

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 September 30, 2005.

or

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

Commission File Number: 0-26494

GSE SYSTEMS, INC.

(Exact name of registrant as specified in its charter)

Delaware

52-1868008

(State or other jurisdiction of
incorporation or organization)

(I.R.S. Employer Identification No.)

7133 Rutherford Road, Baltimore, Maryland 21244

(Address of principal executive office and zip code)

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

9189 Red Branch Road, Columbia, Maryland 21045

(Former name, former address and former fiscal year, if changed since last report)

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 an accelerated filer (as defined in Rule 12b-2 of the Exchange Act). Yes No

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

As of November 1, 2005, there were 8,999,706 shares of the Registrant's common stock outstanding.

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	
	September 30, 2005	December 31, 2004
ASSETS		
Current assets:		
Cash and cash equivalents	\$ 804	\$ 868
Restricted cash	-	29
Contract receivables	7,916	8,723
Prepaid expenses and other current assets	735	819
Total current assets	<u>9,455</u>	<u>10,439</u>
Equipment and leasehold improvements, net	314	596
Software development costs, net	897	909
Goodwill, net	1,739	1,739
Other assets	417	545
Total assets	<u>\$ 12,822</u>	<u>\$ 14,228</u>
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Current portion of long-term debt	\$ 1,182	\$ 9
Accounts payable	2,492	2,998
Due to GP Strategies Corporation	421	291
Accrued expenses	1,284	1,608
Accrued compensation and payroll taxes	1,252	1,523
Billings in excess of revenue earned	848	1,079
Other current liabilities	189	273
Total current liabilities	<u>7,668</u>	<u>7,781</u>
Long-term debt	782	-
Accrued warranty reserves, less current portion	528	483
Other liabilities	775	19
Total liabilities	<u>9,753</u>	<u>8,283</u>
Commitments and contingencies		
Stockholders' equity:		
Series A convertible preferred stock \$.01 par value, 2,000,000 shares authorized, no shares issued and outstanding	-	-
Common stock \$.01 par value, 18,000,000 shares authorized, shares issued and outstanding 8,999,706 and 8,949,706 in 2005 and 2004, respectively	90	89
Additional paid-in capital	30,915	30,815
Accumulated deficit - at formation	(5,112)	(5,112)
Accumulated deficit - since formation	(21,689)	(19,044)
Accumulated other comprehensive loss	(1,135)	(803)
Total stockholders' equity	<u>3,069</u>	<u>5,945</u>
Total liabilities and stockholders' equity	<u>\$ 12,822</u>	<u>\$ 14,228</u>

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		Nine months ended	
	September 30,		September 30,	
	2005	2004	2005	2004
Contract revenue	\$ 4,607	\$ 7,340	\$ 17,617	\$ 22,498
Cost of revenue	4,228	5,835	14,543	17,379
Gross profit	379	1,505	3,074	5,119
Operating expenses:				
Selling, general and administrative	1,395	1,449	5,001	3,871
Administrative charges from GP Strategies	171	247	513	739
Depreciation and amortization	243	64	387	207
Total operating expenses	1,809	1,760	5,901	4,817
Operating income (loss)	(1,430)	(255)	(2,827)	302
Interest expense, net	(180)	(5)	(251)	(164)
Other income, net	593	19	439	35
Income (loss) from continuing operations before provision (benefit) for income taxes	(1,017)	(241)	(2,639)	173
Provision (benefit) for income taxes	30	(44)	6	30
Income (loss) from continuing operations	(1,047)	(197)	(2,645)	143
Income on sale of discontinued operations	-	60	-	60
Net income (loss)	\$ (1,047)	\$ (137)	\$ (2,645)	\$ 203
Basic earnings (loss) per common share:				
Continuing operations	\$ (0.12)	\$ (0.02)	\$ (0.29)	\$ 0.02
Discontinued operations	-	-	-	-
Net income (loss)	\$ (0.12)	\$ (0.02)	\$ (0.29)	\$ 0.02
Diluted earnings (loss) per common share:				
Continuing operations	\$ (0.12)	\$ (0.02)	\$ (0.29)	\$ 0.02
Discontinued operations	-	-	-	-
Net income (loss)	\$ (0.12)	\$ (0.02)	\$ (0.29)	\$ 0.02

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		Nine months ended	
	September 30,		September 30,	
	2005	2004	2005	2004
Net income (loss)	\$ (1,047)	\$ (137)	\$ (2,645)	\$ 203
Foreign currency translation adjustment	10	51	(332)	(3)
Comprehensive income (loss)	<u>\$ (1,037)</u>	<u>\$ (86)</u>	<u>\$ (2,977)</u>	<u>\$ 200</u>

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

GSE SYSTEMS, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS

(in thousands)

(Unaudited)

	Nine months ended	
	September 30,	
	2005	2004
Cash flows from operating activities:		
Net income (loss)	\$ (2,645)	\$ 203
Income on sale of discontinued operations	-	60
Income (loss) from continuing operations	(2,645)	143
Adjustments to reconcile net income (loss) to net cash used in operating activities:		
Depreciation and amortization	844	490
Change in fair market value of liabilities for conversion option and warrants	(577)	-
Changes in assets and liabilities:		
Contract receivables	807	(22)
Prepaid expenses and other assets	374	709
Accounts payable, accrued compensation and accrued expenses	(1,407)	406
Due to GP Strategies Corporation	130	327
Billings in excess of revenue earned	(231)	(2,552)
Accrued warranty reserves	44	320
Other liabilities	(5)	(44)
Net cash used in continuing operations	(2,666)	(223)
Net cash used in discontinued operations	-	(60)
Net cash used in operating activities	(2,666)	(283)
Cash flows from investing activities:		
Capital expenditures	(120)	(144)
Capitalized software development costs	(329)	(319)
Releases of cash as collateral under letters of credit	29	408
Net cash used in investing activities	(420)	(55)
Cash flows from financing activities:		
Borrowings under line of credit	1,182	-
Proceeds from issuance of common stock	100	-
Issuance of subordinated convertible note payable	2,000	-
Deferred financing costs	(212)	-
Other financing activities, net	(9)	(24)
Net cash provided by (used in) financing activities	3,061	(24)
Effect of exchange rate changes on cash	(39)	(1)
Net decrease in cash and cash equivalents	(64)	(363)
Cash and cash equivalents at beginning of year	868	1,388
Cash and cash equivalents at end of period	\$ 804	\$ 1,025

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 Nine Months ended September 30, 2005 and 2004
(Unaudited)

1. Basis of Presentation and Revenue Recognition

The consolidated financial statements included herein have been prepared by GSE Systems, Inc. (the "Company") 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 have been condensed or omitted. These consolidated financial statements should be read in conjunction with the consolidated financial statements and notes thereto included in the Company's Annual Report on Form 10-K for the period ended December 31, 2004 filed with the Securities and Exchange Commission on March 17, 2005.

The Company has only one reportable segment. The Company has a wide range of knowledge of simulation systems and the processes those systems are intended to control and model. The Company's knowledge is concentrated heavily in simulation technology and model development. The Company is primarily engaged in simulation for the power generation industry, the process industries, and the U.S. Government. Contracts typically range from 18 months to three years.

