

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, 2010.

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 has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such period that the registrant was required to submit and post such files). 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 "large accelerated filer", "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

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 19,159,855 shares of common stock, with a par value of \$.01 per share outstanding as of November 8, 2010.

**GSE SYSTEMS, INC.**  
**QUARTERLY REPORT ON FORM 10-Q**

**INDEX**

	<u>PAGE</u>
PART I. FINANCIAL INFORMATION	3
Item 1. Financial Statements:	
Consolidated Balance Sheets as of September 30, 2010 and December 31, 2009	3
Consolidated Statements of Operations for the Three and Nine Months Ended September 30, 2010 and September 30, 2009	4
Consolidated Statements of Comprehensive Income for the Three and Nine Months Ended September 30, 2010 and September 30, 2009	5
Consolidated Statement of Changes in Stockholders' Equity for the Nine Months Ended September 30, 2010	6
Consolidated Statements of Cash Flows for the Nine Months Ended September 30, 2010 and September 30, 2009	7
Notes to Consolidated Financial Statements	8
Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations	19
Item 3. Quantitative and Qualitative Disclosures About Market Risk	29
Item 4. Controls and Procedures	30
PART II. OTHER INFORMATION	31
Item 1. Legal Proceedings	31
Item 1A. Risk Factors	31
Item 2. Unregistered Sales of Equity Securities and Use of Proceeds	31
Item 3. Defaults Upon Senior Securities	32
Item 5. Other Information	32
Item 6. Exhibits	32
SIGNATURES	33

## PART I - FINANCIAL INFORMATION

### Item 1. Financial Statements

#### GSE SYSTEMS, INC. AND SUBSIDIARIES CONSOLIDATED BALANCE SHEETS

(in thousands, except share data)

	Unaudited	
	September 30, 2010	December 31, 2009
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents	\$ 33,821	\$ 25,270
Restricted cash	278	938
Contract receivables	14,037	15,941
Prepaid expenses and other current assets	3,421	1,491
Total current assets	<u>51,557</u>	<u>43,640</u>
Equipment and leasehold improvements	4,757	4,065
Accumulated depreciation	<u>(3,736)</u>	<u>(3,076)</u>
Equipment and leasehold improvements, net	1,021	989
Software development costs, net	2,154	1,865
Goodwill	2,628	1,739
Intangible assets, net	690	-
Long-term restricted cash	898	876
Other assets	485	411
Total assets	<u>\$ 59,433</u>	<u>\$ 49,520</u>
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>		
Current liabilities:		
Accounts payable	\$ 11,597	\$ 5,009
Accrued expenses	927	852
Accrued compensation and payroll taxes	1,895	1,747
Billings in excess of revenue earned	2,619	2,579
Accrued warranty	1,515	1,273
Other current liabilities	745	711
Total current liabilities	<u>19,298</u>	<u>12,171</u>
Other liabilities	1,042	206
Total liabilities	<u>20,340</u>	<u>12,377</u>
Commitments and contingencies	-	-
Stockholders' equity:		
Preferred stock \$.01 par value, 2,000,000 shares authorized, shares issued and outstanding none in 2010 and 2009	-	-
Common stock \$.01 par value, 30,000,000 shares authorized, shares issued and outstanding 19,112,979 in 2010 and 18,930,368 in 2009	191	189
Additional paid-in capital	68,947	67,559
Accumulated deficit	(29,344)	(29,615)
Accumulated other comprehensive (loss)	<u>(701)</u>	<u>(990)</u>
Total stockholders' equity	<u>39,093</u>	<u>37,143</u>
Total liabilities and stockholders' equity	<u>\$ 59,433</u>	<u>\$ 49,520</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)*

