

GSE SYSTEMS INC
Form 10-Q
August 10, 2009

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

FORM 10-Q

Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934 for the Quarterly Period Ended June 30, 2009.

or

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

Commission File Number: 001-14785

GSE SYSTEMS, INC.

(Exact name of registrant as specified in its charter)

Delaware
(State of incorporation)

52-1868008
(I.R.S. Employer Identification No.)

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

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

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Sections 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the Registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of "accelerated filer", "large accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer Accelerated filer Non-accelerated filer Smaller reporting company

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(Do not check if a smaller
reporting company)

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

There were 16,045,372 shares of common stock, with a par value of \$.01 per share outstanding as of August 7, 2009.

GSE SYSTEMS, INC.

QUARTERLY REPORT ON FORM 10-Q

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PART I - FINANCIAL
INFORMATION

Item 1. Financial Statements

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

| | Unaudited June 30, 2009 | December 31, 2008 |
|--|----------------------------|----------------------|
| ASSETS | | |
| Current assets: | | |
| Cash and cash equivalents | \$ 5,324 | \$ 8,274 |
| Restricted cash | 5,779 | 2,962 |
| Contract receivables | 15,365 | 10,951 |
| Prepaid expenses and other current assets | 2,277 | 1,110 |
| Total current assets | 28,745 | 23,297 |
| Equipment and leasehold improvements, net | 1,093 | 1,133 |
| Software development costs, net | 1,406 | 1,487 |
| Goodwill | 1,739 | 1,739 |
| Long-term restricted cash | 1,957 | 2,027 |
| Other assets | 533 | 1,332 |
| Total assets | \$ 35,473 | \$ 31,015 |
| LIABILITIES AND STOCKHOLDERS' EQUITY | | |
| Current liabilities: | | |
| Accounts payable | \$ 3,421 | \$ 1,655 |
| Accrued expenses | 1,317 | 685 |
| Accrued compensation and payroll taxes | 1,345 | 1,234 |
| Billings in excess of revenue earned | 4,583 | 4,020 |
| Accrued warranty | 1,050 | 1,066 |
| Other current liabilities | 664 | 749 |
| Total current liabilities | 12,380 | 9,409 |
| Other liabilities | 798 | 906 |
| Total liabilities | 13,178 | 10,315 |
| Commitments and contingencies | - | - |
| Stockholders' equity: | | |
| Preferred stock \$.01 par value, 2,000,000 shares authorized, | - | - |

shares issued and outstanding none in
2009 and 2008

Common stock \$.01 par value,
30,000,000 shares authorized,
shares issued and outstanding

16,045,372 in 2009 and

15,968,122 in 2008

Additional paid-in capital

Accumulated deficit

Accumulated other comprehensive loss

Total stockholders' equity

Total liabilities and stockholders' equity \$

160

51,234

(27,914)

(1,185)

22,295

35,473

160

50,572

(28,818)

(1,214)

20,700

\$ 31,015

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

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

| | Three months ended June 30, | | Six months ended June 30, | |
|--|--------------------------------|-----------|------------------------------|-----------|
| | 2009 | 2008 | 2009 | 2008 |
| Contract revenue | \$ 10,650 | \$ 6,555 | \$ 18,778 | \$ 13,638 |
| Cost of revenue | 8,037 | 4,648 | 13,736 | 9,866 |
| Gross profit | 2,613 | 1,907 | 5,042 | 3,772 |
| Operating expenses: | | | | |
| Selling, general and administrative | 1,833 | 1,952 | 3,611 | 3,891 |
| Depreciation | 122 | 103 | 242 | 203 |
| Total operating expenses | 1,955 | 2,055 | 3,853 | 4,094 |
| Operating income (loss) | 658 | (148) | 1,189 | (322) |
| Interest income, net | 22 | 40 | 34 | 34 |
| Gain (loss) on derivative instruments | 194 | (5) | 207 | 5 |
| Other expense, net | (111) | (65) | (221) | (129) |
| Income (loss) before income taxes | 763 | (178) | 1,209 | (412) |
| Provision for income taxes | 192 | 92 | 305 | 151 |
| Net income (loss) | \$ 571 | \$ (270) | \$ 904 | \$ (563) |
| Basic income (loss) per common share | \$ 0.04 | \$ (0.02) | \$ 0.06 | \$ (0.04) |
| Diluted income (loss) per common share | \$ 0.03 | \$ (0.02) | \$ 0.05 | \$ (0.04) |

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

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

| | Three months ended June 30, | | Six months ended June 30, | |
|---|--------------------------------|----------|------------------------------|----------|
| | 2009 | 2008 | 2009 | 2008 |
| Net income (loss) | \$ 571 | \$ (270) | \$ 904 | \$ (563) |
| Foreign currency translation adjustment | 131 | (19) | 29 | 88 |
| Comprehensive income (loss) | \$ 702 | \$ (289) | \$ 933 | \$ (475) |

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 | | | | |
| Balance, January 1, 2009 | - | \$ - | 15,968 | \$ 160 | \$ 50,572 | \$ (28,818) | \$ (1,214) | \$ 20,700 |
| Stock-based compensation expense | - | - | - | - | 490 | - | - | 490 |
| Common stock issued for options exercised | - | - | 58 | - | 103 | - | - | 103 |
| Common stock issued for services provided | - | - | 9 | - | 51 | - | - | 51 |
| Common stock issued for warrants exercised | - | - | 10 | - | 18 | - | - | 18 |
| Foreign currency translation adjustment | - | - | - | - | - | - | 29 | 29 |
| Net income | - | - | - | - | - | 904 | - | 904 |
| Balance, June 30, 2009 | - | \$ - | 16,045 | \$ 160 | \$ 51,234 | \$ (27,914) | \$ (1,185) | \$ 22,295 |

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)

| | 2009 | Six months ended June 30, | 2008 |
|--|---------|------------------------------|----------|
| Cash flows from operating activities: | | | |
| Net income (loss) | \$ 904 | | \$ (563) |
| Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities: | | | |
| Depreciation | 242 | | 203 |
| Capitalized software amortization | 224 | | 133 |
| Amortization of deferred financing costs | 27 | | 107 |
| Stock-based compensation expense | 541 | | 284 |
| Elimination of profit on Emirates Simulation Academy, LLC contract | - | | 38 |
| Amortization of deferred profit on Emirates Simulation Academy, LLC contract | (90) | | - |
| Equity loss on investment in Emirates Simulation Academy, LLC | 313 | | 88 |
| Gain on derivative instruments | (207) | | (5) |
| Changes in assets and liabilities: | | | |
| Contract receivables | (4,317) | | (1,918) |
| Prepaid expenses and other assets | (865) | | (132) |
| Accounts payable, accrued compensation and accrued expenses | 2,530 | | (835) |
| Billings in excess of revenues earned | 571 | | 1,239 |
| Accrued warranty reserves | (16) | | 137 |
| Other liabilities | 201 | | 124 |
| Net cash provided by (used in) operating activities | 58 | | (1,100) |
| Cash flows from investing activities: | | | |
| Capital expenditures | (202) | | (393) |
| Capitalized software development costs | (143) | | (393) |
| Investment in Emirates Simulation Academy, LLC | - | | (422) |
| Release (restriction) of cash as collateral under letters of credit and bank guarantees | (2,145) | | 94 |
| Net cash used in investing activities | (2,490) | | (1,114) |
| Cash flows from financing activities: | | | |
| Proceeds from issuance of common stock | 121 | | 291 |
| Restriction of cash for credit facility collateral | (600) | | - |
| Deferred financing costs | (20) | | (88) |
| Net cash provided by (used in) financing activities | (499) | | 203 |

| | | |
|--|----------|----------|
| Effect of exchange rate changes on cash | (19) | 8 |
| Net decrease in cash and cash equivalents | (2,950) | (2,003) |
| Cash and cash equivalents at beginning of year | 8,274 | 8,172 |
| Cash and cash equivalents at end of period | \$ 5,324 | \$ 6,169 |