In the first nine months of 2005, the Company incurred a significant operating loss. The Company's revenue and profitability were impacted by the low volume of orders logged in 2004 and 2005. In addition, the Company continued to spend heavily on business development activities in order to expand the Company's simulation business into new sectors, such as the U.S. military and homeland security markets. Accordingly, the Company's cash position has weakened during the nine months ended September 30, 2005, with total cash decreasing from \$868,000 at December 31, 2004 to \$804,000 at September 30, 2005, despite the infusion of \$2.0 million through the issuance of a Senior Subordinated Secured Convertible Note to Dolphin Direct Equity Partners, LP in May 2005. The Company has also utilized \$1.2 million of its \$1.5 million credit facility during the nine-months ended September 30, 2005. In order to help improve the Company's liquidity and operating results, management terminated a number of employees at the end of the third quarter 2005 and is in negotiations with the landlord of its Columbia, Maryland facility to assign the Company's lease to a third party. In early October, the Company relocated its Maryland operations from its Columbia facility to its Baltimore facility. The Company is currently looking for additional capital to fund its operations. However, there can be no assurance that the Company will be successful in its efforts to raise additional capital to fund its operations. If adequate capital is not available, the Company may not meet its obligations as they become due or may be required to curtail its operations sometime in the future.

The Company must complete its annual goodwill impairment tests in the fourth quarter of 2005. If revenue and operating results continue to decline, there can be no assurance that an impairment would not be required.

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

For the three and nine months ended September 30, 2005, one customer (Battelle's Pacific Northwest National Laboratory) accounted for approximately 19.0% and 27.4%, respectively, of the Company's

GSE SYSTEMS, INC. AND SUBSIDIARIES
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consolidated revenue. For the three and nine months ended September 30, 2004, this customer accounted for approximately 26.4% and 22.8%, respectively, of the Company's consolidated revenue. The Pacific Northwest National Laboratory is the purchasing agent for the Department of Energy and the numerous projects GSE performs in Eastern and Central Europe.

The Company's credit facility requires GSE to comply with certain financial ratios. At September 30, 2005, GSE was not in compliance with its debt service coverage ratio. The Company obtained a letter dated August 4, 2005 in which the lender agreed to forebear from exercising its rights under the credit agreement against GSE with respect to this event of default until the Company has delivered to the lender the Company's financial statements for the year ending December 31, 2005.

On May 26, 2005, GSE issued and sold to Dolphin Direct Equity Partners, LP a Senior Subordinated Secured Convertible Note in the aggregate principal amount of \$2,000,000, which matures March 31, 2009 (the "Dolphin Note"), and a seven-year warrant to purchase 380,952 shares of GSE common stock at an exercise price of \$2.22 per share (the "GSE Warrant"). The Dolphin Note is convertible into 1,038,961 shares of GSE common stock at a conversion price of \$1.925 per share and accrues interest at 8% payable quarterly. Both the convertible note and the warrant are subject to anti-dilution provisions. The aggregate purchase price for the Dolphin Note and GSE Warrant was \$2,000,000. At the date of issuance, the fair value of the GSE Warrant was \$374,000 and the fair value of the Conversion Option of the Dolphin Note was \$959,000, both of which were recorded as noncurrent liabilities, with the offset recorded as original issue discount (OID). OID is accreted over the term of the Dolphin Note and charged to interest expense, and the unamortized balance is netted against long-term debt in the accompanying consolidated balance sheets. The GSE Warrant and Conversion Option liabilities are marked to market through earnings on a quarterly basis in accordance with EITF No. 00-19, *Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in a Company's Common Stock*. For the three and nine months ended September 30, 2005, the Company recognized a gain of \$577,000 from the change in fair value of these liabilities as of September 30, 2005. The gain is recorded in other income, net.

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 income as work progresses on the contract and is based on an estimate of the income earned to date, less income recognized in earlier 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 is recognized in the period in which the change is identified. Estimated losses are charged against earnings in the period such losses are identified.

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

The Company's system design contracts do not provide for "post customer support service" (PCS) in terms of software upgrades, software enhancements or telephone support. In order to obtain PCS, the customers must purchase a separate contract. Such PCS arrangements are generally for a one-year period renewable annually and include customer support, unspecified software upgrades, and maintenance releases. The Company recognizes revenue from these contracts ratably over the life of the agreements in accordance with Statement of Position 97-2, *Software Revenue Recognition*.

GSE SYSTEMS, INC. AND SUBSIDIARIES
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(Unaudited)

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.

Contract receivables unbilled totaled \$5.4 million and \$4.3 million as of September 30, 2005 and December 31, 2004, respectively. In October, 2005 the Company billed \$882,000 of the unbilled amount.

2. Basic and Diluted Earnings (Loss) Per Common Share

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

<i>(in thousands, except for share amounts)</i>	Three months ended September 30,		Nine months ended September 30,	
	2005	2004	2005	2004
Numerator:				
Net income (loss)	\$ (1,047)	\$ (137)	\$ (2,645)	\$ 203
Denominator:				
Weighted-average shares outstanding for basic earnings per share	8,999,706	8,949,706	8,998,607	8,949,706
Effect of dilutive securities:				
Employee stock options, warrants, and convertible subordinated debt	-		-	43,767
Adjusted weighted-average shares outstanding and assumed conversions for diluted earnings per share	8,999,706	8,949,706	8,998,607	8,993,473
Shares related to dilutive securities excluded because inclusion would be anti-dilutive	2,844,672	1,429,383	1,554,873	1,297,826

The difference between the basic and diluted number of weighted average shares outstanding for the nine months ended September 30, 2004 represents dilutive stock options and warrants to purchase shares of common stock computed under the treasury stock method, using the average market price during the period. Conversion of the stock options, warrants and convertible subordinated debt was not assumed for the three and nine months ended September 30, 2005 because the impact was anti-dilutive.

GSE SYSTEMS, INC. AND SUBSIDIARIES
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3. Stock Compensation

The Company applies the intrinsic-value-based method of accounting prescribe by Accounting Principles Board (APB) Opinion No. 25, *Accounting for Stock issued to Employees*, and related interpretations including FASB Interpretation No. 44, *Accounting for Certain Transactions involving Stock Compensation, an interpretation of APB Opinion No. 25*, issued in March 2000, to account for its fixed-plan stock options. Under this method, compensation expense is recorded on the date of grant only if the current market price of the underlying stock exceeds the exercise price. SFAS No. 123, *Accounting for Stock-Based Compensation*, established accounting and disclosure requirements using a fair-value-based method of accounting for stock based employee compensation plans. As allowed by SFAS No. 123, the Company has elected to continue to apply the intrinsic-value-based method of accounting described above and has adopted only the disclosure requirements of SFAS No. 123.

If the computed values of all the Company's stock based awards were calculated and expensed (over the vesting period of the awards) using the fair value method specified under SFAS 123, net income (loss) would have been as follows:

(in thousands, except per share data)	Three months ended September 30,		Nine months ended September 30,	
	2005	2004	2005	2004
Net income (loss), as reported	\$ (1,047)	\$ (137)	\$ (2,645)	\$ 203
Add stock-based employee compensation expense included in reported net income (loss)	-	-	-	-
Deduct total stock-based employee compensation expense determined under fair-value-method for all awards	-	(15)	(672)	(45)
Pro forma net income (loss)	\$ (1,047)	\$ (152)	\$ (3,317)	\$ 158
Net income (loss) per share, as reported:				
Basic	\$ (0.12)	\$ (0.02)	\$ (0.29)	\$ 0.02
Diluted	\$ (0.12)	\$ (0.02)	\$ (0.29)	\$ 0.02
Net income (loss) per share, proforma:				
Basic	\$ (0.12)	\$ (0.02)	\$ (0.37)	\$ 0.02
Diluted	\$ (0.12)	\$ (0.02)	\$ (0.37)	\$ 0.02

GSE SYSTEMS, INC. AND SUBSIDIARIES
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The fair value of each option was estimated on the date of grant using a Black-Scholes option-pricing model with the following weighted-average assumptions:

	Nine months ended	
	September 30,	
	2005	2004
Risk- free interest rates	4.0%	2.4%
Dividend yield	0.0%	0.0%
Expected life	4.4	4.5
Volatility	74.6%	83.7%

Options with an average exercise price of \$1.85 covering a total of 600,000 shares of common stock were granted to 47 employees in March 2005, all of which immediately vested. No other employee stock options were issued in the first nine months of 2005 or in the first nine months of 2004.