	<b>Three months ended</b>		<b>Nine months ended</b>	
	<b>September 30,</b>		<b>September 30,</b>	
	<b>2010</b>	<b>2009</b>	<b>2010</b>	<b>2009</b>
Contract revenue	\$ 11,904	\$ 10,217	\$ 34,886	\$ 28,995
Cost of revenue	<u>9,503</u>	<u>7,662</u>	<u>25,691</u>	<u>21,398</u>
Gross profit	<u>2,401</u>	<u>2,555</u>	<u>9,195</u>	<u>7,597</u>
Operating expenses:				
Selling, general and administrative	2,545	2,000	7,837	5,611
Depreciation	146	127	418	369
Amortization of definite-lived intangible assets	38	-	63	-
Total operating expenses	<u>2,729</u>	<u>2,127</u>	<u>8,318</u>	<u>5,980</u>
Operating income (loss)	(328)	428	877	1,617
Interest income, net	29	16	48	50
Gain (loss) on derivative instruments	47	523	(631)	730
Other income (expense), net	27	(97)	65	(318)
Income (loss) before income taxes	<u>(225)</u>	<u>870</u>	<u>359</u>	<u>2,079</u>
Provision for income taxes	323	412	88	717
Net income (loss)	<u>\$ (548)</u>	<u>\$ 458</u>	<u>\$ 271</u>	<u>\$ 1,362</u>
Basic income (loss) per common share	<u>\$ (0.03)</u>	<u>\$ 0.03</u>	<u>\$ 0.01</u>	<u>\$ 0.08</u>
Diluted income (loss) per common share	<u>\$ (0.03)</u>	<u>\$ 0.03</u>	<u>\$ 0.01</u>	<u>\$ 0.08</u>

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

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

	<b>Three months ended</b>		<b>Nine months ended</b>	
	<b>September 30,</b>		<b>September 30,</b>	
	<b>2010</b>	<b>2009</b>	<b>2010</b>	<b>2009</b>
Net income (loss)	\$ (548)	\$ 458	\$ 271	\$ 1,362
Foreign currency translation adjustment	<u>570</u>	<u>314</u>	<u>289</u>	<u>343</u>
Comprehensive income	<u>\$ 22</u>	<u>\$ 772</u>	<u>\$ 560</u>	<u>\$ 1,705</u>

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)*

	<b>Common Stock</b>		<b>Additional Paid-in Capital</b>	<b>Accumulated Deficit</b>	<b>Accumulated Other Comprehensive Loss</b>	<b>Total</b>
	<b>Shares</b>	<b>Amount</b>				
<b>Balance, January 1, 2010</b>	18,930	\$ 189	\$ 67,559	\$ (29,615)	\$ (990)	\$37,143
Stock-based compensation expense	-	-	563	-	-	563
Common stock issued for options exercised	45	1	73	-	-	74
Common stock issued for services provided	15	-	70	-	-	70
Common stock issued for TAS acquisition	123	1	682	-	-	683
Foreign currency translation adjustment	-	-	-	-	289	289
Net income	-	-	-	271	-	271
<b>Balance, September 30, 2010</b>	<u>19,113</u>	<u>\$ 191</u>	<u>\$ 68,947</u>	<u>\$ (29,344)</u>	<u>\$ (701)</u>	<u>\$39,093</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)*