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

GSE SYSTEMS, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
For the Three and Six Months ended June 30, 2009 and 2008
(Unaudited)

1. Basis of Presentation and Revenue Recognition

Basis of Presentation

The consolidated financial statements included herein have been prepared by GSE Systems, Inc. (the “Company” or “GSE”) without independent audit. In the opinion of the Company's management, all adjustments and reclassifications of a normal and recurring nature necessary to present fairly the financial position, results of operations and cash flows for the periods presented have been made. Certain information and footnote disclosures normally included in financial statements prepared in accordance with U.S. generally accepted accounting principles (“GAAP”) have been condensed or omitted. The results of operations for interim periods are not necessarily an indication of the results for the full year. These consolidated financial statements should be read in conjunction with the consolidated financial statements and notes thereto included in the Company's Annual Report on Form 10-K for the period ended December 31, 2008 filed with the Securities and Exchange Commission on March 16, 2009.

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

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

The global recession and financial credit crisis has not currently had a significant effect on the Company's business. Specifically, the Company has seen no delays or cancellations to the projects it is currently working on and is unaware of any delays or cancellations to projects that the Company expects to secure in 2009.

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. There were no claims outstanding as of June 30, 2009.

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Uncertainties inherent in the performance of contracts include labor availability and productivity, material costs, change order scope and pricing, software modification and customer acceptance issues. The reliability of these cost estimates is critical to the Company's revenue recognition as a significant change in the estimates can cause the Company's revenue and related margins to change significantly from the amounts estimated in the early stages of the project.

As the Company recognizes revenue under the percentage-of-completion method, it provides an accrual for estimated future warranty costs based on historical 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 normally provide for "post customer support service" (PCS) in terms of software upgrades, software enhancements or telephone support. In order to obtain PCS, the customers must normally purchase a separate contract. Such PCS arrangements are generally for a one-year period renewable annually and include customer support, unspecified software upgrades, and maintenance releases. The Company recognizes revenue from these contracts ratably over the life of the agreements in accordance with Statement of Position 97-2, Software Revenue Recognition.

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

Revenue for contracts with multiple elements are recognized in accordance with Emerging Issues Task Force Issue 00-21, Accounting for Revenue Arrangements with Multiple Deliverables.

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.

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

| | Three months ended | | Six months ended | |
|--|--------------------|-------|------------------|-------|
| | June 30, | | June 30, | |
| | 2009 | 2008 | 2009 | 2008 |
| Slovenske Elektrarne, AS | 14.4% | 0.0% | 9.6% | 0.0% |
| Titan-2 Concern | 12.4% | 0.0% | 9.3% | 0.0% |
| Emerson Process Management | 8.6% | 17.1% | 10.6% | 16.4% |
| Sinopec Ningbo Engineering Corporation | 4.1% | 13.0% | 4.6% | 10.3% |

Contract receivables unbilled totaled \$8.8 million and \$3.6 million as of June 30, 2009 and December 31, 2008, respectively. In July 2009, the Company invoiced \$2.8 million of the unbilled amounts; the balance of the unbilled amounts is expected to be invoiced and collected within one year.

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

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| (in thousands, except for share amounts) | Three months ended | | Six months ended | |
|---|--------------------|------------|------------------|------------|
| | June 30, | | June 30, | |
| | 2009 | 2008 | 2009 | 2008 |
| Numerator: | | | | |
| Net income (loss) | \$ 571 | \$ (270) | \$ 904 | \$ (563) |
| Denominator: | | | | |
| Weighted-average shares outstanding for basic earnings per share | 16,004,731 | 15,667,145 | 15,991,108 | 15,593,279 |
| Effect of dilutive securities: | | | | |
| Employee stock options, warrants, and options outside the plan | 640,523 | - | 649,390 | - |
| Adjusted weighted-average shares outstanding and assumed conversions for diluted earnings per share | 16,645,254 | 15,667,145 | 16,640,498 | 15,593,279 |
| Shares related to dilutive securities excluded because inclusion would be anti-dilutive | 1,162,870 | 1,129,513 | 1,133,090 | 1,151,855 |

Conversion of outstanding stock options and warrants was not assumed for either the three or six months ended June 30, 2008 because the impact was anti-dilutive. Included in the 1,129,513 shares and 1,151,855 shares related to dilutive securities excluded from the diluted earnings per share calculation for the three and six months ended June 30, 2008, respectively, were in-the-money options and warrants totaling 989,431 shares and 1,107,624 shares, respectively.

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 \$67,000 and \$143,000 for the three and six months ended June 30, 2009, respectively, and \$200,000 and \$393,000 for the three and six months ended June 30, 2008, respectively. Total amortization expense was \$142,000 and \$224,000 for the three and six months ended June 30, 2009, respectively, and \$62,000 and \$133,000 for the three and six months ended June 30, 2008, 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 June 30, 2009 and December 31, 2008, GSE’s investment in ESA totaled \$405,000 and \$718,000, respectively, and was included on the balance sheet in other assets. The Company accounts for its investment in ESA using the equity method. For the three and six months ended June 30, 2009, the Company recognized a \$156,000 and a \$313,000 equity loss, respectively, on its investment in ESA. For the three and six months ended June 30, 2008, the Company recognized a \$63,000 and \$88,000 equity loss, respectively. The equity losses were recorded in other expense.

In January 2006, GSE received a \$15.1 million contract from ESA to supply five simulators and an integrated training program. A \$1.8 million change order was received from ESA in late 2007 increasing the total order value to \$16.9 million. For the three and six months ended June 30, 2008, the Company recognized \$13,000 and \$1.2 million, respectively, of contract revenue on this project using the percentage-of-completion method. The contract is currently in the warranty period which ends on September 30, 2009. In accordance with the equity method, the Company eliminated 10% of the profit from this contract as the training simulators are assets that have been recorded on the books of ESA, and the Company was thus required to eliminate its proportionate share of the profit included in the asset value. The total profit elimination on the project totaled \$723,000 and was classified as an other liability on the balance sheet at December 31, 2008. ESA assigned a four year life to the simulators and began to amortize the training simulators on their books effective January 1, 2009. Accordingly, on January 1, 2009, GSE began to amortize the deferred profit to other income over a four year period, recognizing a gain of \$45,000 and \$90,000 in the three and six months ended June 30, 2009, respectively.

At both June 30, 2009 and December 31, 2008, the Company had trade receivables from ESA totaling \$1.6 million. The Company has not recorded a reserve against this outstanding receivable at June 30, 2009 as the Company believes that payment will be received in full. 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 September 30, 2009. The Company has deposited \$1.2 million into a restricted, interest-bearing account at the Union National Bank (“UNB”) in the United Arab Emirates as a partial guarantee for the \$11.8 million credit facility that UNB has extended to ESA. The guarantee will be in place until the expiration of the ESA credit facility on December 31, 2014 or earlier if ESA pays down and terminates the credit facility.

