

INNOVATIVE SOLUTIONS & SUPPORT INC
Form 10-K/A
December 19, 2008

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**UNITED STATES
SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

FORM 10-K/A

Amendment No. 1

ý **ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE
SECURITIES EXCHANGE ACT OF 1934**

For the fiscal year ended September 30, 2008

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
(State or other jurisdiction of incorporation)

23-2507402
(IRS Employer Identification No.)

720 Pennsylvania Drive, Exton, Pennsylvania
(Address of principal executive offices)

19341
(Zip Code)

(610) 646-9800

(Registrant's telephone number, including area code)

Securities registered pursuant to Section 12(b) of the Act:

Title of each class:

Common Stock par value \$.001 per share

Name of each exchange on which registered

The NASDAQ Stock Market, LLC

Securities registered pursuant to Section 12(g) of the Act: **None**

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes o No ý

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act Yes o No ý

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Note: Checking the box above will not relieve any registrant required to file reports pursuant to Section 13 or section 15(d) of the Exchange Act from their obligations under those sections.

Indicate by check mark whether the 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 No

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of the registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

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," "non-accelerated filer," and "smaller reporting company," in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated
filer

Accelerated
filer

Non-accelerated
filer

Smaller reporting
company

(Do not check if a
smaller reporting
company)

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

The aggregate market value of the Registrant's common stock held by non-affiliates of the Registrant as of March 31, 2008 (the last business day of the registrant's most recently completed second quarter) was approximately \$136.0 million. Shares of common stock held by each executive officer and director and by each person who owns 10% or more of our outstanding common stock have been excluded since such persons may be deemed affiliates. This determination of affiliate status is not necessarily a conclusive determination for other purposes.

As of December 5, 2008, there were 16,734,149 outstanding shares of the Registrant's Common Stock

Documents Incorporated by Reference

Portions of the Registrant's Proxy Statement for the 2009 Annual Meeting of Shareholders to be filed prior to January 28, 2009 are incorporated by reference into Part III of this Report. Such Proxy Statement, except for the parts therein which have been specifically incorporated by reference, shall not be deemed "filed" for the purposes of this Report on Form 10-K.

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EXPLANATORY NOTE

This Amendment No. 1 to the Annual Report on Form 10-K of Innovative Solutions and Support, Inc. and subsidiaries for the fiscal year ended September 30, 2008 (the "Form 10-K") is being filed for the purpose of correcting a typographical error in the "Net Loss" line item in the Consolidated Statement of Cash Flows for the fiscal year ended September 30, 2008.

This resulted in the need to also correct the related subtotals in the line items: "Net cash provided by (used in) operating activities," "Net decrease in cash and cash equivalents" and "Cash and cash equivalents, end of year" included in the Consolidated Statement of Cash Flows for the fiscal year ended September 30, 2008 in Item 8 of the Form 10-K, as originally filed on December 11, 2008. There are no changes to the original Form 10-K other than those described above.

This Amendment No. 1 speaks as of the original filing date of the Form 10-K and does not reflect events occurring after the filing date of the Form 10-K, or modify or update the disclosures therein in any way other than as required to reflect the amendment described above.

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Item 8. Financial statements and supplementary data.

The financial statements of Innovative Solutions and Support, Inc. listed in the index appearing under Item 8 herein are filed as part of this Report.

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Innovative Solutions and Support, Inc.

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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Shareholders of
Innovative Solutions and Support, Inc.
Exton, Pennsylvania

We have audited the accompanying consolidated balance sheets of Innovative Solutions and Support, Inc. and subsidiaries (the "Company") as of September 30, 2008 and 2007, and the related consolidated statements of operations, cash flows, and shareholders' equity for each of the three years in the period ended September 30, 2008. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on the financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, such consolidated financial statements present fairly, in all material respects, the financial position of the Company as of September 30, 2008 and 2007, and the results of its operations and its cash flows for each of the three years in the period ended September 30, 2008, in conformity with accounting principles generally accepted in the United States of America.

As discussed in Note 9 to the consolidated financial statements, the Company adopted Financial Accounting Standards Board Interpretation No. 48, *Accounting for Uncertainty in Income Taxes*, effective October 1, 2007.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the Company's internal control over financial reporting as of September 30, 2008, based on the criteria established in *Internal Control - Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission and our report dated December 9, 2008 expressed an unqualified opinion on the Company's internal control over financial reporting.

DELOITTE & TOUCHE LLP

Philadelphia, Pennsylvania
December 9, 2008

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INNOVATIVE SOLUTIONS AND SUPPORT, INC.

CONSOLIDATED BALANCE SHEETS

| | As of September 30, 2008 | As of September 30, 2007 |
|--|--------------------------------|--------------------------------|
| ASSETS | | |
| Current Assets: | | |
| Cash and cash equivalents | \$ 35,031,932 | \$ 49,151,078 |
| Accounts receivable, net | 4,218,443 | 6,248,606 |
| Inventories | 9,361,257 | 9,363,795 |
| Deferred income taxes | 414,636 | 899,895 |
| Prepaid expenses and other current assets | 1,406,260 | 6,208,804 |
| Total current assets | 50,432,528 | 71,872,178 |
| Property and Equipment: | | |
| Computers and test equipment | 5,879,362 | 5,444,737 |
| Corporate airplane | 3,076,400 | 3,058,627 |
| Furniture and office equipment | 1,074,029 | 1,016,954 |
| Manufacturing facility | 5,576,536 | 5,557,048 |
| Land | 1,021,245 | 1,021,245 |
| | 16,627,572 | 16,098,611 |
| Less Accumulated depreciation and amortization | (7,669,226) | (6,721,274) |
| Net property and equipment | 8,958,346 | 9,377,337 |
| Deferred income taxes | | 328,060 |
| Other assets | 505,840 | 3,008,210 |
| Total assets | \$ 59,896,714 | \$ 84,585,785 |
| LIABILITIES AND SHAREHOLDERS' EQUITY | | |
| Current Liabilities | | |
| Current portion of capitalized lease obligations | \$ 9,908 | \$ 9,908 |
| Accounts payable | 2,349,981 | 4,077,789 |
| Accrued expenses | 5,130,463 | 4,670,832 |
| Deferred revenue | 450,923 | 660,415 |
| Total current liabilities | 7,941,275 | 9,418,944 |
| Note payable | 4,335,000 | 4,335,000 |
| Long-term portion of capitalized lease obligations | 37,633 | 47,542 |
| Deferred revenue | 114,075 | 50,520 |
| Deferred income taxes | 414,636 | |