	<b>Nine months ended</b>	
	<b>September 30,</b>	
	<b>2010</b>	<b>2009</b>
<b>Cash flows from operating activities:</b>		
Net income	\$ 271	\$ 1,362
Adjustments to reconcile net income to net cash provided by (used in) operating activities:		
Depreciation	418	369
Intangible asset amortization	63	-
Capitalized software amortization	452	354
Amortization of deferred financing costs	29	37
Change in fair value of contingent consideration	82	-
Stock-based compensation expense	633	769
Amortization of deferred profit on Emirates Simulation Academy, LLC contract	-	(136)
Equity loss on investment in Emirates Simulation Academy, LLC	-	466
(Gain)/loss on derivative instruments	631	(730)
Changes in other operating amounts net of acquired amounts:		
Contract receivables	2,340	(5,021)
Prepaid expenses and other assets	(2,134)	293
Accounts payable, accrued compensation and accrued expenses	6,493	2,129
Billings in excess of revenues earned	(23)	(1,144)
Accrued warranty reserves	242	89
Other liabilities	(496)	506
<b>Net cash provided by (used in) operating activities</b>	<b>9,001</b>	<b>(657)</b>
<b>Cash flows from investing activities:</b>		
Capital expenditures	(325)	(256)
Capitalized software development costs	(741)	(476)
Acquisitions, net of cash acquired	(542)	-
Proceeds from sale/leaseback transaction	377	-
Release (restriction) of cash as collateral	638	(626)
<b>Net cash used in investing activities</b>	<b>(593)</b>	<b>(1,358)</b>
<b>Cash flows from financing activities:</b>		
Net proceeds from issuance of common stock	74	16,013
Restriction of cash for credit facility collateral	-	(600)
Deferred financing costs	(82)	(20)
<b>Net cash provided by (used in) financing activities</b>	<b>(8)</b>	<b>15,393</b>
Effect of exchange rate changes on cash	151	65
<b>Net increase in cash and cash equivalents</b>	<b>8,551</b>	<b>13,443</b>
<b>Cash and cash equivalents at beginning of year</b>	<b>25,270</b>	<b>8,274</b>
<b>Cash and cash equivalents at end of period</b>	<b>\$ 33,821</b>	<b>\$ 21,717</b>
<b>Supplemental cash flow disclosures</b>		
Non-cash financing activities		
Issuance of 122,617 shares of common stock to acquire TAS Holdings Ltd.	\$ 683	\$ -

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, 2010 and 2009**  
*(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, 2009 filed with the Securities and Exchange Commission on March 11, 2010.

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.

We evaluated subsequent events through the time of filing this Quarterly Report on Form 10-Q. On October 1, 2010, the Company made their initial equity investment into the GSE-UNIS Simulation Technology Co., Ltd., a limited liability company, which is disclosed in footnote 16 *Subsequent Events*. No significant events occurred subsequent to the balance sheet date or prior to the filing of this report that would have a material impact on our consolidated financial statements.

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, contingent consideration liabilities and the recoverability of deferred tax assets. Actual results could differ from these estimates and those differences could be material.

*Revenue Recognition*

The majority of the Company's revenue is derived through the sale of uniquely designed systems containing hardware, software and other materials under fixed-price contracts. 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 contract profits 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 September 30, 2010.

**GSE SYSTEMS, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**For the Three and Nine Months ended September 30, 2010 and 2009**  
*(Unaudited)*

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 the PCS under 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.

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 is separated and allocated when certain criteria have been met.

Revenue from certain consulting or training contracts is 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		Nine months ended	
	September 30,		September 30,	
	2010	2009	2010	2009
Slovenské Elektrárne, a.s.	30.2%	18.9%	23.3%	12.8%
Emerson Process Management	9.9%	11.8%	11.8%	12.1%
Titan-2 Concern	4.5%	12.6%	6.2%	10.4%

## **2. Recently Issued Accounting Pronouncements**

In January 2010, the FASB issued Accounting Standards Update ("ASU") No. 2010-06, *Fair Value Measurements and Disclosures (Topic 820): Improving Disclosures about Fair Value Measurements*. This ASU requires: (1) disclosure of the amounts of significant transfers in and out of Level 1 and Level 2 fair value measurement categories and the reasons for the transfers; and (2) separate presentation of purchases, sales, issuances, and settlements in the reconciliation for fair value measurements using significant unobservable inputs (Level 3). In addition, ASU 2010-06 clarifies the requirements of the following existing disclosures set forth in the Codification Subtopic 820-10: (1) For purposes of reporting fair value measurement for each class of assets and liabilities, a reporting entity needs to use judgment in determining the appropriate classes of assets and liabilities; and (2) a reporting entity should provide disclosures about the valuation techniques and inputs used to measure fair

**GSE SYSTEMS, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**For the Three and Nine Months ended September 30, 2010 and 2009**  
*(Unaudited)*

value for both recurring and non-recurring fair value measurements. ASU 2010-06 is effective for interim and annual reporting periods beginning January 1, 2010, except for the disclosures about purchases, sales, issuances, and settlements in the roll forward of activity in Level 3 fair value measurements, which are effective for fiscal years beginning January 1, 2011, and for interim periods within those fiscal years. As ASU 2010-06 is disclosure-related only, the adoption of these changes had no impact on the financial statements.