5. Fair Value of Financial Instruments

The Company adopted SFAS No. 157, Fair Value Measurements, (“SFAS 157”) for financial assets and financial liabilities on January 1, 2008, and the adoption did not have a material impact on the Company’s financial statements or disclosures.

The Company adopted SFAS No. 157 for nonfinancial assets and nonfinancial liabilities measured on a nonrecurring basis in the first quarter of fiscal 2009, and such adoption did not have a material impact on the Company’s financial statement disclosures.

SFAS 157 defines fair value as the exchange price that would be received for an asset or paid to transfer a liability (an exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date. SFAS 157 also establishes a fair value hierarchy which requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value.

The levels of the fair value hierarchy established by SFAS 157 are:

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

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

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

The Company considers the recorded value of certain of its financial assets and liabilities, which consist primarily of cash and cash equivalents, accounts receivable and accounts payable, to approximate the fair value of the respective assets and liabilities at June 30, 2009 and December 31, 2008 based upon the short-term nature of the assets and liabilities.

At December 31, 2008, the Company had a commercial automated investment account under which, at the end of each business day, the funds in the Company's operating account were swept into a money market fund. The funds were returned to the operating account at the beginning of the next business day. At December 31, 2008, the balance in this fund was \$7.5 million and was included on the balance sheet under cash and cash equivalents. The Company terminated this automated investment account in the second quarter 2009. At June 30, 2009, the Company has no cash equivalents.

As of June 30, 2009, the Company was contingently liable for six standby letters of credit and two bank guarantees totaling approximately \$7.2 million. The standby letters of credit and bank guarantees were issued as either performance, advance payment or bid bonds on seven contracts. The Company has deposited the full value of five of the standby letters of credit in certificates of deposit (\$4.9 million) which have been restricted in that the Company does not have access to these funds until the related letters of credit have expired. The cash has been recorded on the Company's balance sheet at June 30, 2009 as restricted cash and long-term restricted cash depending on the expiration date of the certificate of deposit.

On May 5, 2009, one of the Company's two credit agreements with Bank of America was amended to increase the principal amount of the line from \$1.5 million to \$2.5 million. In addition, the agreement was amended to include a \$600,000 certificate of deposit issued by Bank of America in the borrowing base calculation to determine the maximum amount of available funds that the Company could borrow from the line. The cash deposited in this certificate of deposit has been recorded on the Company's balance sheet at June 30, 2009 as restricted cash.

The following table presents assets and liabilities measured at fair value at June 30, 2009:

| (in thousands) | Level 1 | Level 2 | Level 3 | Total |
|----------------------------|----------|----------|---------|----------|
| Certificates of Deposit | \$ 5,456 | \$ - | \$ - | \$ 5,456 |
| Foreign exchange contracts | - | 375 | - | 375 |
| Total assets | \$ 5,456 | \$ 375 | \$ - | \$ 5,831 |
| Foreign exchange contracts | \$ - | \$ (314) | \$ - | \$ (314) |
| Total liabilities | \$ - | \$ (314) | \$ - | \$ (314) |

6. Derivative Instruments

The Company adopted SFAS No. 161, Disclosures About Derivative Instruments and Hedging Activities- an amendment of FASB Statement No. 133, (“SFAS 161”) on January 1, 2009. SFAS 161 enhances the disclosure requirements about an entity’s derivative instruments and hedging activities.

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

As of June 30, 2009, the Company had foreign exchange contracts for sale of approximately 2.0 million Pounds Sterling, 3.1 million Euro, and 970 million Japanese Yen at fixed rates. The contracts expire on various dates through February 2014. At December 31, 2008, the Company had contracts for the sale of approximately 2 million Pounds Sterling, 4 million Euro and 68 million Japanese Yen at fixed rates. The Company had not designated any of the foreign exchange contracts outstanding as hedges and had recorded the estimated fair value of the contracts in the consolidated balance sheet as follows:

| (in thousands) | June 30, 2009 | December 31, 2008 |
|------------------------------------|------------------|-------------------------|
| Asset derivatives | | |
| Prepaid expenses and other current | \$ 282 | \$ 14 |

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| | | | |
|---------------|-------|-------|------|
| assets | | | |
| Other | 93 | 537 | |
| assets | | | |
| | 375 | 551 | |
| Liability | | | |
| derivatives | | | |
| Other current | (149) | (426) | |
| liabilities | | | |
| Other | (165) | (183) | |
| liabilities | | | |
| | (314) | (609) | |
| Net fair | \$ | 61 | \$ |
| value | | | (58) |

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

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

For the three and six months ended June 30, 2009 and 2008, the Company recognized a net gain (loss) on its derivative instruments as outlined below:

| (in thousands) | Three months ended June 30, | | Six months ended June 30, | |
|--|--------------------------------|--------|------------------------------|------|
| | 2009 | 2008 | 2009 | 2008 |
| Foreign exchange contracts- change in fair value | \$ (25) | \$ (5) | \$ 101 | \$ 5 |
| Remeasurement of related contract receivables and billings in excess of revenue earned | 219 | - | 106 | - |
| Net gain (loss) on derivatives | \$ 194 | \$ (5) | \$ 207 | \$ 5 |

7. Stock-Based Compensation

The Company accounts for its stock-based compensation awards under SFAS No. 123R, Share-Based Payment, which requires companies to recognize compensation expense for all equity-based compensation awards issued to employees, directors and non-employees that are expected to vest. Compensation cost is based on the fair value of awards as of the grant date. The Company recognized \$249,000 and \$138,000 of pre-tax stock-based compensation expense for the three months ended June 30, 2009 and 2008, respectively, under the fair value method in accordance with SFAS No. 123R and recognized \$541,000 and \$284,000 of pre-tax stock-based compensation expense for the six months ended June 30, 2009 and 2008, respectively. In the six months ended June 30, 2009, the Company granted a total of 54,000 stock options to two employees and granted a total of 60,000 stock options to its six non-employee directors. A total of 58,350 employee stock options and 10,000 warrants were exercised in the six months ended June 30, 2009.

8. Long-term Debt

Line of Credit

On March 28, 2008, the Company entered into two separate revolving line of credit agreements for two-year revolving lines of credit with Bank of America, N.A. ("BOA"). The Company and its subsidiary, GSE Power Systems, Inc., are jointly and severally liable as co-borrowers. The credit facilities enable the Company to borrow funds to support working capital needs and standby letters of credit. The first line of credit in the principal amount of up to \$3.5 million enables the Company to borrow funds up to 90% of eligible foreign accounts receivable, plus 75% of eligible unbilled foreign receivables and 100% of cash collateral pledged to BOA on outstanding warranty standby letters of credit. This line of credit is 90% guaranteed by the Export-Import Bank of the United States. The interest rate on this line of credit is based on the daily LIBOR rate plus 150 basis points, with interest only payments due monthly. The second line of credit was originally in the principal amount of up to \$1.5 million, however, on May 5, 2009, the credit

agreement was amended to increase the principal amount to \$2.5 million. This line of credit enables the Company to borrow funds up to 80% of domestic accounts receivable, 30% of domestic unbilled receivables and 100% of the principal balance of a \$600,000 certificate of deposit issued by BOA. The interest rate on this line of credit is based on the daily LIBOR rate plus 225 basis points, with interest only payments due monthly. Both credit agreements contain financial covenants with respect to the Company's minimum tangible net worth, debt service coverage ratio, and funded debt to EBITDA ratio. At June 30, 2009, the Company was in compliance with all of these financial covenants as shown below:

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| | Covenant | As of June 30, 2009 |
|-----------------------------|----------------------------|---------------------------|
| Tangible net worth | Must Exceed \$15.0 million | \$19.1 million |
| Debt service coverage ratio | Must Exceed 1.25 : 1.00 | 1,425 : 1.00 |
| Funded debt to EBITDA ratio | Not to Exceed 2.50 : 1.00 | .97 : 1.00 |

In addition, the credit agreements contain certain restrictive covenants regarding future acquisitions, incurrence of debt and the payment of dividends. At June 30, 2009, the Company's available borrowing base under the two lines of credit was \$5.4 million of which \$484,000 had been utilized as collateral for a standby letter of credit.