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Other liabilities 249,969

Commitments and contingencies

Shareholders' Equity:

| | | |
|---|---------------|---------------|
| Preferred stock, 10,000,000 shares authorized, \$.001 par value, of which 200,000 shares are authorized as Class A Convertible stock. No shares issued and outstanding at September 30, 2008 and 2007 | | |
| Common stock, \$.001 par value: 75,000,000 shares authorized, 18,177,024 and 18,161,172 shares issued at September 30, 2008 and 2007 | 18,177 | 18,161 |
| Additional paid-in capital | 45,767,960 | 44,607,993 |
| Retained earnings | 20,152,615 | 44,194,053 |
| Treasury stock, at cost, 1,445,510 and 1,272,510, shares at September 30, 2008 and 2007 | (19,134,626) | (18,086,428) |
| Total shareholders' equity | 46,804,126 | 70,733,779 |
| Total liabilities and shareholders' equity | \$ 59,896,714 | \$ 84,585,785 |

The accompanying notes are an integral part of these statements.

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| | For the Fiscal Year Ended September 30, | | |
|---|--|----------------|----------------|
| | 2008 | 2007 | 2006 |
| Net sales: | | | |
| Product | \$ 25,946,917 | \$ 15,083,465 | \$ 15,940,721 |
| Engineering modification and development | 4,586,394 | 3,264,663 | 781,246 |
| Total net sales | 30,533,311 | 18,348,128 | 16,721,967 |
| Cost of sales | | | |
| Product | 17,584,314 | 8,968,939 | 8,006,406 |
| Engineering modification and development | 2,967,543 | 5,185,486 | 625,355 |
| Total cost of sales | 20,551,857 | 14,154,425 | 8,631,761 |
| Gross profit | 9,981,454 | 4,193,703 | 8,090,206 |
| Operating expenses: | | | |
| Research and development | 10,304,279 | 5,180,360 | 6,749,426 |
| Selling, general and administrative | 22,306,016 | 15,840,255 | 9,863,758 |
| Asset impairment | 2,475,000 | | |
| Total operating expenses | 35,085,295 | 21,020,615 | 16,613,184 |
| Operating loss | (25,103,841) | (16,826,912) | (8,522,978) |
| Interest income | 1,576,599 | 3,090,919 | 3,280,179 |
| Interest expense | (160,867) | (204,317) | (188,193) |
| Other income | 17,300,000 | | |
| Loss before income taxes | (6,388,109) | (13,940,310) | (5,430,992) |
| Income taxes expense (benefit) | 1,509,139 | (5,095,022) | (2,548,600) |
| Net loss | \$ (7,897,248) | \$ (8,845,288) | \$ (2,882,392) |
| Net loss per common share: | | | |
| Basic | \$ (0.47) | \$ (0.52) | \$ (0.17) |
| Diluted | \$ (0.47) | \$ (0.52) | \$ (0.17) |
| Weighted average shares outstanding: | | | |
| Basic | 16,887,049 | 16,865,028 | 17,388,524 |
| Diluted | 16,887,049 | 16,865,028 | 17,388,524 |

The accompanying notes are an integral part of these statements.

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INNOVATIVE SOLUTIONS AND SUPPORT, INC.

CONSOLIDATED STATEMENTS OF SHAREHOLDERS' EQUITY

| | Common Stock | Additional Paid-in Capital | Retained Earnings | Treasury Stock | Total |
|---|-----------------|----------------------------------|----------------------|-------------------|---------------|
| Balance, September 30, 2005 | \$ 18,047 | \$ 41,926,318 | \$ 55,921,733 | \$ | \$ 97,866,098 |
| Exercise of options to purchase common stock | 25 | 408,779 | | | 408,804 |
| Share-based compensation | | 655,351 | | | 655,351 |
| Issuance of stock to directors | 16 | 239,904 | | | 239,920 |
| Purchase of treasury stock | | | | (18,086,428) | (18,086,428) |
| Net loss | | | (2,882,392) | | (2,882,392) |
| Balance, September 30, 2006 | 18,088 | 43,230,352 | 53,039,341 | (18,086,428) | 78,201,353 |
| Exercise of options to purchase common stock | 58 | 652,060 | | | 652,118 |
| Share-based compensation | | 505,652 | | | 505,652 |
| Issuance of stock to directors | 15 | 219,929 | | | 219,944 |
| Net loss | | | (8,845,288) | | (8,845,288) |
| Balance, September 30, 2007 | 18,161 | 44,607,993 | 44,194,053 | (18,086,428) | 70,733,779 |
| Exercise of options to purchase common stock | 5 | 22,055 | | | 22,060 |
| Share-based compensation | | 938,013 | | | 938,013 |
| Issuance of stock to directors | 11 | 199,899 | | | 199,910 |
| Purchase of treasury stock | | | | (1,048,198) | (1,048,198) |
| Cumulative effect of adoption of FIN 48 | | | 587,324 | | 587,324 |
| Dividends | | | (16,731,514) | | (16,731,514) |
| Net loss | | | (7,897,248) | | (7,897,248) |
| Balance, September 30, 2008 | \$ 18,177 | \$ 45,767,960 | \$ 20,152,615 | \$ (19,134,626) | \$ 46,804,126 |

The accompanying notes are an integral part of these statements.

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INNOVATIVE SOLUTIONS AND SUPPORT, INC.