In October 2009, the FASB issued ASU 2009-13, Revenue Recognition (Topic 605), *Multiple-Deliverable Arrangements*. ASU 2009-13 amends the guidance that in the absence of vendor-specific objective and third-party evidence for deliverables in multiple-deliverable arrangements, companies will be required to develop a best estimate of the selling price to separate deliverables and allocate arrangements consideration using the relative selling price method. ASU 2009-13 expands the disclosure requirements for multiple-deliverable revenue arrangements. The guidance will be effective for financial statements issued for fiscal years beginning after June 15, 2010. Early adoption is permitted. The Company is currently evaluating the potential impact on its financial statements.

**3. 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:

*(in thousands, except for share amounts)*

	Three months ended		Nine months ended	
	September 30,		September 30,	
	2010	2009	2010	2009
Numerator:				
Net income (loss)	\$ (548)	\$ 458	\$ 271	\$ 1,362
Denominator:				
Weighted-average shares outstanding for basic earnings per share	18,947,752	16,813,379	18,955,356	16,268,210
Effect of dilutive securities:				
Employee stock options and warrants	-	680,812	552,568	659,800
Adjusted weighted-average shares outstanding and assumed conversions for diluted earnings per share	18,947,752	17,494,191	19,507,924	16,928,010
Shares related to dilutive securities excluded because inclusion would be anti-dilutive	1,685,195	1,031,333	1,197,431	1,006,787

**GSE SYSTEMS, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**For the Three and Nine Months ended September 30, 2010 and 2009**  
*(Unaudited)*

**4. Acquisition**

Effective April 26, 2010, GSE Systems Inc., through its wholly owned subsidiary GSE Systems, Ltd. (GSE UK), completed the acquisition of TAS Holdings Ltd. (“TAS”), a provider of engineering consulting, specializing in electrical system design, instrumentation and controls engineering and automation engineering. GSE UK acquired 100% of the outstanding common stock of TAS. The purchase price for the common stock of TAS was equal to (i) the consolidated net asset value of TAS as of April 26, 2010, approximately \$600,000, and (ii) four times the adjusted consolidated pre-tax income of TAS for the year ended September 30, 2009, approximately \$1.7 million (the “Adjusted Profit Consideration”), for a total of approximately \$2.3 million in cash, GSE Systems, Inc. common stock and contingent consideration.

Approximately \$500,000 of the consolidated net asset value was paid on the closing date and the remaining \$100,000 of the consolidated net asset value was paid during the third quarter 2010. On the closing date, the TAS Shareholders were entitled to receive approximately \$689,000 (40% of the Adjusted Profit Consideration) payable in GSE common stock. Based upon the formula agreed to by the parties, the TAS Shareholders received 122,617 shares of GSE common stock post-closing.

On the first anniversary of the closing date, the TAS Shareholders are entitled to receive approximately \$517,000 (30% of the Adjusted Profit Consideration) (the “First Payment”). At the option of GSE, the First Payment will be made either (i) 100% in cash or (b) 50% in cash and 50% in GSE Systems, Inc. common stock. The value of the GSE common stock will be based upon the weighted average of the closing prices of the common stock on the NYSE Amex stock exchange for the five-trading day period ending two trading days prior to the first anniversary of the closing date. If net profit before taxes of TAS for the nine month period ending December 31, 2010 is less than approximately \$323,000, the First Payment will be reduced by an amount equal to four times the difference between (a) \$323,000 and (b) the actual net profit before taxes of TAS for the nine-month period ending December 31, 2010.