9. Product Warranty

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

(in thousands)

| | | |
|------------------------------|----|-------|
| Balance at December 31, 2008 | \$ | 1,066 |
| Warranty provision | | 251 |
| Warranty claims | | (269) |
| Currency adjustment | | 2 |
| Balance at June 30, 2009 | \$ | 1,050 |

10. Letters of Credit and Performance Bonds

As of June 30, 2009, the Company was contingently liable for six standby letters of credit and two bank guarantees totaling approximately \$7.2 million. The standby letters of credit and bank guarantees were issued as either performance, advance payment or bid bonds on seven contracts. Five of the standby letters of credit and the bank guarantees have been cash collateralized; the sixth standby letter of credit was collateralized by the Company's line of credit.

11. Income Taxes

The Company files in the United States federal jurisdiction and in several state and foreign jurisdictions. Because of the net operating loss carryforwards, the Company is subject to U.S. federal and state income tax examinations from years 1997 forward and is subject to foreign tax examinations by tax authorities for years 2003 and forward. Open tax years related to state and foreign jurisdictions remain subject to examination but are not considered material to our financial position, results of operations or cash flows.

As of June 30, 2009, there have been no material changes to the liability for uncertain tax positions. Furthermore, the Company is not aware of any tax positions for which it is reasonably possible that the total amounts of unrecognized tax benefits would significantly decrease or increase within the next twelve months.

The Company expects to pay U.S. federal alternative minimum income taxes in 2009 and to pay income taxes in Sweden and China. In addition, the Company will pay foreign income tax withholding on several non-U.S. contracts. The Company has a full valuation allowance on its deferred tax assets at June 30, 2009 with the exception of the deferred tax assets of its Swedish subsidiary which are expected to be realized in 2009, which total \$126,000.

12. Subsequent Events

In May 2009, the FASB issued SFAS No. 165, Subsequent Events (“SFAS No. 165”), setting forth principles and requirements to be applied to the accounting for and disclosure of subsequent events. The statement sets forth the period after the balance sheet date during which management shall evaluate events or transactions that may occur for potential recognition or disclosure in the financial statements, the circumstances under which events or transactions occurring after the balance sheet date shall be recognized in the financial statements and the required disclosures about events or transactions that occurred after the balance sheet date. SFAS No. 165 is effective for interim or annual reporting periods ending after June 15, 2009, and shall be applied prospectively. Accordingly, the Company has adopted this pronouncement for the quarter ended June 30, 2009. The Company has evaluated the period subsequent to June 30, 2009 and through August 10, 2009 (the date the financial statements were available to be issued) for events that did not exist at the balance sheet date but arose after that date and determined that no subsequent events arose that should be disclosed in order to keep the financial statements from being misleading.

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

GSE Systems, Inc. (“GSE Systems”, “GSE” or the “Company”) is a world leader in real-time high fidelity simulation. The Company provides simulation and educational solutions and services to the nuclear and fossil electric utility industry, and the chemical and petrochemical industries. In addition, the Company provides plant monitoring and signal analysis monitoring and optimization software primarily to the power industry. GSE is the parent company of GSE Power Systems, Inc., a Delaware corporation; GSE Power Systems, AB, a Swedish corporation; GSE Engineering Systems (Beijing) Co. Ltd, a Chinese limited liability company; GSE Systems, Ltd, a UK limited liability company; and has a 10% minority interest in Emirates Simulation Academy, LLC, a United Arab Emirates limited liability company. The Company has only one reportable segment.

Cautionary Statement Regarding Forward-Looking Statements

This report contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. The Private Securities Litigation Reform Act of 1995 provides a “safe harbor” for forward looking statements. Forward-looking statements are not

statements of historical facts, but rather reflect our current expectations concerning future events and results. We use words such as “expects”, “intends”, “believes”, “may”, “will” and “anticipates” to indicate forward-looking statements. Because these forward-looking statements involve risks and uncertainties, there are important factors that could cause actual results to differ materially from those expressed or implied by these forward-looking statements, including, but not limited to, those factors set forth under Item 1A - Risk Factors of the Company’s 2008 Annual Report on Form 10-K and those other risks and uncertainties detailed in the Company’s periodic reports and registration statements filed with the Securities and Exchange Commission. We caution that these risk factors may not be exhaustive. We operate in a continually changing business environment, and new risk factors emerge from time to time. We cannot predict these new risk factors, nor can we assess the effect, if any, of the new risk factors on our business or the extent to which any factor or combination of factors may cause actual results to differ from those expressed or implied by these forward-looking statements.

If any one or more of these expectations and assumptions proves incorrect, actual results will likely differ materially from those contemplated by the forward-looking statements. Even if all of the foregoing assumptions and expectations prove correct, actual results may still differ materially from those expressed in the forward-looking statements as a result of factors we may not anticipate or that may be beyond our control. While we cannot assess the future impact that any of these differences could have on our business, financial condition, results of operations and cash flows or the market price of shares of our common stock, the differences could be significant. We do not undertake to update any forward-looking statements made by us, whether as a result of new information, future events or otherwise. You are cautioned not to unduly rely on such forward-looking statements when evaluating the information presented in this report.

General Business Environment

The nuclear power industry has been largely dormant for the last thirty years with few opportunities to provide new full scope simulators. The Company's nuclear simulation business has concentrated mainly on providing services to the installed base of nuclear simulators worldwide. These services are primarily related to upgrading antiquated simulation software and hardware systems, providing new and improved plant and system simulation models, and modifying the simulator to reflect changes in the physical plant. However, over the last several years, the nuclear power industry has experienced a dramatic change, and most energy experts believe the industry is on the verge of a "renaissance", driven by the gap between the energy that the world is projected to need versus the current capacity, the rising cost of oil, and growing environmental concerns caused by fossil fuels. Government and industry sources and trade journals report that up to 200 new nuclear plants will be built over the next 20 years. In the U.S. alone, applications for accelerated construction and operating licenses have been or are expected to be submitted for 35 new nuclear plants. Each new plant will be required to have a full scope simulator ready for operator training and certification about two years prior to plant operation. In some cases where identical plants share a common site, one simulator will serve both plants. Similar nuclear plant construction programs are underway or planned in China, Russia, Ukraine, Japan and Central Europe to meet growing energy demands. In addition, most U.S. nuclear electric utilities have applied for license extensions and/or power upgrades. These license extensions will lead to significant upgrades to the physical equipment and control room technology which will result in the need to modify or replace the existing plant control room simulators. The Company, having what it believes is the largest installed base of existing simulators, over 60% on a global basis, is well positioned to capture a large portion of this business, although no assurance can be given that it will be successful in doing so.