CONSOLIDATED STATEMENTS OF CASH FLOWS

| | For the Fiscal Year Ended September 30, | | |
|--|---|----------------|----------------|
| | 2008 | 2007 | 2006 |
| CASH FLOWS FROM OPERATING ACTIVITIES: | | | |
| Net loss | \$ (7,897,248) | \$ (8,845,288) | \$ (2,882,392) |
| Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities: | | | |
| Depreciation and amortization | 1,048,267 | 946,215 | 858,641 |
| Share-based compensation expense: | | | |
| Stock options | 938,013 | 505,652 | 655,351 |
| Nonvested stock awards | 199,910 | 219,944 | 239,920 |
| Tax benefit (expense) from share-based arrangements: | | | |
| Stock options | 10,497 | 162,985 | 227,965 |
| Nonvested stock awards | (21,655) | (3,588) | (8,456) |
| Provision for losses on accounts receivable | 4,077,319 | | |
| Excess tax benefits from share-based payments arrangements | (11,424) | (154,873) | (44,504) |
| Loss on disposal of fixed assets | 9,531 | 7,278 | 22,066 |
| Excess and obsolete inventory expense | 1,856,827 | 100,000 | 38,861 |
| Asset impairment | 2,475,000 | | |
| Deferred income taxes | 1,227,955 | (635,096) | (272,756) |
| (Increase) decrease in: | | | |
| Accounts receivable | (2,047,156) | (2,915,475) | 2,146,805 |
| Inventories | (1,854,289) | (2,997,639) | (2,593,391) |
| Prepaid expenses and other current assets | 4,802,544 | (2,143,108) | (35,348) |
| Other non current assets | (41,080) | (88,446) | |
| Increase (decrease) in: | | | |
| Accounts payable | (1,727,808) | 3,718,971 | 53,302 |
| Accrued expenses | 1,046,955 | 1,548,291 | (381,272) |
| Deferred revenue | (145,937) | (1,682) | 344,504 |
| Other non current liabilities | 249,969 | | |
| Net cash provided by (used in) operating activities | 4,196,190 | (10,575,859) | (1,630,704) |
| CASH FLOWS FROM INVESTING ACTIVITIES: | | | |
| Purchases of property and equipment | (573,357) | (1,276,508) | (456,528) |
| Purchases of other assets | | (2,616,500) | (240,000) |
| Proceeds on sale of fixed assets | 3,000 | | |
| Net cash used in investing activities | (570,357) | (3,893,008) | (696,528) |
| CASH FLOWS FROM FINANCING ACTIVITIES: | | | |
| Proceeds from exercise of stock options | 33,218 | 492,721 | 189,295 |
| Purchase of treasury stock | (1,048,198) | | (18,086,428) |
| Dividend paid | (16,731,514) | | |
| Repayment of capitalized lease obligations | (9,909) | (12,478) | (7,892) |
| Excess tax benefits from share-based payments arrangements | 11,424 | 154,873 | 44,504 |
| Net cash (used in) provided by financing activities | (17,744,979) | 635,116 | (17,860,521) |
| Net decrease in cash and cash equivalents | (14,119,146) | (13,833,751) | (20,187,753) |

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| | | | |
|--|---------------|---------------|---------------|
| Cash and cash equivalents, beginning of year | 49,151,078 | 62,984,829 | 83,172,582 |
| Cash and cash equivalents, end of year | \$ 35,031,932 | \$ 49,151,078 | \$ 62,984,829 |

**SUPPLEMENTAL DISCLOSURE OF CASH FLOW
INFORMATION**

| | | | |
|--------------------------------------|----------------|----------------|----------------|
| Cash paid for interest | \$ 120,650 | \$ 164,091 | \$ 147,332 |
| Cash paid for income taxes | \$ 9,073 | \$ | \$ 457,672 |
| Cash received from income tax refund | \$ (5,107,269) | \$ (2,424,704) | \$ (3,278,844) |

The accompanying notes are an integral part of these statements.

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1. Background:

Innovative Solutions and Support, Inc., (the "Company"), was incorporated in Pennsylvania on February 12, 1988. The Company's primary business is the design, manufacture and sale of flight information computers, large flat panel displays and advanced monitoring systems to the Department of Defense (DoD), defense contractors, commercial air transport and corporate/general aviation markets.

2. Concentrations:

Major Customers and Products

In fiscal 2008, 2007, and 2006 the Company derived 72%, 58%, and 47% of net sales from five customers, although not all the same customers in each year. Accounts receivable related to those top five customers was \$2.3 million, \$4.7 million, and \$1.8 million for fiscal 2008, 2007, and 2006, respectively.

The Company recorded sales with two customers that individually accounted for 42% and 10% of total sales for fiscal year 2008, three customers that individually accounted for 20%, 16% and 11% of net sales for fiscal year 2007 and one customer that accounted for 17% of net sales for fiscal year 2006.

Sales of air data systems and components were 23%, 47%, and 62% of total sales for the years ended September 30, 2008, 2007, and 2006 respectively. Flat Panel sales were 77%, 53%, and 38% of net sales in the years ended September 30, 2008, 2007, and 2006 respectively. Sales to government contractors and agencies accounted for approximately 23%, 36%, and 51% of total sales during fiscal years 2008, 2007, and 2006, respectively.

Major Suppliers

The Company currently buys several of its components from sole source suppliers. Although there are a limited number of manufacturers of particular components, management believes other suppliers could provide similar components on comparable terms.

Concentration of Credit Risk

Financial instruments that potentially subject the Company to concentration of credit risk consist principally of cash balances and accounts receivable. The Company invests its excess cash where preservation of principal is the major consideration. The Company's customer base principally consists of companies within the aviation industry. The Company routinely requests advance payments and/or letters of credit from new customers.

The Company has maintained a reserve for doubtful accounts in the amount of \$4.1 million, \$0 and \$0.1million for fiscal year 2008, 2007 and 2006, respectively. The large increase in the reserve for doubtful accounts in fiscal year 2008 was directly related to accounts receivable from Eclipse Aviation, a customer that filed for bankruptcy under Chapter 11 subsequent to the Company's year end. There were no accounts receivable write-offs in fiscal 2008, 2007, and 2006, respectively.

3. Summary Of Significant Accounting Policies:

Principles of Consolidation

The consolidated financial statements include the accounts of the Company and its subsidiaries. All material inter-company balances and transactions have been eliminated in consolidation.

Table of Contents**3. Summary Of Significant Accounting Policies: (Continued)***Use of Estimates*

Preparation of consolidated financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect reported amounts of assets and liabilities, and disclosure of contingent assets and liabilities, as of the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ materially from those estimates.

Cash and Cash Equivalents

Highly liquid investments purchased with an original maturity of three months or less are classified as cash equivalents. Cash equivalents at September 30, 2008 and 2007 consist of funds invested in money market accounts with financial institutions.