On the second anniversary of the closing date, the TAS Shareholders are entitled to receive approximately \$517,000 (30% of the Adjusted Profit Consideration) (the “Second Payment”). At the option of GSE, the Second Payment will be made either (i) 100% in cash or (ii) 50% in cash and 50% in GSE Systems, Inc. common stock. The value of the GSE common stock will be based upon the weighted average of the closing prices of the common stock on the NYSE Amex stock exchange for the five-trading day period ending two-trading days prior to the second anniversary of the closing date. If net profit before taxes of TAS for the twelve month period ending December 31, 2011 is less than approximately \$431,000, the Second Payment will be reduced by an amount equal to four times the difference between (a) \$431,000 and (b) the actual net profit before taxes of TAS for the twelve-month period ending December 31, 2011.

Of the \$2.3 million gross purchase price, the Company accrued \$740,000 of contingent consideration based on its estimate of the fair value of the potential contingent consideration payable to the TAS Shareholders on the first and second anniversaries of the closing date. The Company will estimate the fair value of the recorded amount of contingent consideration on a quarterly basis and any subsequent adjustments based on actual payments or revised estimates will be recognized in the selling, general, and administrative expenses of the consolidated statement of operations during the period of adjustment.

The estimated fair value of the purchase price recorded by the Company consisted of the following (in thousands):

**GSE SYSTEMS, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**For the Three and Nine Months ended September 30, 2010 and 2009**  
*(Unaudited)*

Cash and stock purchase price	\$	1,289
Estimated contingent consideration		740
Total estimated purchase price	\$	2,029

The Company's purchase price allocation for the net assets acquired was as follows (in thousands):

April 26, 2010  
*(unaudited)*

Cash	\$	68
Contract receivables		594
Prepaid expenses and other current assets		17
Property, plant and equipment, net		496
Intangible assets		735
Goodwill		865
Total assets		2,775
Accounts payable, accrued expenses and other liabilities		703
Billings in excess of costs and estimated earnings on uncompleted contracts		43
Total liabilities assumed		746
Net assets acquired	\$	2,029

The Company recorded intangible assets as a result of the acquisition, which included \$686,000 relating to contractual and non-contractual customer relationships. Contractual customer relationships acquired totaled \$208,000 and are being amortized over the remaining life of the contracts, 1-4 years. Non-contractual customer relationships acquired totaled \$478,000 and are being amortized over an estimated useful life of 10 years. The Company acquired \$35,000 of customer related intangible assets for contract backlog which are being amortized over 1 year subsequent to the acquisition, and \$14,000 related to trademarks, domain names and other marketing related intangibles which are being amortized over an estimated useful life of 3 years. The intangible assets and accrued contingent consideration for TAS were recorded at fair value.

TAS' results of operations are included in the consolidated financial statements for the period beginning April 26, 2010.

On the closing date, TAS entered into a sale and leaseback agreement with the TAS Shareholders. Under the terms of the agreement, the TAS Shareholders purchased the building occupied by TAS for approximately \$377,000 in cash, which was paid on the closing date, and TAS entered into a five-year lease for approximately \$31,000 per year, payable in equal monthly installments. TAS may terminate the lease after April 26, 2013 upon six months written notice.

**GSE SYSTEMS, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**For the Three and Nine Months ended September 30, 2010 and 2009**  
*(Unaudited)*

**Pro forma results.** Our consolidated financial statements include the operating results of TAS from the date of acquisition. For the three and nine months ended September 30, 2009 and 2010, the unaudited pro forma financial information below assumes that our material business acquisition of TAS occurred on January 1, 2009.