In the first quarter 2009, the Company was awarded a contract valued at over \$18 million to build a new nuclear power plant simulator for a two unit reactor plant in Slovakia. The contract includes approximately \$12 million of hardware that the customer has requested be a part of the contract in addition to approximately \$6 million related specifically to the simulator. Margins on the hardware portion of the contract are minimal, while margins on the more traditional simulation portions will be consistent with those in the past. The utility customer in Slovakia is constructing two new Russian designed VVER-440 nuclear reactors at the site that will incorporate Siemens / Areva control systems. Work on this contract commenced in the first quarter 2009 and is scheduled for completion in approximately 30 months. GSE, in partnership with Siemens, built the first full scope simulator at the same site in 1997. Including this contract, the Company logged approximately \$39.2 million in nuclear simulation orders in the six months ended June 30, 2009.

In July 2009, the Company announced the award of a multi-million dollar contract from Westinghouse Electric Company (“Westinghouse”) to build an AP1000™ nuclear power plant simulator based upon Westinghouse’s design for domestic customers. This award covers an initial phase of work that will focus on building high fidelity simulation models for the AP1000 nuclear systems. These models will help Westinghouse demonstrate the plant design and control room human factors. The models that will be built in this current phase will be largely common to all future U.S.-based AP1000 plants and hence highly reusable from plant to plant. GSE anticipates future awards that will address the remaining plant systems. These future systems are expected to be different from plant to plant, and, therefore, the Company expects these contracts to be issued on a plant specific basis in the future. The Westinghouse AP1000 is the technology of choice for no less than 14 announced U.S. nuclear power plants, including six for which Engineering, Procurement and Construction contracts have been signed with Westinghouse. Providing a plant simulator at each site is included within the scope of work between Westinghouse and these U.S. customers.

The Company’s fossil fueled power simulation business has grown rapidly over the past three years. The transition from obsolete analog control systems to modern digital control systems and the new requirements for complex emission control systems are contributing to the growth the Company is experiencing in this business, coupled with the fact that GSE’s high-fidelity simulation models can be used to validate control schemes and logics for new designs before the control systems are deployed to the field. GSE builds the plant models based upon design specifications supplied by its customers, and the models then drive the actual digital control systems in the factory. This testing can uncover numerous control system discrepancies. By correcting these problems at the factory versus in the field, GSE’s customers can save millions in reduced down time and reduced commissioning time.

The global recession and financial credit crisis has not currently had a significant effect on the Company’s business. Specifically, the Company has seen no delays or cancellations to the projects it is currently working on, and is unaware of any delays or cancellations to projects that the Company expects to secure in 2009.

Results of Operations

The following table sets forth the results of operations for the periods presented expressed in thousands of dollars and as a percentage of revenue:

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| (in thousands) | Three months ended June 30, | | | | Six months ended June 30, | | | |
|---------------------------------------|-----------------------------|--------|----------|--------|---------------------------|--------|-----------|--------|
| | 2009 | % | 2008 | % | 2009 | % | 2008 | % |
| Contract revenue | \$ 10,650 | 100.0% | \$ 6,555 | 100.0% | \$ 18,778 | 100.0% | \$ 13,638 | 100.0% |
| Cost of revenue | 8,037 | 75.5% | 4,648 | 70.9% | 13,736 | 73.1% | 9,866 | 72.3% |
| Gross profit | 2,613 | 24.5% | 1,907 | 29.1% | 5,042 | 26.9% | 3,772 | 27.7% |
| Operating expenses: | | | | | | | | |
| Selling, general and administrative | 1,833 | 17.2% | 1,952 | 29.8% | 3,611 | 19.3% | 3,891 | 28.6% |
| Depreciation | 122 | 1.1% | 103 | 1.6% | 242 | 1.3% | 203 | 1.5% |
| Total operating expenses | 1,955 | 18.3% | 2,055 | 31.4% | 3,853 | 20.6% | 4,094 | 30.1% |
| Operating income (loss) | 658 | 6.2% | (148) | (2.3)% | 1,189 | 6.3% | (322) | (2.4)% |
| Interest income, net | 22 | 0.2% | 40 | 0.6% | 34 | 0.2% | 34 | 0.3% |
| Gain (loss) on derivative instruments | 194 | 1.8% | (5) | (0.1)% | 207 | 1.1% | 5 | 0.0% |
| Other expense, net | (111) | (1.0)% | (65) | (0.9)% | (221) | (1.2)% | (129) | (0.9)% |
| Income (loss) before income taxes | 763 | 7.2% | (178) | (2.7)% | 1,209 | 6.4% | (412) | (3.0)% |
| Provision for income taxes | 192 | 1.8% | 92 | 1.4% | 305 | 1.6% | 151 | 1.1% |
| Net income (loss) | \$ 571 | 5.4% | \$ (270) | (4.1)% | \$ 904 | 4.8% | \$ (563) | (4.1)% |

Critical Accounting Policies and Estimates

The preparation of financial statements in accordance with U.S. generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Our estimates, judgments and assumptions are continually evaluated based on available information and experience. Because of the use of estimates inherent in the financial reporting process, actual results could differ from those estimates.

A summary of the Company's significant accounting policies as of December 31, 2008 is included in Note 2 to the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2008. Certain of our accounting policies require higher degrees of judgment than others in their application. These include revenue recognition on long-term contracts, capitalization of computer software development costs, and deferred income tax valuation allowances. These critical accounting policies and estimates are discussed in the Management's Discussion and Analysis of Financial Condition and Results of Operations section in the 2008 Annual Report on Form 10-K for the fiscal year ended December 31, 2008.

Results of Operations - Three and Six Months ended June 30, 2009 versus Three and Six Months ended June 30, 2008

Contract Revenue. Total contract revenue for the quarter ended June 30, 2009 totaled \$10.6 million, which was 62.5% higher than the \$6.6 million total revenue for the quarter ended June 30, 2008. For the six months ended June 30, 2009, contract revenue totaled \$18.8 million, a 37.7% increase from the \$13.6 million for the six months ended June 30, 2008. The Company recorded total orders of \$42.4 million in the six months ended June 30, 2009 versus \$18.0 million in the six months ended June 30, 2008. Included in the 2009 orders was an \$18.4 million contract to build a new nuclear power plant simulator for a two unit reactor plant in Slovakia. The contract includes approximately \$12 million for hardware, the largest portion being a digital control system from Siemens, that the customer has requested be a part of the contract in addition to approximately \$6 million related specifically to the simulator. Due to the significant hardware portion of the project, the overall margin on the project is lower than the Company's normal gross margin. In the three and six months ended June 30, 2009, the Company recognized \$1.5 million and \$1.8 million, respectively, of contract revenue on this project using the percentage-of-completion method, which accounted for 14.4% and 9.6%, respectively, of the Company's consolidated revenue. At June 30, 2009, the Company's backlog was \$62.2 million, of which \$16.6 million related to this contract.

Gross Profit. Gross profit totaled \$2.6 million for the quarter ended June 30, 2009 versus \$1.9 million for the same quarter in 2008. As a percentage of revenue, gross profit decreased from 29.1% for the three months ended June 30, 2008 to 24.5% for the three months ended June 30, 2009. For the six months ended June 30, 2009, gross profit increased \$1.3 million from the same period in 2008 to \$5.0 million, however, as a percentage of revenue, gross profit decreased from 27.7% to 26.9%. The decrease in gross profit percentage mainly reflects the impact of the lower margin on the \$18.4 million full scope simulator and digital control system order received in the first quarter 2009 from a Slovak utility.

