exercised the warrant through a cashless exercise procedure as defined in the warrant. Laurus received 366,666 shares of GSE common stock.

Conversion of the convertible preferred stock was not assumed for the nine months ended September 30, 2006 because the impact was anti-dilutive.

3. 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, not to exceed five years.

Software development costs capitalized were $127,000 and $274,000 for the three and nine months ended September 30, 2006, respectively, and $170,000 and $329,000 for the three and nine months ended September 30, 2005, respectively. Total amortization expense was $133,000 and $111,000 for the quarters ended September 30, 2006 and 2005, respectively, and for the nine months ended September 30, 2006 and 2005, total amortization expense was $321,000 and $341,000, respectively.

4. Investment in Emirates Simulation Academy, LLC

On November 8, 2005, the Emirates Simulation Academy, LLC (“ESA”), headquartered in Abu Dhabi, United Arab Emirates, was formed to build and operate simulation training academies in the Arab Gulf Region. These simulation training centers will be designed to train and certify indigenous workers for deployment to critical infrastructure facilities including power plants, oil refineries, petro-chemical plants, desalination units and other industrial facilities. The members of the limited liability company include Al Qudra Holding PJSC of the United Arab Emirates (60% ownership), the Centre of Excellence for Applied Research and Training of the United Arab Emirates (30% ownership) and GSE (10% ownership). At September 30, 2006, GSE’s investment in ESA totaled $238,000 and was classified on the balance sheet as an other asset. The Company accounts for its investment in ESA using the equity method.

In January 2006, GSE received a $15.1 million contract from ESA to supply five simulators and an integrated training program. For the three and nine months ended September 30, 2006, the Company recognized $1.9 million and $3.5 million, respectively, of contract revenue on this project using the percentage-of-completion method, which accounted for 26.3% and 17.9% of the Company’s consolidated revenue for the respective periods.
In accordance with the equity method, the Company has eliminated 10% of the profit from this contract as the training simulators are assets that will be recorded on the books of ESA, and the Company is thus required to eliminate its proportionate share of the profit included in the asset value. The profit elimination totaled $80,000 and $147,000 for the three and nine months ended September 30, 2006, respectively, and has been recorded as an other expense in the income statement and as an other liability on the balance sheet. Once ESA begins to amortize the training simulators on their books, GSE will begin to amortize the other liability to other income.

In January 2006 the Company issued a $2.1 million invoice to ESA for an advance payment on the UAE training center project. The Company received $1.5 million of the ESA receivable in July 2006 and expects to receive the remaining $600,000. A second invoice for $1.7 million was issued to ESA in August 2006 and is still outstanding at September 30, 2006. No bad debt reserve has been established for any of the outstanding receivable at September 30, 2006. Under the terms of the contract, the Company provided a $2.1 million performance bond to ESA that will remain outstanding until the end of the warranty period on October 31, 2008.

5. Stock-Based Compensation

Accounting Standard Adopted

In December 2004, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standard (SFAS) No. 123R, *Share-Based Payment* (SFAS No. 123R), which revises SFAS No. 123, *Accounting for Stock-Based Compensation* (SFAS No. 123), and supersedes Accounting Principles Board Opinion No. 25, *Accounting for Stock Issued to Employee*s (APB No. 25), and requires companies to recognize compensation expense for all equity-based compensation awards issued to employees that are expected to vest. The Company adopted SFAS No. 123R on January 1, 2006, using the Modified Prospective Application method without restatement of prior periods. Under this method, the Company would begin to amortize compensation cost for the remaining portion of its outstanding awards for which the requisite service was not yet rendered as of January 1, 2006. However, at January 1, 2006, all of the Company's outstanding options were fully vested and thus there will be no compensation expense in 2006 related to the adoption of SFAS No. 123R on these outstanding options. The Company will determine the fair value of and account for awards that are granted, modified, or settled after January 1, 2006 in accordance with SFAS No. 123R.

The following table presents the impact of SFAS No. 123R on operating income, income (loss) before income tax expense, net income (loss), basic and diluted earnings (loss) per share, and cash flows from operating and financing activities:

(In thousands, except per share data) Three Months Ended September 30, 2006	As Reported Including SFAS No. 123R Adoption	Excluding SFAS No. 123R Adoption	Impact
Operating income	$ 686	$ 753	$ (67)
Income before income tax expense	422	489	(67)
Net income	422	489	(67)
Basic income per common share	0.04	0.04	-
Diluted income per common share	0.03	0.04	(0.01)
Nine Months Ended September 30, 2006			
Operating income	$ 1,337	$ 1,472	$ (135)
Loss before income tax expense	(748)	(613)	(135)
Net loss	(776)	(641)	(135)
Basic loss per common share	(0.11)	(0.09)	(0.02)
Diluted loss per common share	(0.11)	(0.09)	(0.02)
Net cash used in operating activities	(697)	(697)	-
Net cash provided by financing activities	3,130	3,130	-

Long-term incentive plan

During 1995, the Company established the 1995 Long-Term Incentive Stock Option Plan (the “Plan”), which includes all officers, key employees and non-employee members of the Company’s Board of Directors. All options to purchase shares of the Company’s common stock under the Plan expire seven years from the date of grant and generally become exercisable in three installments with 40% vesting on the first anniversary of the grant date and 30% vesting on each of the second and third anniversaries of the grant date, subject to acceleration under certain circumstances. As of September 30, 2006, the Company had 222,686 shares of common stock reserved for future grants under the Plan.

Under SFAS No. 123R, the Company recognizes compensation expense on a straight-line basis over the requisite service period for stock-based compensation awards with both graded and cliff vesting terms. The Company applies a forfeiture estimate to compensation expense recognized for awards that are expected to vest during the requisite service period, and revises that estimate if subsequent information indicates that the actual forfeitures will differ from the estimate. The Company recognizes the cumulative effect of a change in the number of awards expected to vest in compensation expense in the period of change. The Company has not capitalized any portion of its stock-based compensation.

During the three and nine months ended September 30, 2006, the Company recognized $67,000 and $135,000, respectively, of pre-tax stock-based compensation expense under the fair value method in accordance with SFAS No. 123R.

Summarized information for the Company’s non-qualified stock options is as follows:

	Shares	Weighted Average Exercise Price	Weighted Average Remaining Years	Aggregate Intrinsic Value
Outstanding as of December 31, 2005	1,917,678	$ 3.13		
Granted	660,000	1.78		
Exercised	(81,784)	2.17		
Cancelled/expired	(514,244)	3.98		
Outstanding as of September 30, 2006	1,981,650	2.49	3.96	$ 4,936,525
Exercisable at September 30, 2006	1,321,650	2.85	2.70	3,763,375
Nonvested at September 30, 2006	660,000	1.78	6.47	1,173,150

14

A summary of the status of the Company's nonvested options as of September 30, 2006 and changes during the nine months ended September 30, 2006 is presented below:

	Number of Shares	Weighted Average Grant-Date Fair Value
Nonvested at January 1, 2006	-	$ -