Inventories

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

| | September 30, | |
|-----------------|---------------|-------------|
| | 2008 | 2007 |
| Raw materials | \$4,705,134 | \$6,420,184 |
| Work-in-process | 3,046,451 | 2,216,111 |
| Finished goods | 1,609,672 | 727,500 |
| | \$9,361,257 | \$9,363,795 |

The growth in Finished goods is a result of contractual requirements to hold inventory prior to scheduled delivery.

Property and Equipment

Property and equipment is stated at cost. Depreciation is provided using an accelerated method over estimated useful lives of the assets (the lesser of three to seven years or over the lease term), except for the airplane and manufacturing facility, which are depreciated over a straight-line method. Major additions and improvements are capitalized, while maintenance and repairs that do not improve or extend the life of assets are charged to expense as incurred. Depreciation expense was \$1.0 million, \$0.9 million and \$0.8 million for the fiscal years ended September 30, 2008, 2007, and 2006.

Long-Lived Assets

The Company assesses the impairment of long-lived assets in accordance with SFAS No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets". This statement requires that long-lived assets be reviewed for impairment whenever events or changes in circumstances indicate the carrying amount of an asset may not be recoverable. Also, in general, long-lived assets to be disposed of should be reported at the lower of the carrying amount or fair value less cost to sell. The Company considers historical performance and future estimated results in its evaluation of potential impairment and then compares the carrying amount of the asset to estimated future cash flows expected to result from use of the asset. If the carrying amount of the asset exceeds the estimated expected undiscounted future cash flows, the Company measures the amount of the impairment by comparing the carrying amount of the asset to its fair value. The estimation of fair value is generally measured by discounting

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3. Summary Of Significant Accounting Policies: (Continued)

expected future cash flows. The Company recorded an asset impairment of \$2.5 million, the full carrying value of previously acquired engineering software which is no longer part of the Company's product offering and will generate no future cash flows. No impairment charges were recorded in fiscal years 2007 and 2006.

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 EMD 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 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." For Software arrangements that include multiple elements revenue is allocated to the various elements, including the post contract customer support (PCS), if applicable, based on vendor-specific objective evidence of fair value. Revenue for each element other than PCS 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) collectability is reasonably assured. The portion of the revenue allocated to PCS should be recognized as revenue ratably over the term of the PCS arrangement, because the PCS services are assumed to be provided ratably.

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." The Company considers 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. The Company recognizes its construction-type contracts using either the percentage-of-completion method or completed contract method of accounting. The Company records sales relating to these contracts using the percentage-of-completion method when the Company determines that progress toward completion is reasonable and reliably estimable and the contract is long-term in nature; the Company uses the completed contract method for all others. Sales related to these types of contracts were \$1.4 million, \$3.3 million and \$.8 million for fiscal years ended September 30, 2008, 2007, and 2006 respectively.

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.

Warranty

Estimated cost to repair or replace products under warranty is provided when sales of product are recorded.

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3. Summary Of Significant Accounting Policies: (Continued)

Income Taxes

Income taxes are recorded in accordance with Statement of Financial Accounting Standards (SFAS) No. 109, "Accounting for Income Taxes" (SFAS 109), which principally utilizes a balance sheet approach to provide for income taxes. Under this method, 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. The Company files a consolidated United States federal income tax return (see Note 9).

Effective October 1, 2007 (the first day of fiscal 2008), the Company adopted Financial Accounting Standards Board (FASB) Interpretation No. 48, "Accounting for Uncertainty in Income Taxes" (FIN 48). FIN 48 prescribes a comprehensive model for how a company should recognize, measure, present and disclose in its financial statements uncertain tax positions that the company has taken or expects to take on a tax return. The Company has elected to record any interest or penalties from the uncertain tax position as income tax expense (see Note 9).

Research and Development

Research and development charges incurred for product enhancements and future product development are recorded as expense as incurred.

Comprehensive Income

Pursuant to SFAS No. 130, "Reporting Comprehensive Income," the Company would be required to classify items of other comprehensive income by their nature in a financial statement and display the accumulated balance of other comprehensive income separately from retained earnings and additional paid-in capital in the equity section of a statement of financial position. Comprehensive income consists of net income and there were no items of other comprehensive income for any of the periods presented.

Fair Value of Financial Instruments

The estimated fair value amounts presented in these consolidated financial statements were determined by the Company using available market information and appropriate methodologies. The Company's financial instruments consist primarily of cash and cash equivalents, accounts receivable, accounts payable, accrued liabilities and debt instruments. The carrying values of these assets and liabilities are considered to be representative of respective fair values based on pertinent information available to management as of September 30, 2008 and 2007.

Stock-Based Compensation

We account for stock-based compensation under SFAS No. 123 (revised 2004), *Share-Based Payment* (SFAS 123(R)). SFAS 123(R) requires us to measure the cost of employee services received in exchange for an award of equity instruments based on the grant-date fair value of the award using an option pricing model. That cost is recognized over the period during which an employee is required to provide service in exchange for the award.

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3. Summary Of Significant Accounting Policies: (Continued)

New Accounting Pronouncements

In December 2007, the FASB issued SFAS No. 141R, "Business Combinations" (SFAS 141R), which replaces SFAS No. 141, "Business Combinations." SFAS 141R, among other things, establishes principles and requirements for how an acquirer entity recognizes and measures in its financial statements the identifiable assets acquired, the liabilities assumed and any controlling interests in the acquired entity; recognizes and measures the goodwill acquired in the business combination or a gain from a bargain purchase; and determines what information to disclose to enable users of the financial statements to evaluate the nature and financial effects of the business combination. Costs of the acquisition will be recognized separately from the business combination. SFAS 141R applies prospectively, except for taxes, to business combinations for which the acquisition date is on or after the beginning of the first annual reporting period on or after December 15, 2008.

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.

4. Net Income (Loss) Per Share:

Net income (loss) per share is calculated pursuant to SFAS No. 128, "Earnings per Share" (SFAS 128). Basic earnings per share EPS excludes potentially dilutive securities and is computed by dividing net income by the weighted-average number of Common shares outstanding for the period. Diluted EPS is computed assuming the conversion or exercise of all dilutive securities such as preferred stock, options and warrants.