<i>(in thousands)</i>	<u>Three Months Ended September 30,</u>		<u>Nine Months Ended September 30,</u>	
<b>Pro forma financial information including the acquisition of TAS</b>	2010	2009	2010	2009
Revenue	\$ 11,904	\$ 11,171	\$ 36,054	\$ 31,749
Operating income (loss)	(240)	352	1,058	1,564
Net income (loss)	(445)	390	439	1,333
Earnings per common share — basic	<u>\$ (0.02)</u>	<u>\$ 0.02</u>	<u>\$ 0.02</u>	<u>\$ 0.08</u>
Earnings per common share — diluted	<u>\$ (0.02)</u>	<u>\$ 0.02</u>	<u>\$ 0.02</u>	<u>\$ 0.08</u>

**5. Contract Receivables**

Contract receivables represent balances due from a broad base of both domestic and international customers. All contract receivables are considered to be collectible within twelve months. Recoverable costs and accrued profit not billed represent costs incurred and associated profit accrued on contracts that will become billable upon future milestones or completion of contracts. The components of contract receivables are as follows:

<i>(in thousands)</i>	<u>September 30, 2010</u>	<u>December 31, 2009</u>
Billed receivables	\$ 5,200	\$ 8,183
Recoverable costs and accrued profit not billed	10,443	9,504
Allowance for doubtful accounts	(1,606)	(1,746)
Total contract receivables, net	<u>\$ 14,037</u>	<u>\$ 15,941</u>

Recoverable costs and accrued profit not billed totaled \$10.4 million and \$9.5 million as of September 30, 2010 and December 31, 2009, respectively. In October 2010, the Company invoiced \$2.5 million of the unbilled amounts; the balance of the September 30, 2010 unbilled amount is expected to be invoiced and collected within one year.

The following customers account for more than 10% of the Company's consolidated net billed receivables for the indicated periods:

	<u>September 30, 2010</u>	<u>December 31, 2009</u>
Genden Information System Co.	38.0%	0.0%
Westinghouse Electric Company	11.7%	0.0%
Sinopec Ningbo Engineering Co.	0.0%	12.7%

**GSE SYSTEMS, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**For the Three and Nine Months ended September 30, 2010 and 2009**  
*(Unaudited)*

**6. 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, typically three years.

Software development costs capitalized were \$266,000 and \$741,000 for the three and nine months ended September 30, 2010, respectively, and \$333,000 and \$476,000 for the three and nine months ended September 30, 2009, respectively. Total amortization expense was \$170,000 and \$452,000 for the three and nine months ended September 30, 2010, respectively, and \$131,000 and \$354,000 for the three and nine months ended September 30, 2009, respectively.

**7. 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. 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). The Company accounted for its investment in ESA using the equity method. For the three and nine months ended September 30, 2009, the Company recognized an equity loss of \$153,000 and \$466,000, respectively, on its investment in ESA which was recorded in other income (expense), net. In December 2009, the Company determined that its investment in ESA had been impaired and wrote off the remaining balance.

In 2006, GSE had received a contract totaling \$16.9 million from ESA to supply five simulators and an integrated training program. The contract was completed in 2008. In accordance with the equity method of accounting, the Company eliminated 10% of the profit from the ESA contract as the training simulators were assets that had 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. ESA assigned a four year life to the simulators and began to amortize them 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 income of \$45,000 and \$136,000 in the three and nine months ended September 30, 2009, respectively. In conjunction with the Company’s determination that its investment in ESA had been impaired, the remaining balance of the deferred profit was written off in December 2009.

The Company has provided a partial guarantee of 10% of ESA’s credit facility with Union National Bank (“UNB”); \$1.2 million was deposited into a restricted interest-bearing account with UNB in 2007. The interest earned on the restricted cash was part of the pledged deposit. In January 2010, UNB drew upon the guarantees of the three partners to pay off ESA’s delinquent principal and interest, withdrawing \$145,000 from GSE’s restricted cash account. UNB drew an additional \$17,000 in August 2010 related to delinquent principal and interest. GSE established a reserve against the entire restricted cash balance as of December 31, 2009.

At both September 30, 2010 and December 31, 2009, the Company had trade receivables from ESA totaling \$1.6 million. The Company established an allowance for doubtful accounts for the total ESA receivable balance at December 31, 2009.

**GSE SYSTEMS, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**For the Three and Nine Months ended September 30, 2010 and 2009**  
*(Unaudited)*

**8. Fair Value of Financial Instruments**

Accounting Standards Codification (“ASC”) 820, *Fair Value Measurements and Disclosures*, 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. ASC 820 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 ASC 820 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 September 30, 2010 and December 31, 2009 based upon the short-term nature of the assets and liabilities.