4. Long-term Debt

The Company's long-term debt consists of the following:

<i>(in thousands)</i>	September 30, 2005	December 31, 2004
Line of credit with bank	\$ 1,182	\$ -
Senior convertible secured subordinated note payable	2,000	-
Note payable, other	-	9
	<u>3,182</u>	<u>9</u>
Less warrant related discount, net of accretion	(343)	-
Less convertible option discount, net of accretion	<u>(875)</u>	<u>-</u>
	1,964	9
Less current portion	<u>(1,182)</u>	<u>(9)</u>
Long-term debt, less current portion	<u>\$ 782</u>	<u>\$ -</u>

Line of Credit

General Physics Corporation ("General Physics") is a wholly owned subsidiary of GP Strategies. On March 30, 2004, the Company was added as an additional borrower under the Financing and Security Agreement between General Physics Corporation and a financial institution. Under the terms of the agreement, \$1.5 million of General Physics' available credit facility has been carved out for use by GSE. The line is collateralized by substantially all of the Company's assets and provides for borrowings up to 80% of eligible accounts receivable and 80% of eligible unbilled receivables. GP Strategies guarantees GSE's borrowings under the credit facility in consideration for a fee pursuant to the Management Services Agreement with GSE. The interest rate on this line of credit is based upon the Daily LIBOR Market Index Rate plus 3% (6.8375% as of September 30, 2005), with interest only payments due monthly. At September 30, 2005, the Company's available borrowing base was \$1.5 million, of which \$1,192,000 had been utilized, including \$10,000 for a letter of credit. Subsequent to the spin-off of GSE on September 30, 2005, GP Strategies agreed to continue to guarantee GSE's borrowings under the credit facility through its expiration on August 13, 2006.

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The Company's credit facility requires GSE to comply with certain financial ratios. At September 30, 2005, GSE was not in compliance with its debt service coverage. The Company obtained a letter dated August 4, 2005 in which the lender has agreed to forebear from exercising its rights under the credit agreement against GSE with respect to this event of default until the Company has delivered to the lender the Company's financial statements for the year ending December 31, 2005.

Senior Convertible Secured Subordinated Note Payable

On May 26, 2005, GSE issued and sold to Dolphin Direct Equity Partners, LP a Senior Subordinated Secured Convertible Note in the aggregate principal amount of \$2,000,000, which matures March 31, 2009 (the "Dolphin Note"), and a seven-year warrant to purchase 380,952 shares of GSE common stock at an exercise price of \$2.22 per share (the "GSE Warrant"). The Dolphin Note is convertible into 1,038,961 shares of GSE common stock at a conversion price of \$1.925 per share and accrues interest at 8% payable quarterly. Both the convertible note and the warrant are subject to anti-dilution provisions. The aggregate purchase price for the Dolphin Note and GSE Warrant was \$2,000,000. At the date of issuance, the fair value of the GSE Warrant was \$374,000 and the fair value of the Conversion Option of the Dolphin Note was \$959,000, both of which were recorded as noncurrent liabilities, with the offset recorded as original issue discount (OID). OID is accreted over the term of the Dolphin Note and charged to interest expense, and the unamortized balance is netted against long-term debt in the accompanying consolidated balance sheets. The GSE Warrant and Conversion Option liabilities are marked to market through earnings on a quarterly basis in accordance with EITF No. 00-19, *Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in a Company's Common Stock*. For the three and nine months ended September 30, 2005, the Company recognized a gain of \$577,000 from the change in the fair value of these liabilities as of September 30, 2005. The gain is recorded in other income, net.

Note Payable, Other

The Company had an unsecured promissory note payable to a former employee. The final payment on the note was made in April 2005.

5. Series A Convertible Preferred Stock

The Series A convertible preferred stock had no voting rights and required dividends at the rate of 6% per annum payable quarterly. Dividends accumulated if not paid quarterly and compounded interest accrued on any unpaid dividends. On October 23, 2003, the outstanding 39,000 shares of preferred stock were converted to common stock. Thus, as of September 30, 2005 and December 31, 2004 there are no shares of preferred stock outstanding. The Company had accrued dividends payable of \$366,000 as of September 30, 2005 and December 31, 2004. Such amount accrues interest at the rate of 6% until paid.

6. Letters of Credit and Performance Bonds

As of September 30, 2005, the Company outstanding one \$10,000 bid bond which is secured by a \$10,000 letter of credit and a \$30,000 performance bond which is secured by a bank guarantee of the Company's foreign subsidiary.

7. Income Taxes

The Company's effective tax rate was 0.2% and 15.1% for the nine months ended September 30, 2005 and September 30, 2004, respectively. The decrease in the effective tax rate is attributable primarily to lower taxable income in Sweden. The Company has a full valuation allowance on its deferred tax assets.

GSE SYSTEMS, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
For the Three and Nine Months ended September 30, 2005 and 2004
(Unaudited)

8. Administrative Charges from GP Strategies and Other Related Party Transactions

On January 1, 2004, the Company entered into a Management Services Agreement with GP Strategies in which GP Strategies agreed to provide corporate support services to GSE, including accounting, finance, human resources, legal, network support and tax. In addition, GSE uses the financial system of General Physics, a subsidiary of GP Strategies. GP Strategies guarantees GSE's borrowings under its credit facility in consideration for a fee included in the Management Services Agreement charge. The Agreement has been extended through December 31, 2005 and can be renewed for successive one-year terms.

In December 2003, GSE's Board of Directors elected John Moran, a GP Strategies executive with experience in the power industry and simulation technology, as Chief Executive Officer. Mr. Moran continued as a GP Strategies employee throughout most of 2004, however, Mr. Moran devoted 100% of his time to the performance of his duties as CEO of GSE. On December 16, 2004, Mr. Moran became an employee of GSE. For the three and nine months ended September 30, 2004, GSE was charged \$75,000 and \$225,000, respectively by GP Strategies for Mr. Moran's compensation and benefits.

Total expense recognized by the Company for GP Strategies administrative charges for the three and nine months ended September 30, 2005 was \$171,000 and \$513,000, respectively. Total expense recognized for the same periods in 2004 was \$247,000 and \$739,000, respectively.

9. Commitments and Contingencies

In conjunction with the move of its Process Automation business to its Columbia, Maryland facility in May 2003, the Company subleased most of its vacated facility in Baltimore, Maryland to Alpharma USPD Inc. for a five-year period, although Alpharma could terminate the lease at the end of the second year provided a six-month notice was given. Alpharma elected to terminate the sublease on April 30, 2005. In May 2005, the Company's lease for the Baltimore facility was amended to release the Company from its rental obligation for 14,000 sq. ft. of the total 34,000 sq. ft. being leased effective October 1, 2005, as the landlord had entered into a new lease with another tenant for this space. In October 2005, the Company relocated its Maryland operations from its facility in Columbia to the Baltimore facility. Accordingly, the Company reversed its loss accrual for the Baltimore facility of \$182,000 in the third quarter 2005; this credit was recorded in selling, general and administrative expenses.