There is no difference between basic weighted average shares outstanding and diluted weighted-average shares outstanding used to compute diluted EPS for fiscal years 2008, 2007 and 2006 because the Company is in a net loss position.

The number of incremental shares from the assumed exercise of stock options is calculated by using the treasury stock method. For the fiscal years ended September 30, 2008, 2007 and 2006, there were 750,608, 572,959 and 701,854 options to purchase common stock outstanding, respectively, that were excluded from the computation of diluted earnings per share as the effect would be anti-dilutive.

5. Prepaid Expenses and Other Current Assets:

Prepaid expenses consist of the following:

| | September 30, | |
|----------------------|---------------|-------------|
| | 2008 | 2007 |
| Prepaid income taxes | \$ | \$5,017,794 |
| Other | 1,406,260 | 1,191,010 |
| | \$1,406,260 | \$6,208,804 |

Table of Contents**6. Other Assets:**

Other assets consist of the following:

| | September 30, | |
|--|------------------|--------------------|
| | 2008 | 2007 |
| Intangible assets, net of accumulated amortization of \$89,950 and \$36,000 at September 30, 2008 and 2007 | \$289,050 | \$2,820,500 |
| Other | 216,790 | 187,710 |
| | \$505,840 | \$3,008,210 |

Intangible assets consist of licensing and certification rights which are amortized over a defined number of units. During the fiscal year ended September 30, 2008, the Company recorded an asset impairment of \$2.5 million, the full carrying value of previously acquired engineering software which is no longer part of the Company's product offering and will generate no future cash flows. No impairment charge was recorded in fiscal year 2007. Total amortization expense was \$68,450 and \$14,400 for the fiscal years ended September 30, 2008 and 2007, respectively. Because the intangible assets are being amortized over a defined number of units, the future amortization expense over the next five years cannot be determined at this time.

7. Accrued Expenses:

Accrued expenses consist of the following:

| | September 30, | |
|------------------------------------|--------------------|--------------------|
| | 2008 | 2007 |
| Salary, benefits and payroll taxes | \$ 904,904 | \$ 603,565 |
| Warranty | 736,815 | 592,524 |
| Income taxes payable | 798,801 | 959,227 |
| Professional fees | 474,730 | 1,515,630 |
| Reduction in workforce/Severance | 904,163 | |
| Materials on order | 467,759 | 137,245 |
| Other | 843,291 | 862,641 |
| | \$5,130,463 | \$4,670,832 |

During the fiscal year ended September 30, 2008, the Company incurred \$904,163 in severance and other costs associated with the reduction in workforce and the September termination of its Chief Executive Officer.

8. Warranty:

The Company provides for estimated cost of product warranties at the time revenue is recognized. Warranty cost is recorded as cost of sales 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 Company estimates, revisions to estimated warranty liability would be required.

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8. Warranty: (Continued)

Warranty cost and accrual information for the fiscal years ended September 30, 2008 and 2007:

| | 2008 | 2007 |
|--|------------|------------|
| Warranty accrual at October 1, | \$ 592,524 | \$ 617,116 |
| Accrued expense for the fiscal year ended September 30 | 317,968 | 210,555 |
| Warranty costs for the fiscal year ended September 30 | (173,677) | (235,147) |
| Warranty accrual at September 30 | \$ 736,815 | \$ 592,524 |

9. Income Taxes:

The Company accounts for income taxes under SFAS No. 109, which generally provides that deferred tax assets and liabilities be recognized for temporary differences between financial reporting and tax basis of the Company's assets and liabilities and expected benefits of utilizing net operating loss (NOL) carry forwards. 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 financial statements in the period of enactment.

Components of income taxes are as follows:

| | For the Fiscal Year Ended September 30, | | |
|-------------------------------|---|---------------|---------------|
| | 2008 | 2007 | 2006 |
| Current provision (benefit): | | | |
| Federal | \$ 236,170 | \$(4,463,302) | \$(1,943,991) |
| State | (30,708) | 3,377 | |
| | 205,462 | (4,459,925) | (1,943,991) |
| Deferred provision (benefit): | | | |
| Federal | 883,439 | (639,263) | (158,789) |
| State | 420,238 | 4,166 | (445,820) |
| | 1,303,677 | (635,097) | (604,609) |
| | \$ 1,509,139 | \$(5,095,022) | \$(2,548,600) |

Following is a reconciliation of the statutory federal rate to the Company's effective income tax rate:

| | For the Fiscal Year Ended September 30, | | |
|--|--|--------|-------|
| | 2008 | 2007 | 2006 |
| Federal statutory tax rate | 34.0% | 34.0% | 35.0% |
| State income taxes, net of federal benefit | 7.3% | 0.0% | 5.3% |
| Research and development tax credits | 1.8% | 5.1% | 0.5% |
| Increase in valuation allowance | (74.5)% | | |
| Additional benefit from federal amended and carryback claims | 6.3% | | |
| Other | 1.5% | (2.6)% | 6.1% |
| | (23.6)% | 36.5% | 46.9% |

In October of 2008, an extension of the Research and Experimentation ("R&E") tax credit was enacted into law. This retroactive extension is for amounts paid or incurred after December 31, 2007.

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9. Income Taxes: (Continued)

The entire impact of this retroactive extension will be recognized in the first quarter of the fiscal year ending September 30, 2009 as required by SFAS 109.