At September 30, 2010 and December 31, 2009, the Company had approximately \$25.2 million and \$150,000, respectively, deposited in a money market account with Bank of America (“BOA”). The money market account is insured up to the limits granted by the Federal Deposit Insurance Corporation (“FDIC”) for the applicable time period.

As of September 30, 2010, the Company was contingently liable for five standby letters of credit, one bank guarantee and three surety bonds totaling \$4.8 million which represent performance bonds on twelve contracts. The Company has deposited the full value of one standby letter of credit (\$179,000) in a certificate of deposit, which has been restricted in that the Company does not have access to these funds until the related letter of credit has expired. The cash has been recorded on the Company’s balance sheet at September 30, 2010 as restricted cash.

On May 5, 2009, one of the Company’s two credit agreements with BOA 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 September 30, 2010 as long-term restricted cash.

The following table presents assets and liabilities measured at fair value at September 30, 2010:

**GSE SYSTEMS, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**For the Three and Nine Months ended September 30, 2010 and 2009**  
*(Unaudited)*

<i>(in thousands)</i>	Level 1	Level 2	Level 3	Total
Money market fund	\$ 25,199	\$ -	\$ -	\$ 25,199
Certificates of deposit	779	-	-	779
Foreign exchange contracts	-	755	-	755
<b>Total assets</b>	<b>\$ 25,978</b>	<b>\$ 755</b>	<b>\$ -</b>	<b>\$ 26,733</b>
Foreign exchange contracts	\$ -	\$ (360)	\$ -	\$ (360)
<b>Total liabilities</b>	<b>\$ -</b>	<b>\$ (360)</b>	<b>\$ -</b>	<b>\$ (360)</b>

## 9. Derivative Instruments

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 September 30, 2010, the Company had foreign exchange contracts outstanding of approximately 1.6 million Pounds Sterling, 11.7 million Euro, and 968 million Japanese Yen at fixed rates. The contracts expire on various dates through February 2014. At December 31, 2009, the Company had contracts outstanding of approximately 2 million Pounds Sterling, 3 million Euro and 759 million Japanese Yen at fixed rates. The Company had not designated the foreign exchange contracts as hedges and had recorded the estimated fair value of the contracts in the consolidated balance sheet as follows:

<i>(in thousands)</i>	September 30, 2010	December 31, 2009
Asset derivatives		
Prepaid expenses and other current assets	\$ 416	\$ 515
Other assets	339	396
	<u>755</u>	<u>911</u>
Liability derivatives		
Other current liabilities	(182)	(34)
Other liabilities	(178)	(65)
	<u>(360)</u>	<u>(99)</u>
<b>Net fair value</b>	<b>\$ 395</b>	<b>\$ 812</b>

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.

**GSE SYSTEMS, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**For the Three and Nine Months ended September 30, 2010 and 2009**  
*(Unaudited)*

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 nine months ended September 30, 2010 and 2009, the Company recognized a net gain (loss) on its derivative instruments as outlined below:

	Three months ended September 30,		Nine months ended September 30,	
<i>(in thousands)</i>	2010	2009	2010	2009
Foreign exchange contracts- change in fair value	\$ (412)	\$ 705	\$ (470)	\$ 806
Remeasurement of related contract receivables and billings in excess of revenue earned	459	(182)	(161)	(76)
Net gain (loss) on derivatives	\$ 47	\$ 523	\$ (631)	\$ 730

## 10. Stock-Based Compensation

The Company recognizes 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 \$210,000 and \$228,000 of pre-tax stock-based compensation expense for the three months ended September 30, 2010 and 2009, respectively, under the fair value method and recognized \$633,000 and \$769,000 of pre-tax stock-based compensation expense for the nine months ended September 30, 2010 and 2009, respectively. In the nine months ended September 30, 2010, the Company granted a total of 60,000 stock options to its six non-employee directors. A total of 45,000 employee stock options were exercised in the nine months ended September 30, 2010.