In October 2005, the Company signed an "Assignment of Lease and Amendment to Lease" that assigns and transfers to another tenant (the "assignee") the Company's rights, title and interest in its Columbia, Maryland facility lease. The Amendment is contingent upon the written approval of the landlord's bank. The effective date of the Agreement is the date that the Company delivers possession of the Columbia facility to the assignee, but no later than December 31, 2005. The assignee's obligation to pay rent under the Lease will begin on the date the assignee commences its intended renovations to the facility, but no later than February 1, 2006. The Company remains fully liable for the payment of all rent and for the performance of all obligations under the lease through the scheduled expiration of the lease, May 31, 2008, should the assignee default on their obligations. Assuming that the Company continues to pay the rent on the Columbia facility until February 1, 2006, the Company will record a charge of approximately \$350,000 related to the estimated loss on the lease assignment and moving expenses in the fourth quarter 2005.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
For the Three and Nine Months ended September 30, 2005 and 2004
(Unaudited)

10. New Accounting Standards

In December 2004, the FASB issued SFAS No. 123 - Revised (SFAS No. 123R), *Share-Based Payment*, which revises SFAS No. 123, *Accounting for Stock-Based Compensation*, and supercedes APB No. 25, *Accounting for Stock Issued to Employees*. Currently, the Company does not record compensation expense for certain stock-based compensation. Under SFAS No. 123R, the Company will measure the cost of employee services received in exchange for stock, based on the grant-date fair value (with limited exceptions) of the stock award. Such cost will be recognized over the period during which the employee is required to provide service in exchange for the stock award (usually the vesting period). The fair value of the stock award will be estimated using an option-pricing model, with excess tax benefits, as defined in SFAS No. 123R, being recognized as an addition to paid in capital. SFAS No. 123R was to be effective as of July 1, 2005. However, on April 14, 2005, the Securities and Exchange Commission announced that the effective date of SFAS 123R will be postponed until January 1, 2006, for calendar year companies. The Company is currently in the process of evaluating the impact of SFAS No. 123R on its consolidated financial statements.

GSE SYSTEMS, INC. AND SUBSIDIARIES
FORM 10-Q
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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 leader in real-time high fidelity simulation technology and model development. The Company provides simulation solutions and services to the power generation industry, the process industries, and the U.S. Government. In addition, the Company provides plant monitoring and signal analysis monitoring and optimization software primarily to the power industry, and develops specialized software applications for emerging technologies. The Company has only one reportable segment.

In the first nine months of 2005, the Company incurred a significant operating loss. The Company's revenue and profitability were impacted by the lower volume of orders logged in 2004 and 2005, and the Company's backlog has decreased from \$19.6 million at December 31, 2004 to \$13.9 million at September 30, 2005. In addition, the Company continued to spend heavily on business development activities in order to expand the Company's simulation business into new sectors, such as the U.S. military and homeland security markets. Accordingly, the Company's cash position has weakened during the nine months ended September 30, 2005, with total cash decreasing from \$868,000 at December 31, 2004 to \$804,000 at September 30, 2005, despite the infusion of \$2.0 million through the issuance of a Senior Subordinated Secured Convertible Note to Dolphin Direct Equity Partners, LP in May 2005. The Company has also utilized \$1.2 million of its \$1.5 million credit facility during the nine-months ended September 30, 2005. In order to help improve the Company's liquidity and operating results, management terminated a number of employees at the end of the third quarter 2005 and is in negotiations with the landlord of its Columbia, Maryland facility to assign the Company's lease to a third party. In early October, the Company relocated its Maryland operations from its Columbia facility to its Baltimore facility. The Company is currently looking for additional capital to fund its operations. However, there can be no assurance that the Company will be successful in its efforts to raise additional capital to fund its operations. If adequate capital is not available, the Company may not meet its obligations as they become due or may be required to curtail its operations sometime in the future.

The Company must complete its annual goodwill impairment tests in the fourth quarter of 2005. If revenue and operating results continue to decline, there can be no assurance that an impairment would not be required.

On June 21, 2005, the Board of Directors of GP Strategies Corporation ("GP Strategies") approved plans to spin-off its 57% interest in GSE through a special dividend to the GP Strategies' stockholders. On September 30, 2005, the GP Strategies' stockholders received 0.283075 share of GSE common stock for each share of GP Strategies common stock or Class B stock held on the record date of September 19, 2005. Following the spin-off, GP Strategies ceased to have any ownership interest in GSE.

On January 1, 2004, the Company entered into a Management Services Agreement with GP Strategies in which GP Strategies agreed to provide corporate support services to GSE, including accounting, finance, human resources, legal, network support and tax. During the nine months ended September 30, 2005, GSE was charged \$513,000 for GP Strategies' services. The Agreement has been extended through December 31, 2005 and can be renewed for successive one-year terms.

On March 30, 2004, the Company was added as an additional borrower under the Financing and Security Agreement between General Physics Corporation and a financial institution. Under the terms of the agreement, \$1.5 million of General Physics' available credit facility has been carved out for use by GSE. GP Strategies guarantees GSE's borrowings under the credit facility in consideration for a fee pursuant to the Management Services Agreement with GSE. The guarantee continues in place after the spin-off from GP Strategies until August 2006.

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On May 26, 2005, GSE issued and sold to Dolphin Direct Equity Partners, LP a Senior Subordinated Secured Convertible Note in the aggregate principle amount of \$2,000,000, which matures March 31, 2009 (the "Dolphin Note"), and a seven-year warrant to purchase 380,952 shares of GSE common stock at an exercise price of \$2.22 per share (the "GSE Warrant"). The Dolphin Note is convertible into 1,038,961 shares of GSE common stock at a conversion price of \$1.925 per share and accrues interest at 8% payable quarterly. Both the convertible note and the warrant are subject to anti-dilution provisions. The aggregate purchase price for the Dolphin Note and GSE Warrant was \$2,000,000. At the date of issuance, the fair value of the GSE Warrant was \$374,000 and the fair value of the Conversion Option of the Dolphin Note was \$959,000, both of which were recorded as noncurrent liabilities, with the offset recorded as original issue discount (OID). OID is accreted over the term of the Dolphin Note and charged to interest expense, and the unamortized balance is netted against long-term debt in the accompanying consolidated balance sheets. The GSE Warrant and Conversion Option liabilities are marked to market through earnings on a quarterly basis in accordance with EITF No. 00-19, *Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in a Company's Common Stock*. For the three and nine months ended September 30, 2005, the Company recognized a gain of \$577,000 from the change in the fair value of these liabilities as of September 30, 2005. The gain is recorded in other income, net.

The Company's credit facility requires GSE to comply with certain financial ratios. At September 30, 2005, GSE was not in compliance with its debt service coverage ratio. The Company obtained a letter dated August 4, 2005 in which the lender has agreed to forebear from exercising its rights under the credit agreement against GSE with respect to this event of default until the Company has delivered to the lender the Company's financial statements for the year ending December 31, 2005.

Cautionary Statement Regarding Forward-Looking Statements

This report contains certain forward-looking statements. Any statements contained herein that are not statements of historical facts may be deemed forward-looking statements. These statements are based on management's current beliefs and expectations and are subject to numerous risks and uncertainties and changes in circumstances. Actual results may differ materially from these forward-looking statements due to changes in global, economic, business, governmental, technical, competitive, market and regulatory factors.