The deferred tax effect of temporary differences giving rise to the Company's deferred tax assets and liabilities consists of the components below.

| | September 30, | | | |
|---|-------------------|---------------------|-------------------|-------------------|
| | 2008 | | 2007 | |
| | Current | Non Current | Current | Non Current |
| Deferred tax assets: | | | | |
| Deferred revenue | \$ 77,920 | \$ | \$ 45,504 | \$ |
| Reserves and accruals | 3,172,061 | 237,460 | 657,250 | 198,456 |
| Research and development credit | 184,837 | | 462,267 | |
| Software | | 596,469 | | |
| NOL carryforwards state | | 1,050,052 | | 824,573 |
| Stock options | | 687,353 | | 362,894 |
| Other | | 55,131 | | |
| | 3,434,818 | 2,626,465 | 1,165,021 | 1,385,923 |
| Less: Valuation allowance | (3,002,107) | (2,295,589) | (246,325) | (293,032) |
| Deferred tax asset | 432,711 | 330,876 | 918,696 | 1,092,891 |
| Deferred tax liabilities: | | | | |
| Depreciation | | (745,512) | | (764,831) |
| Other | (18,075) | | (18,801) | |
| Deferred tax liability | (18,075) | (745,512) | (18,801) | (764,831) |
| Net deferred tax asset (liability) | \$ 414,636 | \$ (414,636) | \$ 899,895 | \$ 328,060 |

During the fiscal year ended September 30, 2007 the Company generated a federal net operating loss (NOL) of approximately \$14.2 million. The NOL was carried-back to previous tax years and the Company received a refund of previously paid federal income tax of approximately \$5.1 million during the quarter ended March 31, 2008. As of September 30, 2008, the Company had state net operating losses of \$17.8 million which expire in varying amounts beginning in 2026. In addition, the Company has research and development tax credit carryforwards of approximately \$214,049, which expire in varying amounts beginning 2027.

The Company's financial statements contain certain deferred tax assets which have arisen primarily as a result of tax benefits associated with the loss before income tax incurred during the twelve months ended September 30, 2008, as well as deferred income tax assets resulting from temporary differences in prior tax years. SFAS 109 requires the consideration of a valuation allowance to reflect the likelihood of realization of deferred tax assets. Significant management judgment is required in determining any valuation allowance recorded against net deferred tax assets. The Company considered all available positive and negative evidence, including significant operating losses incurred in 2006 and 2007, continued operating losses in 2008, uncertainty as to the extent and timing of profitability in future periods, and ongoing tax planning strategies. Based on the weight of available evidence, the Company recorded a full valuation allowance against net deferred tax assets during the quarter ended March 31, 2008. There were no significant changes in management's judgment during the quarter ended September 30, 2008 and the Company continues to carry a full valuation allowance against its net deferred tax assets.

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9. Income Taxes: (Continued)

If realization of deferred tax assets in the future is considered more likely than not, a reduction to the valuation allowance related to deferred tax assets would increase net income in the period such determination is made. The amount of deferred tax assets considered realizable is based on significant estimates, and it is possible that changes in these estimates could materially affect the financial condition and results of operations. The Company's effective tax rate may vary from period to period based on changes in estimated taxable income or loss; changes to the valuation allowance; changes to federal or state tax laws; and as a result of acquisitions.

The Company adopted provisions of FASB Interpretation 48, "Accounting for Uncertainty in Income Taxes" (FIN 48), on October 1, 2007. Previously, the Company 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 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 \$435,000, all of which, if ultimately recognized, would reduce the Company's annual effective tax rate.

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 related tax laws and regulations and require significant judgment to apply. During the fiscal year ended September 30, 2008, the Internal Revenue Service concluded an examination for tax years through September 30, 2006. The Company also files income tax returns in various state jurisdictions, as appropriate, with varying statutes of limitation. There are no state income tax examinations in process at this time.

The Company's policy is to recognize interest accrued and, if applicable, penalties related to unrecognized tax benefits in income tax expense for all periods presented. The Company has accrued approximately \$21,000 for the payment of interest, net of tax benefits, at September 30, 2008 (\$27,000 at October 1, 2007). There is no accrual recorded for penalties.

For the fiscal year ended September 30, 2008, the Company recognized a benefit of \$6,000 of interest (net of federal impact) within income tax expense.

Following is a reconciliation of beginning and ending balances of total amounts of gross unrecognized tax benefits:

| | |
|---|------------|
| Balance at October 1, 2007 | \$ 435,000 |
| Unrecognized tax benefits related to prior years | (125,000) |
| Unrecognized tax benefits related to the current year | 72,000 |
| Settlements | |
| Decrease in unrecognized tax benefits due to the lapse of applicable statute of limitations | (58,000) |
| Balance at September 30, 2008 | \$ 324,000 |

It is not anticipated that unrecognized tax benefits taken regarding previously filed returns will change significantly over the next twelve months.

10. 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

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10. Notes Payable: (Continued)

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 allowing the Company the option of forgoing any principal pay-down until such time the bonds expire in 2015. The Company has exercised its option not to pay-down the outstanding balance and accordingly, the balance of the notes payable will be due in 2015.

The loan agreement previously required the Company to maintain certain financial covenants including a ratio of liabilities to earnings before interest, taxes and depreciation and amortization (EBITDA), fixed charge ratio and a minimum tangible net worth. As of June 30, 2006, the Company was in violation of certain of these financial covenants. The defaults were subsequently waived and an amendment to the agreement was entered into with the lender whereby the defaulted covenants were modified. Effective November 30, 2007 prior loan agreement covenants were changed to only require the Company to maintain at all times unencumbered cash and marketable securities having a market value of at least \$20.0 million and a minimum Tangible Net Worth of \$65.0 million. The lender, however, agreed on January 10, 2008 to discontinue the Tangible Net Worth covenant so that the only remaining requirement is that the Company maintain at all times unencumbered cash and marketable securities having a value of at least \$20.0 million.

The interest cost related to this debt for fiscal years 2008 and 2007 was \$117,000 and \$164,000 respectively. The interest rate on this debt was 3.98% at September 30, 2008. The Company is also required to maintain a letter of credit in the amount of \$5,000,000 covering the debt.

11. Savings Plan:

The Company sponsors a voluntary defined contribution savings plan covering all employees. The Company made contributions of \$172,000, \$0 and \$0 for the fiscal years ended September 30, 2008, 2007 and 2006, respectively.

12. Share-Based Compensation:

Effective October 1, 2005 the Company adopted the provisions of Statement of Financial Accounting Standards (SFAS) 123R 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 \$1,138,000, \$726,000 and \$895,000 for the fiscal years ended September 30, 2008, 2007, and 2006, respectively. The total income tax (expense) benefit recognized in the statement of operations for share-based compensation arrangements was (\$11,000), \$265,000 and \$420,000 for the fiscal years ended September 30, 2008, 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. The Plan expired on November 13, 2008.