Selling, General and Administrative Expenses. Selling, general and administrative (“SG&A”) expenses totaled \$1.8 million in the quarter ended June 30, 2009, a 6.1% decrease from the \$2.0 million for the same period in 2008. For the six months ended June 30, 2009 and 2008, SG&A expenses totaled \$3.6 million and \$3.9 million, respectively. The decrease reflects the following spending variances:

- ◆ Business development and marketing costs decreased from \$809,000 in the second quarter 2008 to \$783,000 in the second quarter of 2009 and decreased from \$1.6 million for the six months ended June 30, 2008 to \$1.4 million in the same period 2009. The decrease mainly reflects a reduction in bidding and proposal costs, which are the costs of operations personnel in assisting with the preparation of contract proposals.
- ◆ The Company’s general and administrative expenses were virtually unchanged, totaling \$1.0 million in both the second quarter 2009 and 2008 and totaling \$2.1 million in both the six months ending June 30, 2009 and 2008.
- ◆ Gross spending on software product development (“development”) totaled \$139,000 in the quarter ended June 30, 2009 as compared to \$299,000 in the same period of 2008. For the three months ended June 30, 2009, the Company expensed \$72,000 and capitalized \$67,000 of its development spending while in the three months ended June 30, 2008, the Company expensed \$99,000 and capitalized \$200,000 of its development spending. For the six months ended June 30, 2009, gross development spending totaled \$240,000 versus \$537,000 in the same period of 2008. The Company expensed \$97,000 and capitalized \$143,000 of its development spending in the six months ended June 30, 2009 and expensed \$144,000 and capitalized \$393,000 of its development spending in the same period of 2008. The Company’s capitalized development expenditures in 2009 were mainly related to the customization of RELAP5-RT software (which simulates transient fluid dynamics, neutronics and heat transfer in nuclear power plants) to run on the Company’s real-time executive software and the replacement of the current Graphic User Interface of SimSuite Pro with JADE Designer. The Company anticipates that its total gross development spending in 2009 will approximate \$500,000.

Depreciation. Depreciation expense totaled \$122,000 and \$103,000 during the quarters ended June 30, 2009 and 2008, respectively. For the six months ended June 30, 2009 and 2008, depreciation expense totaled \$242,000 and \$203,000, respectively. The higher 2009 depreciation expense is a result of the Company’s 2008 capital purchases related to the Company’s move to its Sykesville, Maryland headquarters in 2008 and the purchase of new computers for new hires.

Operating Income. The Company had operating income of \$658,000 (6.2% of revenue) in the second quarter 2009, as compared with an operating loss of \$148,000 (2.3% of revenue) for the same period in 2008. For the six months ended June 30, 2009 and 2008, the Company had operating income of \$1.2 million (6.3% of revenue) and an operating loss of \$322,000 (2.4% of revenue), respectively. The variances were due to the factors outlined above.

Interest Income, Net. Net interest income totaled \$22,000 in the quarter ended June 30, 2009 versus net interest income of \$40,000 in the quarter ended June 30, 2008. For both the six months ended June 30, 2009 and 2008, net interest income totaled \$34,000.

On March 28, 2008 the Company entered into two separate revolving line of credit agreements for two-year revolving lines of credit with Bank of America (“BOA”), replacing the Company’s credit facility with Laurus Master Fund. One line of credit is in the principal amount of up to \$3.5 million and is guaranteed by the U.S. Export-Import Bank. The second line of credit was originally in the principal amount of up to \$1.5 million, however, on May 5, 2009, the credit agreement was amended to increase the principal amount to \$2.5 million. The other line of credit is in the principal amount of up to \$2.5 million. The Company has not borrowed any funds against either BOA line of credit.

The deferred financing costs incurred in conjunction with the Laurus Master Fund line of credit were amortized over the two-year period of the line of credit, with the final amortization expense recorded in February 2008. Amortization expense totaled \$89,000 in the six months ended June 30, 2008. The deferred financing costs incurred in conjunction with the BOA lines of credit are being amortized over the two-year period of the lines of credit. Amortization began in April 2008 and totaled \$9,000 and \$27,000 for the three and six months ended June 30, 2009, respectively, and \$18,000 in both the three and six months ended June 30, 2008.

At June 30, 2009 and 2008, the Company had approximately \$4.9 million and \$2.9 million, respectively, of cash in Certificates of Deposit with BOA that were being used as collateral for various performance and advance payment bonds. The Company recorded interest income of \$17,000 and \$29,000 from the Certificates of Deposit in the three and six months ended June 30, 2009, respectively, versus \$40,000 and \$64,000 of interest income in the three and six months ended June 30, 2008, respectively. The reduction in interest income reflects lower interest rates on the Certificates of Deposit in 2009.

In May 2007, the Company deposited \$1.2 million into a restricted, interest-bearing account at the Union National Bank in the United Arab Emirates as a partial guarantee for the \$11.8 million credit facility that UNB has extended to ESA. The Company recorded interest income of \$10,000 and \$19,000 in the three and six months ended June 30, 2009 respectively. For the three and six months ended June 30, 2008, the Company recorded interest income of \$14,000 and \$29,000, respectively.

Interest income earned on short-term investments of the Company’s operating cash totaled \$1,000 for the three months ended June 30, 2009 versus \$7,000 for the three months ended June 30, 2008 and totaled \$4,000 for the six months ended June 30, 2009 versus \$40,000 for the six months ended June 30, 2008. The lower interest income in 2009 mainly reflects lower interest rates on the short-term investments.

Gain (Loss) on Derivative Instruments. The Company periodically enters into forward foreign exchange contracts to manage market risks associated with the fluctuations in foreign currency exchange rates on foreign-denominated trade receivables. As of June 30, 2009, the Company had foreign exchange contracts for sale of approximately 2.0 million Pounds Sterling, 3.1 million Euro and 970 million Japanese Yen at fixed rates. The contracts expire on various dates through February 2014. The Company has not designated the contracts as hedges and has recognized a loss on the change in the estimated fair value of the contracts of \$25,000 for the three months ended June 30, 2009 and a gain of \$101,000 for the six months ended June 30, 2009.

The foreign currency denominated trade receivables and unbilled receivables that are related to the outstanding foreign exchange contracts were remeasured into the functional currency using the current exchange rate at the end of the period. For the three and six months ended June 30, 2009, the Company recognized a \$219,000 and \$106,000 gain, respectively, from the remeasurement of such contract receivables and billings in excess of revenue earned.

At June 30, 2008, the Company had contracts for the sale of approximately 225,000 Euro at fixed rates. The contracts expired on various dates through February 2009. The Company had not designated the contracts as hedges and recognized a loss of \$5,000 in the change in the estimated fair value of the contracts during the three months ended June 30, 2008 and a gain of \$5,000 during the six months ended June 30, 2008.