General Business Environment

Despite the Company's poor operating results and liquidity requirements previously discussed, the Company believes it is positioned to take advantage of emerging trends in the power industry including a global nuclear power renaissance driven by the high cost of oil coupled with environmental concerns caused by fossil fuels. In the U.S. alone, the operating licenses for 32 nuclear power plants will expire over the next several years. Many of these plants are planning significant upgrades to the physical equipment and control room technology in conjunction with the license extensions. Both 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 65%, is well positioned to capture a large portion of this business, although no assurance can be given.

In the first quarter 2005, the Company completed an agreement with Westinghouse Electric Company LLC to become their preferred vendor for the development of simulators for the AP1000 reactor design. As a result of this agreement, GSE will work closely with Westinghouse to finalize the verification and validation of the AP1000 Reactor Human-Machine Interface for the Main Control Room. GSE expects to spend \$125,000 in 2005 on developing simulation models for the AP1000 reactor. In turn, Westinghouse and GSE will collaborate on new opportunities both internationally and domestically. The first of these opportunities has developed in China. Recent reports indicate that the Chinese government expects to build 40 new nuclear plants over the next

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10 years utilizing Western technology. Most of these new plants will require a stand alone simulator for which the Company believes it is best qualified to supply.

In addition, in the second quarter 2005, the Company was awarded a contract to develop simulation models for the novel Pebble Bed Modular Reactor System (PBMR) being developed by a South African company. The PBMR is a new high temperature gas cooled reactor that is inherently safe and reliable. Each reactor is designed to produce 165 MW, enough to provide energy for 40,000 hours. The system is designed such that additional reactors can easily be added as energy demand increases. The PBMR is ideally suited for areas with current modest energy needs that are expected to grow. GSE believes it is in an excellent position to provide the simulators that will be required with each PBMR installation, although there is no guarantee the Company will be awarded additional contracts.

The Company continues to focus on the fossil power segment of the power industry. In the second quarter 2005, the Company logged additional fossil power orders of approximately \$700,000. The Company expects continued growth in this market segment and is focusing on second time simulation buyers that now demand the more sophisticated and realistic simulation models offered by the Company.

While GSE simulators are primarily utilized for power plant operator training, the uses are expanding to include engineering analysis, plant modification studies, and operation efficiency improvements for both nuclear and fossil utilities. During plant construction, simulators are used to test control strategies and ensure on-time start-up. After commissioning, the same tools can be used to increase plant availability and optimize plant performance for the life of the facility. In partnership with an industry leading optimization company, GSE will be participating in DOE grant programs to utilize simulation and optimization for DOE's clean coal power initiative.

The Company continues to invest heavily in developing business with the U.S. government and in particular its military component. There are two areas of emphasis in this market – Homeland Security and Military Defense simulation. In Homeland Security, the Company has turned its attention to opportunities for simulation in disaster recovery and terrorist threat response. In the third quarter 2005, the Company continued development of its REMITS product used to simulate the operation of Emergency Operations Centers (EOC) run by municipal and state governments. REMITS is a Real-time Emergency Management Interactive Training System designed to simulate emergency situations and enable EOC staffs to train without requiring human participation in the field. REMITS enables the EOC staff to stay current with the technology and enables instructors to introduce new problems and challenges during the exercise to test the EOC staff response to changing situations. As the Federal Government spends billions in first responder training, the Company believes its REMITS product will find a large market in the developing field of training for disaster recovery and terrorist threat response. The Company is currently in final negotiations with a provider of command and control software that is installed in over 150 Homeland Security EOCs. REMITS would be integrated with their software. There is no certainty that REMITS will have a materially positive impact upon the Company's future performance.

With regard to military defense simulation, the Company continues to execute its plan to capitalize on what is clearly recognized as the biggest simulation spender in the world, the U.S. Military. In the third quarter 2005, the Company executed approximately \$430,000 in simulation work for the U.S. Navy on their nuclear propulsion program. The Navy selected GSE's technology for this program, which is expected to extend through the year 2025. The Company has entered into an agreement with Atlantis Systems Corporation, a leading training integrator specializing in the military and commercial aviation markets worldwide, to jointly market, win and execute contracts in the U.S. Government and Military markets. Under the terms of the agreement, GSE will license its proprietary simulation technology to Atlantis.

As of September 30, 2005, the Company's backlog was \$13.9 million.

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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:

<i>(in thousands)</i>	Three months ended September 30,				Nine months ended September 30,			
	2005	%	2004	%	2005	%	2004	%
Contract revenue	\$ 4,607	100.0 %	\$ 7,340	100.0 %	\$ 17,617	100.0 %	\$ 22,498	100.0 %
Cost of revenue	4,228	91.8 %	5,835	79.5 %	14,543	82.6 %	17,379	77.2 %
Gross profit	379	8.2 %	1,505	20.5 %	3,074	17.4 %	5,119	22.8 %
Operating expenses:								
Selling, general and administrative	1,395	30.3 %	1,449	19.7 %	5,001	28.4 %	3,871	17.3 %
Administrative charges from GP Strategies	171	3.7 %	247	3.4 %	513	2.9 %	739	3.3 %
Depreciation and amortization	243	5.2 %	64	0.9 %	387	2.2 %	207	0.9 %
Total operating expenses	1,809	39.2 %	1,760	24.0 %	5,901	33.5 %	4,817	21.5 %
Operating income (loss)	(1,430)	(31.0)%	(255)	(3.5)%	(2,827)	(16.1)%	302	1.3 %
Interest expense, net	(180)	(3.9)%	(5)	(0.1)%	(251)	(1.4)%	(164)	(0.7)%
Other income, net	593	12.8 %	19	0.3 %	439	2.5 %	35	0.2 %
Income (loss) from continuing operations before provision (benefit) for income taxes	(1,017)	(22.1)%	(241)	(3.3)%	(2,639)	(15.0)%	173	0.8 %
Provision (benefit) for income taxes	30	0.6 %	(44)	(0.6)%	6	0.0 %	30	0.2 %
Income (loss) from continuing operations	(1,047)	(22.7)%	(197)	(2.7)%	(2,645)	(15.0)%	143	0.6%
Income from sale of discontinued operations	-	0.0%	60	0.8%	-	0.0%	60	0.3%
Net income (loss)	\$ (1,047)	(22.7)%	\$ (137)	(1.9)%	\$ (2,645)	(15.0)%	\$ 203	0.9%

Critical Accounting Policies and Estimates

In preparing the Company's financial statements, management makes several estimates and assumptions that affect the Company's reported amounts of assets, liabilities, revenue and expenses. Those accounting estimates that have the most significant impact on the Company's operating results and place the most significant demands on management's judgment are discussed below. For all of these policies, management cautions that future events rarely develop exactly as forecast, and the best estimates may require adjustment.

Revenue Recognition on Long-Term Contracts. The Company uses the percentage-of-completion revenue recognition methodology to record revenue under its long-term fixed-price contracts in accordance with the AICPA Statement of Position 81-1, *Accounting for Performance of Construction-Type and Certain Production-Type Contracts*. This methodology recognizes income as work progresses on the contract and is based on an estimate of the income earned to date, less income recognized in earlier 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. The Company's project managers are responsible for estimating the costs to be incurred at the beginning of each project and are responsible for updating the estimate monthly as the project progresses. Management reviews the status of each project monthly with the project managers and determines whether the cost estimates are reasonable. If changes in the estimated costs to complete the projects are required, the cumulative impact on the percentage of completion revenue calculation is recognized in the period identified. Whenever evidence indicates that the estimated total cost of a contract will exceed its total

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contract value, the Company's operating results are charged for the full amount of the estimated losses immediately. Uncertainties inherent in the performance of contracts include labor availability and productivity, material costs, change order scope and pricing, software modification issues 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.