Stock Options

The Plan allows granting of incentive and nonqualified stock options to employees, officers, directors and independent contractors and consultants. Through September 30, 2008 no stock options have been granted to independent contractors or consultants under this Plan. Total compensation

Table of Contents**12. Share-Based Compensation: (Continued)**

expense was \$938,000, \$506,000 and \$655,000 for fiscal years ended September 30, 2008, 2007, and 2006 respectively. Incentive stock options granted under the Plan have exercise prices that must be at least equal to fair value of the common stock on grant date. 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. At September 30, 2008 there were 1,502,173 shares remaining and available for grant under the Plan, however the Plan expired on November 13, 2008 and no additional shares may be granted under the Plan after that date.

Following is a summary of option activity under the Plan for fiscal years ended September 30, 2008, 2007, and 2006 and changes during the periods then ended:

| | Options | Weighted Average Exercise Price | Aggregate Intrinsic Value |
|---|-----------|--|---------------------------------|
| Outstanding at September 30, 2005 | 594,253 | \$ 8.76 | |
| Granted | 204,000 | 14.36 | |
| Exercised | (25,300) | 7.48 | |
| Cancelled | (71,099) | 13.70 | |
| Outstanding at September 30, 2006 | 701,854 | \$ 8.76 | |
| Granted | 49,000 | 24.42 | |
| Exercised | (57,995) | 8.50 | |
| Cancelled | (119,900) | 14.79 | |
| Outstanding at September 30, 2007 | 572,959 | \$ 10.30 | |
| Granted | 409,000 | 10.16 | |
| Exercised | (4,497) | 7.31 | |
| Cancelled | (226,854) | 11.88 | |
| Outstanding at September 30, 2008 | 750,608 | \$ 9.76 | \$250,455 |
| Vested and expected to vest | 735,848 | \$ 8.04 | \$250,455 |
| Options exercisable at September 30, 2008 | 455,408 | \$ 8.04 | \$250,289 |

The weighted-average grant date fair value of individual options granted during the fiscal years ended September 30, 2008, 2007 and 2006 was \$5.05, \$14.38 and \$7.53, respectively. The total intrinsic value of options exercised during the fiscal years ended September 30, 2008, 2007 and 2006 were \$33,000, \$620,000 and \$187,000, respectively.

Table of Contents**12. Share-Based Compensation: (Continued)**

Following table summarizes information about stock options under the Plan at September 30, 2008:

| Range of Exercise Prices | Options Outstanding | | | Options Exercisable | | |
|--------------------------|---|--|---|--------------------------------|---|--|
| | Outstanding As of September 30, 2008 | Weighted- Average Remaining Contractual Life | Weighted- Average Exercise Price | As of September 30, 2008 | Weighted- Average Exercise Price | |
| \$ 5.00 | 201,909 | 3.3 | \$ 4.22 | 201,909 | \$ 4.22 | |
| \$ 5.01 \$10.00 | 209,099 | 5.6 | \$ 7.82 | 121,599 | \$ 7.69 | |
| \$10.01 \$15.00 | 251,200 | 8.0 | \$ 11.70 | 88,000 | \$ 11.73 | |
| \$15.01 \$20.00 | 40,600 | 6.1 | \$ 16.84 | 30,500 | \$ 16.84 | |
| \$20.01 \$26.97 | 47,800 | 6.1 | \$ 25.53 | 13,400 | \$ 24.52 | |
| | 750,608 | 6.3 | \$ 9.76 | 455,408 | \$ 8.04 | |

Fair value of each option grant is estimated on the date of grant using the Black-Scholes option pricing model. Options are exercisable over a maximum term of ten years from 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 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 grant. Compensation expense for employee stock options also includes an estimate for forfeitures and is recognized ratably over the vesting term. Below are fair value assumptions used to record compensation expense for the period identified:

| | Fiscal Year Ended September 30, | | |
|--|------------------------------------|-------|-------|
| | 2008 | 2007 | 2006 |
| Expected dividend rate | | | |
| Expected volatility | 61.9% | 64.4% | 63.7% |
| Weighted average risk-free interest rate | 2.1% | 2.3% | 2.4% |
| Expected lives (years) | 8.00 | 8.62 | 8.41 |

At September 30, 2008, there was approximately \$1.6 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. It calls for an annual award of non-vested stock having a fair market value of \$40,000 at 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 \$200,000, \$220,000 and \$220,000 for the fiscal years ended September 30, 2008, 2007, and 2006,

Table of Contents**12. Share-Based Compensation: (Continued)**

respectively. The following outlines restricted stock awards for fiscal years ended September 30, 2008, 2007, and 2006:

| | Non-vested Stock Awards | Weighted Average Share Price |
|-------------------------------|-------------------------------|------------------------------------|
| Balance at September 30, 2005 | 3,588 | \$ 16.68 |
| Granted | 15,738 | 15.25 |
| Issued | (15,396) | 15.58 |
| Cancelled | (655) | 15.25 |
| Balance at September 30, 2006 | 3,275 | \$ 15.25 |
| Granted | 15,939 | 14.43 |
| Issued | (15,056) | 14.61 |
| Cancelled | (693) | 14.43 |
| Balance at September 30, 2007 | 3,465 | \$ 14.43 |
| Granted | 10,525 | 19.00 |
| Issued | (11,355) | 17.61 |
| Cancelled | | |
| Balance at September 30, 2008 | 2,635 | \$ 19.00 |

13. Commitments and Contingencies:*Capital Lease*

The Company leases certain equipment under capital leases with terms of five years and implicit interest rate of 7.2%. The capitalized cost of \$57,450 and related accumulated amortization of \$22,816 and \$8,207 have been included in property and equipment at September 30, 2008 and 2007 respectively. The balance due on these leases was \$47,542 and \$57,450 as of September 30, 2008 and 2007 respectively. Future payments, including interest relating to these leases are \$13,788 annually for the next four years.

Operating Leases

Rent expense under operating leases totaled \$196,000, \$109,000 and \$11,000 for the years ended September 30, 2008, 2007 and 2006, respectively. As of September 30, 2008, future minimum payments related to all non-cancelable operating leases is \$11,000 in fiscal 2009.

Product Liability

The Company has product liability insurance of \$50,000,000, which management believes is adequate to cover potential liabilities that may arise.

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 IS&S.