Other Expense, Net. For the three and six months ended June 30, 2009, other expense, net was \$111,000 and \$221,000, respectively. For the three and six months ended June 30, 2008, other expense, net was \$65,000 and \$129,000, respectively. The major components of other expense, net included the following items:

- ◆ The Company accounts for its investment in the Emirates Simulation Academy using the equity method. In accordance with the equity method, the Company eliminated 10% of the profit from this contract as the training simulators are assets that have been recorded on the books of ESA, and the Company was thus required to eliminate its proportionate share of the profit included in the asset value. The profit elimination totaled \$(1,000) and \$38,000 for the three and six months ended June 30, 2008. ESA began to amortize the training simulators effective January 1, 2009 over a four year life; accordingly, GSE began to amortize the deferred profit in January 2009 and recognized a gain of \$45,000 and \$90,000 for the three and six months ended June 30, 2009, respectively.
- ◆ For the three and six months ended June 30, 2009, the Company recognized a \$156,000 and \$313,000 equity loss, respectively, on its investment in ESA. For the three and six months ended June 30, 2008, the Company's recognized a \$63,000 and \$88,000 equity loss, respectively.

Provision for Income Taxes.

The Company files in the United States federal jurisdiction and in several state and foreign jurisdictions. Because of the net operating loss carryforwards, the Company is subject to U.S. federal and state income tax examinations from years 1997 and forward and is subject to foreign tax examinations by tax authorities for years 2001 and forward. Open tax years related to state and foreign jurisdictions remain subject to examination but are not considered material to our financial position, results of operations or cash flows.

As of June 30, 2009, there have been no material changes to the liability for uncertain tax positions. Furthermore, the Company is not aware of any tax positions for which it is reasonably possible that the total amounts of unrecognized tax benefits would significantly decrease or increase within the next twelve months.

The Company expects to pay U.S. federal alternative minimum income taxes in 2009 and to pay income taxes in Sweden and China. In addition, the Company will pay foreign income tax withholding on several non-U.S. contracts. The Company has a full valuation allowance on its deferred tax assets at June 30, 2009 with the exception of the deferred tax assets of its Swedish subsidiary which are expected to be realized in 2009, which total \$126,000.

Liquidity and Capital Resources

As of June 30, 2009, the Company's cash and cash equivalents totaled \$5.3 million compared to \$8.3 million at December 31, 2008.

Cash provided by (used in) operating activities. For the six months ended June 30, 2009, net cash provided by operations totaled \$58,000. Significant changes in the Company's assets and liabilities in the six months ended June 30, 2009 included:

- ◆ A \$4.3 million increase in the Company's contract receivables. The Company's trade receivables decreased from \$7.3 million at December 31, 2008 to \$6.5 million at June 30, 2009 while the Company's unbilled receivables increased by \$5.1 million to \$8.8 million at June 30, 2009. At June 30, 2009, trade receivables outstanding for more than 90 days totaled \$1.9 million versus \$2.2 million at December 31, 2008. Included in the over 90 day balance at both June 30, 2009 and December 31, 2008 was \$1.6 million due from ESA. The Company believes the entire overdue balance will be received and has not increased its bad debt reserve. The increase in the unbilled receivables is due to the timing of contracted billing milestones of the Company's current projects. In July 2009, the Company invoiced \$2.8 million of the unbilled amounts; the balance of the unbilled amounts is expected to be invoiced and collected within one year.
- ◆ A \$2.5 million increase in accounts payable, accrued compensation and accrued expenses. The Company's accounts payable and accrued liabilities have increased due to material purchases and the utilization of subcontractors on several of the Company's current projects.

Net cash used in operating activities for the six months ended June 30, 2008 totaled \$1.1 million. Significant changes in the Company's assets and liabilities in the six months ended June 30, 2008 included:

- ◆ A \$1.9 million increase in the Company's contract receivables. The Company's trade receivables increased from \$4.2 million at December 31, 2007 (including \$1.0 million due from ESA) to \$8.5 million at June 30, 2008 (including \$3.9 million due from ESA) while the Company's unbilled receivables decreased by \$2.4 million to \$4.2 million at June 30, 2008. At June 30, 2008, trade receivables outstanding for more than 90 days totaled \$3.0 million (including \$2.6 million from ESA) versus \$2,000 at December 31, 2007.
- ◆ A \$1.2 million increase in billings in excess of revenues earned. The increase was due to the timing of contracted billing milestones of the Company's projects.

Cash used in investing activities. Net cash used in investing activities totaled \$2.5 million for the six months ended June 30, 2009. Capital expenditures totaled \$202,000 and capitalized software development costs totaled \$143,000. The Company utilized \$2.1 million to cash collateralize a standby letter of credit and a bank guarantee.

For the six months ended June 30, 2008, net cash used in investing activities totaled \$1.1 million. Capital expenditures totaled \$393,000, capitalized software development costs totaled \$393,000, and the Company increased its investment in ESA by \$422,000. Cash used as collateral for stand-by letters of credit decreased by \$94,000.

Cash provided by financing activities. For the six months ended June 30, 2009, net cash used in financing activities totaled \$499,000, and for the six months ended June 30, 2008, net cash provided by financing activities totaled \$203,000. The Company received \$121,000 and \$291,000 from the issuance of common stock in the six months ended June 30, 2009 and 2008, respectively. In the six months ended June 30, 2009 and 2008, the Company spent \$20,000 and \$88,000, respectively, on deferred financing costs in conjunction with the Bank of America lines of credit. In accordance with the amendment to the Company's \$2.5 million BOA line of credit effective May 5, 2009, the Company placed \$600,000 in a restricted certificate of deposit. This certificate of deposit is included in the borrowing base calculation to determine the amount of funds that the Company can utilize under its \$2.5 million line of credit.

At June 30, 2009, the Company had cash of \$5.3 million and another \$4.9 million available under its lines of credit. Based on the Company's forecasted expenditures and cash flow, the Company believes that it will generate sufficient cash through its normal operations and through the utilization of its current credit facility to meet its liquidity and working capital needs for the next twelve months. However, notwithstanding the foregoing, the Company may be required to look for additional capital to fund its operations if the Company is unable to operate profitably and generate sufficient cash from operations. There can be no assurance that the Company would be successful in raising such additional funds.

Credit Facilities

On March 28, 2008, the Company entered into two separate revolving line of credit agreements for two-year revolving lines of credit with Bank of America, N.A. ("BOA"). The Company and its subsidiary, GSE Power Systems, Inc., are jointly and severally liable as co-borrowers. The credit facilities enable the Company to borrow funds to support working capital needs and standby letters of credit. The first line of credit in the principal amount of up to \$3.5 million enables the Company to borrow funds up to 90% of eligible foreign accounts receivable, plus 75% of eligible unbilled foreign receivables and 100% of cash collateral pledged to BOA on outstanding warranty standby letters of credit. This line of credit is 90% guaranteed by the Export-Import Bank of the United States. The interest rate on this line of credit is based on the daily LIBOR rate plus 150 basis points, with interest only payments due monthly. The second line of credit was originally in the principal amount of up to \$1.5 million, however, on May 5, 2009, the credit agreement was amended to increase the principal amount to \$2.5 million. This line of credit enables the Company to borrow funds up to 80% of domestic accounts receivable, 30% of domestic unbilled receivables and 100% of the principal balance of a \$600,000 certificate of deposit issued by BOA. The interest rate on this line of credit is based on the daily LIBOR rate plus 225 basis points, with interest only payments due monthly. Both credit agreements contain financial covenants with respect to the Company's minimum tangible net worth, debt service coverage ratio, and funded debt to EBITDA ratio. At June 30, 2009, the Company was in compliance with all of these financial covenants as shown below:

| | Covenant | As of June 30, 2009 |
|-----------------------------|----------------------------|---------------------------|
| Tangible net worth | Must Exceed \$15.0 million | \$19.1 million |
| Debt service coverage ratio | Must Exceed 1.25 : 1.00 | 1,425 : 1.00 |
| Funded debt to EBITDA ratio | Not to Exceed 2.50 : 1.00 | .97 : 1.00 |

In addition, the credit agreements contain certain restrictive covenants regarding future acquisitions, incurrence of debt and the payment of dividends. At June 30, 2009, the Company's available borrowing base under the two lines of credit was \$5.4 million of which \$484,000 had been utilized as collateral for a standby letter of credit.