Capitalization of Computer Software Development Costs. In accordance with Statement of Financial Accounting Standards (SFAS) No. 86, *Accounting for the Costs of Computer Software to Be Sold, Leased, or Otherwise Marketed*, the Company capitalizes computer software development costs incurred after technological feasibility has been established, but prior to the release of the software product for sale to customers. Once the product is available to be sold, the Company begins to amortize the costs over the estimated useful life of the product, which normally ranges from three to five years. At September 30, 2005, the Company has net capitalized software development costs of \$897,000. On an annual basis, and more frequently as conditions indicate, the Company assesses the recovery of the unamortized software computer costs by estimating the net undiscounted cash flows expected to be generated by the sale of the product. If the undiscounted cash flows are not sufficient to recover the unamortized software costs the Company will write-down the investment to its estimated fair value based on future discounted cash flows. The excess of any unamortized computer software costs over the related net realizable value is written down and charged to operations. Significant changes in the sales projections could result in an impairment with respect to the capitalized software that is reported on the Company's balance sheet.

Deferred Income Tax Valuation Allowance. Deferred income taxes arise from temporary differences between the tax bases of assets and liabilities and their reported amounts in the financial statements. As required by SFAS No. 109, *Accounting for Income Taxes*, management makes a regular assessment of the realizability of the Company's deferred tax assets. In making this assessment, management considers whether it is more likely than not that some or all of the deferred tax assets will not be realized. The ultimate realization of deferred tax assets is dependent upon the generation of future taxable income during the periods in which those temporary differences become deductible. Management considers the scheduled reversal of deferred tax liabilities and projected future taxable income of the Company in making this assessment. A valuation allowance is recorded to reduce the total deferred income tax asset to its realizable value. At September 30, 2005, the Company's largest deferred tax asset related to a U.S. net operating loss carryforward of \$16.1 million which expires in various amounts over the next twenty years. The amount of loss carryforward which can be used by the Company may be significantly limited. The recovery of the net deferred tax asset could not be substantiated by currently available objective evidence. Accordingly, the Company has established an \$8.7 million valuation allowance for its deferred tax assets. The valuation allowance will be reduced if the Company's operations are able to realize taxable income in the future.

Results of Operations - Three and Nine Months ended September 30, 2005 versus Three and Nine Months ended September 30, 2004.

Contract Revenue. Total contract revenue for the quarter ended September 30, 2005 totaled \$4.6 million, which was 37.2% lower than the \$7.3 million total revenue for the quarter ended September 30, 2004. Revenue for the nine months ended September 30, 2005 was \$17.6 million versus \$22.5 million in the same period of 2004, a 21.7% decrease. For the nine months ended September 30, 2005, the Company has logged new orders totaling only \$12.1 million. The decline is attributed to lower orders in 2005. At September 30, 2005, the Company's backlog was \$13.9 million of which the Company believes approximately \$4.7 million will be recognized as revenue in the next three months.

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Gross Profit. Gross profit totaled \$379,000 (8.2% of revenue) for the quarter ended September 30, 2005, as compared with \$1.5 million (20.5% of revenue) for the quarter ended September 30, 2004. For the nine months ended September 30, 2005, gross profit decreased from \$5.1 million (22.8% of revenue) for the nine months ended September 30, 2004 to \$3.1 million (17.4% of revenue). The decrease in gross profit percentage is due to the following:

- ◆ The Company adjusted the estimated costs to complete on several long-term contracts during the third quarter, due principally to a change in the mix of internal and external labor cost, which resulted in a net reduction of the project-to-date gross profit recognized on the projects of approximately \$407,000.
- ◆ A lower revenue base to recover the Company's relatively fixed overhead.

Selling, General and Administrative Expenses. Selling, general and administrative ("SG&A") expenses totaled \$1.4 million in the quarter ended September 30, 2005, a 3.7% decrease as compared to the third quarter 2004. SG&A expenses for the nine months ended September 30, 2005 increased 29.2%, from \$3.9 million for the nine months ended September 30, 2004 to \$5.0 million. Business development costs decreased from \$803,000 in the third quarter 2004 to \$659,000 in the third quarter 2005 but increased from \$2.0 million for the nine months ended September 30, 2004 to \$2.3 million in the same period of 2005. The Company expanded its business development organization throughout 2004 into the first quarter of 2005, adding an additional five employees between the first quarter 2004 and the first quarter 2005. In addition, the Company incurred higher bidding and proposal costs in the pursuit of new orders. In order to reduce operating expenses, the Company terminated several of its business development personnel in the third quarter 2005 and reassigned others to operating positions. The Company's corporate and G&A expenses increased slightly from \$835,000 in the third quarter 2004 to \$852,000 in the third quarter 2005. For the nine months ended September 30, 2005, corporate and G&A expenses increased from \$2.6 million for the first nine months of 2004 to \$3.1 million in 2005. The Company has increased its reserve for bad debts by \$153,000 in the third quarter 2005 and \$246,000 for the nine months ended September 30, 2005. The increase in the third quarter 2005 bad debt expense was offset by lower corporate salary and travel expense. Other factors contributing to the increase in corporate and G&A expense for the nine months ended September 30, 2005 included (a) salary and benefit costs of John Moran, the Company's CEO who became a GSE employee in December 2004 and (b) \$184,000 of severance costs, of which \$67,000 had not been paid at September 30, 2005. Prior to December 2004, the Company was charged for Mr. Moran's services by GP Strategies and his costs were classified as GP Strategies administration fees. Gross spending on software product development ("development") totaled \$227,000 in the quarter ended September 30, 2005 as compared to \$134,000 in the same period of 2004. For the nine months ended September 30, 2005, gross development spending totaled \$517,000 versus \$373,000 in the same period of 2004. The Company anticipates that its total gross development spending in 2005 will approximate \$800,000.

The Company capitalized \$170,000 of software development costs in the three months ended September 30, 2005 as compared to \$80,000 in the same period of 2004. For the nine months ended September 30, 2005 and 2004, the Company capitalized \$328,000 and \$319,000, respectively. The Company's capitalized costs in the first nine months of 2005 were related to:

- ◆ Additional enhancements to JADE (Java Applications & Development Environment), a Java-based application that provides a window into the simulation station and takes advantage of the web capabilities of Java, allowing customers to access the simulator and run scenarios from anywhere they have access to the web. JADE 3.0 was released in April 2005.
- ◆ The continued development of the Company's REMITS product used to simulate the operation of Emergency Operations Centers (EOC) run by municipal and state governments.
- ◆ The development of generic simulation models representing the Westinghouse Electric Company LLC AP1000 nuclear plant design.

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- ◆ The development of new features for the XFlow modeling tool for modeling power plant buildings.

Administrative Charges from GP Strategies. On January 1, 2004, the Company entered into a Management Services Agreement with GP Strategies Corporation in which GP Strategies agreed to provide corporate support services to GSE, including accounting, finance, human resources, legal, network support and tax. Expense for the three and nine months ended September 30, 2005 was \$171,000 and \$513,000, respectively.

In December 2003, GSE's Board of Directors elected John Moran, a GP Strategies executive with experience in the power industry and simulation technology, as Chief Executive Officer. Mr. Moran continued as a GP Strategies employee until December 15, 2004 when he became a GSE employee. In the first nine months of 2004, GSE was charged \$225,000 by GP Strategies for Mr. Moran's compensation and benefits.