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13. Commitments and Contingencies: (Continued)

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 IS&S's air data computer technology. The jury found that IS&S 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 IS&S'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. On March 14, 2008, the judge presiding over the case heard the Company's claims for a permanent injunction as well as punitive and exemplary damages and attorneys' fees against Kollsman and the other defendants.

On July 7, 2008, the court issued several rulings in the case. In the rulings, the court awarded damages, interest and fees in addition to the more than \$6 million in compensatory damages awarded by the jury when it rendered its verdict in the case in November 2007. The additional awards bring the damages assessed against Kollsman, Inc. to a total of more than \$23 million. The court also entered an order granting the Company's request for permanent injunctive relief.

On August 27, 2008, the Company entered into a Settlement Agreement (the Settlement Agreement) with Kollsman, Inc. On August 29, 2008, the settlement became effective with respect to all claims filed by the Company and Kollsman against each other in the United States District Court for the Western District of Tennessee and a Consent Order was entered. Under the Settlement Agreement, all claims between the Company and Kollsman have been dismissed with prejudice, a final agreed injunction has been entered and the matter has been fully and finally mutually settled without any admission of guilt by either party. In addition, an agreed settlement payment of \$17 million has been made by Kollsman to the Company.

On October 9, 2008, Zachary and ZTI consented to the entry of judgment against and to a permanent injunction, which resulted in the conclusion of all claims with respect to those parties. On November 17, 2008, the court granted the Company's motion to dismiss its patent infringement claims against Caesar and J2, and dismissed Caesar and J2's counterclaims for noninfringement, invalidity and unenforceability because there was no longer a justifiable claim or controversy with respect to those counterclaims.

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 IS&S trade secret and proprietary information in assisting J2 and Kollsman in developing the J2/Kollsman Air Data Computer. The case is ongoing.

Through September 30, 2008 and 2007 the Company has incurred approximately \$13.6 million and \$8.0 million, respectively, in legal fees in connection with the two matters discussed above.

14. Related-Party Transactions:

The Company incurred legal fees of \$129,000, \$146,000 and \$357,000 with a law firm which is a shareholder of the Company for the years ended September 30, 2008, 2007 and 2006, respectively. The fees paid and services rendered were comparable with the fees paid and services rendered prior to the law firm's investment in the Company.

Table of Contents**14. Related-Party Transactions: (Continued)**

For the years ended September 30, 2008, 2007 and 2006, respectively, the Company incurred service fees of \$67,000, \$18,000 and \$25,000 with a commercial graphics firm controlled by an individual who is married to a shareholder and daughter of the Company's Chairman and Chief Executive Officer.

15. Quarterly Financial Data (unaudited):

Summarized quarterly results of operations of the Company for the years ended September 30, 2008 and September 30, 2007 are presented below:

| | Year Ended September 30, 2008 | | | |
|---------------------------|-------------------------------|----------------|---------------|----------------|
| | First Quarter | Second Quarter | Third Quarter | Fourth Quarter |
| Net sales | \$ 4,725,647 | \$ 6,824,360 | \$ 8,751,309 | \$ 10,221,995 |
| Cost of sales | 3,659,059 | 3,790,661 | 4,568,303 | 8,533,834 |
| Gross profit | 1,066,588 | 3,033,699 | 4,183,006 | 1,688,161 |
| Operating loss | (6,599,986) | (4,477,323) | (4,795,875) | (9,230,657) |
| Net (loss) income | (4,121,941) | (7,060,157) | (4,288,871) | 7,573,721 |
| Net loss per common share | | | | |
| Basic | \$ (0.24) | \$ (0.42) | \$ (0.25) | \$ 0.45 |
| Diluted | \$ (0.24) | \$ (0.42) | \$ (0.25) | \$ 0.45 |

| | Year Ended September 30, 2007 | | | |
|---------------------------|-------------------------------|----------------|---------------|----------------|
| | First Quarter | Second Quarter | Third Quarter | Fourth Quarter |
| Net sales | \$ 3,428,648 | \$ 3,955,298 | \$ 5,844,405 | \$ 5,119,777 |
| Cost of sales | 2,033,945 | 3,018,028 | 3,639,235 | 5,463,217 |
| Gross profit | 1,394,703 | 937,270 | 2,205,170 | (343,440) |
| Operating loss | (2,988,666) | (4,417,238) | (3,094,228) | (6,326,780) |
| Net loss | (1,098,444) | (2,359,146) | (1,350,857) | (4,036,841) |
| Net loss per common share | | | | |
| Basic | \$ (0.07) | \$ (0.14) | \$ (0.08) | \$ (0.24) |
| Diluted | \$ (0.07) | \$ (0.14) | \$ (0.08) | \$ (0.24) |

Quarterly and total year earnings per share are calculated independently based on the weighted average number of shares outstanding during each period.

16. Business Segments

The Company operates in one principal business segment which designs, manufactures and sells flight information computers, flat panel displays and advanced monitoring systems to the DoD, government agencies, commercial air transport carriers and corporate/general aviation markets. The Company currently derives virtually all of its revenues from the sale of this equipment. Almost all of the Company's sales, operating results and identifiable assets are in the United States. Net sales, operating results and identifiable assets outside the U.S. are not material. During fiscal 2008, 2007 and 2006 we derived 77%, 53% and 38%, respectively, of our revenues from the sale of Flat Panel Display Systems. During fiscal 2008, 2007, and 2006 we derived 23%, 47% and 62% respectively, of revenues from the sale of air data systems related products.

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16. Business Segments (Continued)

Geographic Data

Almost all of the Company's sales, operating results and identifiable assets are in the United States. Net sales, operating results and identifiable assets outside the U.S. are not material. In fiscal year 2008, 2007 and 2006 net sales outside the United States amounted to \$1.7 million, \$1.1 million, and \$2.8 million, respectively.

Product Data

Our current product line includes flat panel display systems and air data systems and components. During fiscal 2008, 2007 and 2006, the Company derived 77%, 53% and 38%, respectively, of its revenue from sales of flat panel display systems. The remaining revenue for each of the fiscal years was from sales of air data systems and components.

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| Exhibit Number | Exhibit Title |
|---------------------------|--|
| 23.1 | Consent of Deloitte and Touche LLP. |
| 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. |