Item 3. Quantitative and Qualitative Disclosure about Market Risk

The Company's market risk is principally confined to changes in foreign currency exchange rates. The Company's exposure to foreign exchange rate fluctuations arises in part from inter-company accounts in which costs incurred in one entity are charged to other entities in different foreign jurisdictions. The Company is also exposed to foreign exchange rate fluctuations as the financial results of all foreign subsidiaries are translated into U.S. dollars in consolidation. As exchange rates vary, those results when translated may vary from expectations and adversely impact overall expected profitability.

The Company utilizes forward foreign currency exchange contracts to manage market risks associated with the fluctuations in foreign currency exchange rates. The principal currencies for which such forward exchange contracts are entered into are the Pound Sterling, the Euro and the Japanese Yen. It is the Company's policy to use such derivative financial instruments to protect against market risk arising in the normal course of business in order to reduce the impact of these exposures. The Company minimizes credit exposure by limiting counterparties to nationally recognized financial institutions.

As of June 30, 2009, the Company had foreign exchange contracts for sale of approximately 2.0 million Pounds Sterling, 3.1 million Euro and 970 million Japanese Yen at fixed rates. The contracts expire on various dates through February 2014. The Company had not designated the contracts as hedges and has recognized a loss on the change in the estimated fair value of the contracts of \$25,000 for the three months ended June 30, 2009 and a gain of \$101,000 for the six months ended June 30, 2009. A 10% fluctuation in the foreign currency exchange rates up or down as of June 30, 2009 would have increased/ decreased the change in estimated fair value of the contracts by \$6,000.

At June 30, 2008, the Company had contracts for the sale of approximately 225,000 Euro at fixed rates. The contracts expired on various dates through February 2009. The Company had not designated the contracts as hedges and had recognized a loss of \$5,000 on the change in the estimated fair value of the contracts during the three months ended June 30, 2008 and a gain of \$5,000 during the six months ended June 30, 2008.

The Company is also subject to market risk related to the interest rate on its existing lines of credit. However, during the first six months of 2009, the Company had no outstanding borrowings from its lines of credit.

Item 4. Controls and Procedures

(a) Evaluation of disclosure controls and procedures. The Company maintains adequate internal disclosure controls and procedures (as such term is defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934 (the "Exchange Act"), as amended) as of the end of the period covered by this quarterly report on Form 10-Q pursuant to Rule 13a-15(b) under the Exchange Act that are designed to ensure that information required to be disclosed by it in its reports filed or submitted pursuant to the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the Commission's rules and forms and that information required to be disclosed by the Company in its Exchange Act reports is accumulated and communicated to management, including the Company's Chief Executive Officer ("CEO"), who is its principal executive officer, and Chief Financial Officer ("CFO"), who is its principal financial officer, to allow timely decisions regarding required disclosure.

The Company's CEO and CFO are responsible for establishing and maintaining adequate internal control over the Company's financial reporting. They have reviewed and evaluated the effectiveness of the Company's disclosure controls and procedures pursuant to Exchange Act Rule 13a-14 as of June 30, 2009 in order to ensure the reporting of material information required to be included in the Company's periodic filings with the Commission comply with the Commission's requirements for certification of this Form 10-Q. Based on that evaluation, the Company's CEO and CFO have concluded that as of June 30, 2009 the Company's disclosure controls and procedures were effective at the reasonable assurance level to satisfy the objectives for which they were intended and that the information required to be disclosed is (a) recorded, processed, summarized and reported within the time periods specified in the Commission's rules and forms and (b) compiled and communicated to our management to allow timely decisions regarding required disclosure.

(b) Changes in internal control. There were no changes in the Company's internal control over financial reporting that occurred during the most recent fiscal quarter that have materially affected or are reasonably likely to materially affect the Company's internal control over financial reporting.

Limitation of Effectiveness of Controls

It should be noted that any system of controls, however well designed and operated, can provide only reasonable, and not absolute, assurance that the objectives of the system will be met. The design of any control system is based, in part, upon the benefits of the control system relative to its costs. Because of the inherent limitations in all control systems, no evaluation of controls can provide absolute assurance that all control issues and instances of fraud, if any, within the Company have been detected. These inherent limitations include the realities that judgments in decision making can be faulty, and that controls can be circumvented by the individual acts of some persons, by collusion of two or more people or by management override of control. In addition, over time, controls may become inadequate because of changes in conditions, or the degree of compliance with the policies or procedures may deteriorate. In addition, the design of any control system is based in part upon certain assumptions about the likelihood of future events. Because of inherent limitation in a cost-effective control system, misstatements due to error or fraud may occur and not be detected. The Company's controls and procedures are designed to provide a reasonable level of assurance of achieving their objectives.

PART II - OTHER INFORMATION

Item 1. Legal Proceedings

None.

Item 1A. Risk Factors

The Company has no material changes to the disclosure on this matter made in its Annual Report on Form 10-K for the fiscal year ended December 31, 2008.

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

None

Item 3. Defaults Upon Senior Securities

None

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

On June 25, 2009, the Company held its annual meeting of shareholders. At that meeting, the following matters were voted upon:

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| Proposal | For | Withheld | Total |
|--|------------|----------|------------|
| 1) Election of Directors for a three year term expiring in 2012: | | | |
| Joseph W. Lewis | 14,464,493 | 212,090 | 14,676,583 |
| Jane Bryant Quinn | 14,592,258 | 84,325 | 14,676,583 |
| O. Lee Tawes, III | 14,406,274 | 270,309 | 14,676,583 |

The following directors are serving terms until the annual meeting in 2010 and were not reelected at the June 25, 2009 annual meeting:

Jerome I. Feldman
John V. Moran
George J. Pedersen

The following directors are serving terms until the annual meeting in 2011 and were not reelected at the June 25, 2009 annual meeting:

Michael D. Feldman
Sheldon L. Glashow
Roger L. Hagenruber

| Proposal | For | Against | Abstain | Total |
|--|------------|---------|---------|------------|
| 2) Ratification of KPMG LLP as the Company's independent registered public accountants for the 2009 fiscal year. | 14,550,938 | 121,082 | 4,563 | 14,676,583 |

Item 5. Other Information

None

Item 6. Exhibits

31.1 Certification of the Chief Executive Officer pursuant to Section 302 of the Sarbanes- Oxley Act of 2002, filed herewith.

31.2 Certification of the Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002, filed herewith.

32.1 Certification of the Chief Executive Officer and Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, filed herewith.

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

Date: August 10, 2009

GSE SYSTEMS, INC.

/S/ JOHN V. MORAN
John V. Moran
Chief Executive Officer
(Principal Executive Officer)

/S/ JEFFERY G. HOUGH
Jeffery G. Hough
Senior Vice President and Chief Financial Officer
(Principal Financial and Accounting Officer)