Depreciation and Amortization. Depreciation expense totaled \$243,000 and \$64,000 during the quarters ended September 30, 2005 and 2004, respectively. For the nine months ended September 30, 2005 and 2004 depreciation expense totaled \$387,000 and \$207,000, respectively. Due to the relocation of the Company's Maryland operations from Columbia, Maryland to Baltimore, Maryland, the Company accelerated the depreciation of certain leasehold improvements in the third quarter 2005.

Operating Income (Loss). The Company had an operating loss of \$1.4 million (31.0% of revenue) in the third quarter 2005, as compared with operating loss of \$255,000 (3.5% of revenue) for the same period in 2004. For the nine months ended September 30, 2005 and 2004, the Company had an operating loss of \$2.8 million (16.1% of revenue) and operating income of \$302,000 (1.3% of revenue), respectively. The decrease was due to the factors outlined above.

Interest Expense, Net. Net interest expense increased from \$5,000 in the quarter ended September 30, 2004 to \$180,000 for the same quarter in 2005. For the nine months ended September 30, 2005 and 2004, net interest expense totaled \$251,000 and \$164,000, respectively. Included in interest expense in the three and nine months ended September 30, 2005 was OID accretion related to the Dolphin Note and GSE Warrant of \$107,000 and \$116,000, respectively. The Company expects interest in the fourth quarter 2005 to be comparable with that incurred in the third quarter 2005.

For the three and nine months ended September 30, 2005, the Company incurred interest expense of \$15,000 and \$36,000, respectively, on borrowings against its \$1.5 million credit facility. In 2004, the Company had no borrowings against the credit facility.

The fees paid to the Company's financial institution as consideration for the extension of the Company's credit facility for a one-year period beginning March 23, 2003 were amortized over the one year extension. In the first quarter 2004, the Company recognized \$94,000 of interest expense which completed the amortization of these costs.

Other Income, Net. Other income, net was \$593,000 and \$479,000 in the three and nine months ended September 30, 2005. This includes gains and losses on the Company's derivative instruments including the liabilities associated with the Dolphin Note Conversion Option and GSE Warrants. At September 30, 2005, the Company had foreign currency contracts for sale of approximately \$2.3 million Japanese Yen at fixed rates. The contracts expire on various dates through May 2007. The Company has not designated the contracts as hedges and, accordingly, has recorded the reduction in estimated fair value of the contracts during the third quarter 2005 of \$8,000, and for the first nine months of 2005 of \$164,000, in other expense. The estimated fair value of the contracts was \$37,000 at September 30, 2005.

In conjunction with the Dolphin Note and GSE Warrants, the fair value of the GSE Warrant was \$374,000 and the fair value of the Conversion Option of the Dolphin Note was \$959,000. The GSE Warrant and

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Conversion Option liabilities are marked to market through earnings on a quarterly basis in accordance with EITF No. 00-19, *Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in a Company's Common Stock*. For the three and nine months ended September 30, 2005, the Company recognized a gain of \$577,000 from the change in fair market value of these liabilities as of September 30, 2005

Provision (Benefit) for Income Taxes. The Company's effective tax rate was .2% and 15.1% for the nine months ended September 30, 2005 and September 30, 2004, respectively. The decrease in the effective tax rate is attributable primarily to lower taxable income in Sweden. The Company has a full valuation allowance on its deferred tax assets.

Income on Sale of Discontinued Operations. In conjunction with the Company's sale of its Process business in September 2003, the Company received \$5.5 million in cash, subject to certain adjustments. The Company incurred approximately \$865,000 of closing costs associated with the transaction, including a \$100,000 accrual for possible post-closing claims from Novatech in the twelve months following the sale, as outlined in various provisions of the Asset Purchase Agreement. In the third quarter 2004, the Company reduced the accrual to management's best estimate of the Company's exposure to loss.

Liquidity and Capital Resources

As of September 30, 2005, the Company's cash and cash equivalents totaled \$804,000 compared to \$868,000 at December 31, 2004.

Cash used in operating activities. For the nine months ended September 30, 2005, net cash used in operating activities was \$2.7 million. The \$577,000 gain on change in the fair value of the Dolphin Warrant and Conversion Option liabilities was a non-cash transaction. Significant changes in the Company's assets and liabilities in 2005 included:

- ◆ an \$807,000 decrease in contract receivables. The decrease reflects the net of (a) a decrease in outstanding trade receivables of \$1.7 million due to the lower project activity, (b) an increase in the Company's unbilled receivable balance of \$1.2 million due to the timing of contract invoicing milestones, and (c) an increase in the bad debt reserve of \$272,000.
- ◆ a \$1.4 million decrease in accounts payable, accrued compensation and accrued expenses. The reduction mainly reflects (a) a \$175,000 reduction in obligations due to the Company's subcontractors working on projects in Mexico and Eastern Europe as some of the projects have been completed, (b) the payment of deferred bonuses to GSE management in 2005, totaling \$187,000, related to the sale of the Process Automation business in 2003, and (c) the reversal of the \$182,000 loss accrual for the Company's Baltimore Facility.

Net cash used in operating activities was \$283,000 for the nine months ended September 30, 2004; \$223,000 was used by continuing operations and \$60,000 was used by discontinued operations. Significant changes in the Company's assets and liabilities in 2004 included:

- ◆ a \$709,000 reduction in prepaid expenses and other assets. The reduction reflects (1) lower prepaid insurance expense due to the participation of the Company in some of GP Strategies' insurance programs, (2) the collection from Novatech Process Solutions LLC of expenses paid by the Company on behalf of Novatech after the sale of the Process business in 2003 and (3) a reduction in capitalized bank commitment fees.
- ◆ An increase in accounts payable, accrued compensation and accrued expenses of \$406,000. The increase reflects the increase in project activity in 2004 as compared to the prior year and the related increase in

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obligations to the Company's subcontractors that are working on projects located in Mexico and Eastern Europe.

- ◆ a decrease in billings in excess of revenue earned by \$2.6 million. In 2003, the Company had entered into a \$6.6 million contract with a Mexican customer for a full scope simulator that allowed the Company to invoice the customer for 20% of the contract upon the receipt of the purchase order as an advance payment. The reduction in billings in excess of revenue earned largely reflects the completion of work which reduced the Company's liability to the customer for the advance payment.

Cash used in investing activities. Net cash used in investing activities for the nine months ended September 30, 2005 totaled \$420,000. Capital expenditures totaled \$120,000 and capitalized software development costs totaled \$329,000. A \$29,000 cash collateralized stand-by letter of credit expired in June 2005 and the cash collateral was released.

Net cash used in investing activities was \$55,000 for the nine months ended September 30, 2004, consisting of \$144,000 of capitalized software development costs and \$319,000 of capital expenditures, offset by the expiration of \$408,000 of cash collateralized stand-by letters of credit for which the cash collateral was released.

Cash used in financing activities. During the nine months ended September 30, 2005, the Company generated \$3.1 million in cash from financing activities. The Company borrowed \$1,182,000 from its bank line of credit, generated \$100,000 from the conversion of employee stock options, and issued to Dolphin Direct Equity partners, LP a Senior Subordinated Secured Convertible Note in the aggregate principle amount of \$2,000,000. The Company also paid down a note payable by \$9,000.

The Company incurred \$212,000 of deferred financing costs which will be amortized over the term of the note.

In the nine months ended September 30, 2004, the Company used \$24,000 in financing activities related to the pay down of a note payable.

Credit Facilities

General Physics Corporation ("General Physics") is a wholly owned subsidiary of GP Strategies. On March 30, 2004, the Company was added as an additional borrower under the Financing and Security Agreement between General Physics Corporation and a financial institution. Under the terms of the agreement, \$1.5 million of General Physics' available credit facility has been carved out for use by GSE. The line is collateralized by substantially all of the Company's assets and provides for borrowings up to 80% of eligible accounts receivable and 80% of eligible unbilled receivables. The interest rate on this line of credit is based upon the Daily LIBOR Market Index Rate plus 3% (6.8375% as of September 30, 2005), with interest only payments due monthly. At September 30, 2005, the Company's available borrowing base was \$1.5 million, of which \$1,192,000 had been utilized, inclusive of \$10,000 for a letter of credit. The credit facility expires on August 12, 2006.

The Company's credit facility requires GSE to comply with certain financial ratios. At September 30, 2005, GSE was not in compliance with its debt service coverage ratio. The Company obtained a letter dated August 4, 2005 in which the lender has agreed to forebear from exercising its rights under the credit agreement against GSE with respect to this event of default. Company has delivered to the lender the Company's financial statements for the year ending December 31, 2005.

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On May 26, 2005, GSE issued and sold to Dolphin Direct Equity Partners, LP a Senior Subordinated Secured Convertible Note in the aggregate principle amount of \$2,000,000, which matures March 31, 2009 (the "Dolphin Note"), and a seven-year warrant to purchase 380,952 shares of GSE common stock at an exercise price of \$2.22 per share (the "GSE Warrant"). The Dolphin Note is convertible into 1,038,961 shares of GSE common stock at a conversion price of \$1.925 per share and accrues interest at 8% payable quarterly. Both the convertible note and the warrant are subject to anti-dilution provisions. The aggregate purchase price for the Dolphin Note and GSE Warrant was \$2,000,000. At the date of issuance, the fair value of the GSE Warrant was \$374,000 and the fair value of the Conversion Option of the Dolphin Note was \$959,000, both of which were recorded as noncurrent liabilities, with the offset recorded as original issue discount (OID). OID is accreted over the term of the Dolphin Note and charged to interest expense, and the unamortized balance is netted against long-term debt in the accompanying consolidated balance sheets. The GSE Warrant and Conversion Option liabilities are marked to market through earnings on a quarterly basis in accordance with EITF No. 00-19, *Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in a Company's Common Stock*.

At September 30, 2005, the Company had foreign currency contracts for sale of approximately \$2.3 million Japanese Yen at fixed rates. The contracts expire on various dates through May 2007. The Company has not designated the contracts as hedges and, accordingly, has recorded the reduction in estimated fair value of the contracts during the third quarter 2005 of \$8,000, and for the first nine months of 2005 of \$164,000, in other expense. The estimated fair value of the contracts was \$37,000 at September 30, 2005.

New Accounting Standards

In December 2004, the FASB issued SFAS No. 123 - Revised (SFAS No. 123R), *Share-Based Payment*, which revises SFAS No. 123, *Accounting for Stock-Based Compensation*, and supercedes APB No. 25, *Accounting for Stock Issued to Employees*. Currently, the Company does not record compensation expense for certain stock-based compensation. Under SFAS No. 123R, the Company will measure the cost of employee services received in exchange for stock, based on the grant-date fair value (with limited exceptions) of the stock award. Such cost will be recognized over the period during which the employee is required to provide service in exchange for the stock award (usually the vesting period). The fair value of the stock award will be estimated using an option-pricing model, with excess tax benefits, as defined in SFAS No. 123R, being recognized as an addition to paid in capital. SFAS No. 123R was to be effective as of July 1, 2005. However, on April 14, 2005, the Securities and Exchange Commission announced that the effective date of SFAS 123R will be postponed until January 1, 2006, for calendar year companies. The Company is currently in the process of evaluating the impact of SFAS No. 123R on its consolidated financial statements.

Item 3. Quantitative and Qualitative Disclosure about Market Risk

The Company's most significant market risk is 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 various derivative financial instruments to manage market risks associated with the fluctuations in foreign currency exchange rates. It is the Company's policy to use derivative financial instruments to protect against market risk arising in the normal course of business. The Company monitors its foreign currency exposures to maximize the overall effectiveness of its foreign currency positions. Principal currencies hedged include the Euro and the Japanese yen. The Company's objectives for holding derivatives are to minimize

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the risks using the most effective methods to reduce the impact of these exposures. The Company minimizes credit exposure by limiting counterparties to nationally recognized financial institutions.

At June 30, 2005, the Company had foreign currency contracts for sale of approximately \$2.3 million Japanese Yen at fixed rates. The contracts expire on various dates through May 2007. The Company has not designated the contracts as hedges and, accordingly, has recorded the reduction in estimated fair value of the contracts during the third quarter 2005 of \$8,000, and for the first nine months of 2005 of \$164,000, in other expense. The estimated fair value of the contracts was \$37,000 at September 30, 2005.

The Company is also subject to market risk related to the interest rate on its existing line of credit. As of September 30, 2005, such interest rate is based on the Libor Market Index Rate plus 300 basis-points. A 100 basis-point change in such rates during the three and nine months ended September 30, 2005 would have changed the Company's interest expense by approximately \$2,000 and \$5,000, respectively.

On May 26, 2005, GSE issued and sold to Dolphin Direct Equity Partners, LP a Senior Subordinated Secured Convertible Note in the aggregate principle amount of \$2,000,000, which matures March 31, 2009, and a seven-year warrant to purchase 380,952 shares of GSE common stock at an exercise price of \$2.22 per share. The Dolphin Note is convertible into 1,038,961 shares of GSE common stock at a conversion price of \$1.925 per share and accrues interest at 8% payable quarterly. Both the convertible note and the warrant are subject to anti-dilution provisions. The aggregate purchase price for the Dolphin Note and GSE Warrant was \$2,000,000. At the date of issuance, the fair value of the GSE Warrant was \$374,000 and the fair value of the Conversion Option of the Dolphin Note was \$959,000, both of which were recorded as noncurrent liabilities, with the offset recorded as original issue discount (OID). The GSE Warrant and Conversion Option liabilities are marked to market through earnings on a quarterly basis in accordance with EITF No. 00-19, *Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in a Company's Common Stock*.

Item 4. Controls and Procedures

(a) *Evaluation of disclosure controls and procedures.* Based on their evaluation as of the end of the period covered by this Form 10-Q, the Company's principal executive officer and principal financial officer have concluded that the Company's disclosure controls and procedures (as defined in Rules 13a-15(e) under the Securities Exchange Act of 1934 (the "Exchange Act")) are effective to ensure that information required to be disclosed by the Company in reports that it files or submits under the Exchange Act is recorded, processed, and summarized and reported within the time periods specified in Securities and Exchange Commission rules and forms.

(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.

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PART II - OTHER INFORMATION

Item 1. Legal Proceedings

In accordance with its conduct in the ordinary course of business, certain actions and proceedings are pending to which the Company is a party. In the opinion of management, the aggregate liabilities, if any, arising from such actions are not expected to have a material adverse effect on the financial condition of the Company.

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

None

Item 3. Defaults Upon Senior Securities

The Company's credit facility requires GSE to comply with certain financial ratios. At September 30, 2005, GSE was not in compliance with its debt service coverage ratio. The Company obtained a letter dated August 4, 2005 in which the lender has agreed to forebear from exercising its rights under the credit agreement against GSE with respect to this event of default. Company has delivered to the lender the Company's financial statements for the period ending December 31, 2005.

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

None.

Item 5. Other Information

None

Item 6. Exhibits

(a) Exhibits

- 31.1 Certification of the Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.*
- 31.2 Certification of the Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.*
- 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

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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: November 14, 2005

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)