## 11. Long-term Debt

At September 30, 2010 and December 31, 2009, the Company had no long-term debt.

### *Lines of Credit*

The Company has two separate revolving credit agreements for revolving lines of credit with Bank of America, N.A. ("BOA") which expire on May 31, 2012. 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 which was in the principal amount of up to \$3.5 million was amended on March 29, 2010 to increase the principal amount to \$5.0 million. This revolving line of credit 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

**GSE SYSTEMS, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**For the Three and Nine Months ended September 30, 2010 and 2009**  
*(Unaudited)*

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 is in the principal amount of up 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. The credit agreements contain certain restrictive covenants regarding future acquisitions, incurrence of debt and the payment of dividends. In addition, 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 September 30, 2010, the Company had not paid any interest or principal payments related to any borrowings for over one year. As such the debt service coverage ratio is not applicable at September 30, 2010. At September 30, 2010, the Company was in compliance with the financial covenants as shown below:

	Covenant	As of Sept. 30, 2010
Tangible net worth	Must Exceed \$15.0 million	\$33.5 million
Funded debt to EBITDA ratio	Not to Exceed 2.50 : 1.00	1.64 : 1.00

At September 30, 2010, the Company's available borrowing base under the two lines of credit was \$4.1 million.

## 12. 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, 2009	\$	1,273
Warranty provision		472
Warranty claims		(251)
Currency adjustment		21
Balance at September 30, 2010	<u>\$</u>	<u>1,515</u>

## 13. Letters of Credit and Performance Bonds

As of September 30, 2010, the Company was contingently liable for five standby letters of credit, one bank guarantee, and three surety bonds totaling approximately \$4.8 million. The letters of credit, bank guarantee and surety bonds were issued either as performance on nine contracts. One of the standby letters of credit and the bank guarantee have been cash collateralized; four of the standby letters of credit were collateralized by the Company's line of credit.

**GSE SYSTEMS, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**For the Three and Nine Months ended September 30, 2010 and 2009**  
*(Unaudited)*

**14. 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 September 30, 2010, 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 2010 and to pay income taxes in Sweden, China and the United Kingdom. In addition, the Company will pay foreign income tax withholding on several non-U.S. contracts. In the first quarter 2010, the Company reversed a \$400,000 accrual for foreign income tax withholding on a contract that it completed in China. The Company has a full valuation allowance on its U.S. net deferred tax assets at September 30, 2010.

**15. Common Stock**

On September 4, 2009, the Company raised \$15.0 million through the sale of 2.5 million shares of its common stock, \$.01 par value per share. The shares were sold under a shelf registration statement which was declared effective by the Securities and Exchange Commission on August 21, 2009. On September 23, 2009, the Company raised an additional \$2,250,000 when the Company's underwriter exercised an over-allotment option in full to purchase an additional 375,000 shares of the Company's common stock at the public offering price of \$6.00 per share. The aggregate net proceeds received by the Company from the two transactions was approximately \$15.9 million. The Company paid the underwriter a fee in the amount of 6% of the gross proceeds received by the Company from the offering (\$1,035,000) and paid \$323,000 in other transaction fees.

**16. Subsequent Events**

On October 1, 2010, the Company contributed \$587,000 in cash, as its initial investment to the Chinese joint venture, GSE-UNIS Simulation Technology Co., Ltd. ("GSE-UNIS"), a limited liability company. GSE-UNIS is 51% owned by Beijing UNIS Investment Co., Ltd. ("UNIS") and 49% owned by GSE. GSE-UNIS received their formal business license from the Chinese government on July 28, 2010 but has not yet commenced operations as of the filing of this report. In September 2010, UNIS contributed approximately \$600,000 in cash as its initial investment to GSE-UNIS. UNIS will contribute approximately \$900,000 additionally to the joint venture as well as various software platforms and tools for fossil fuel power plant simulation; GSE will also contribute approximately \$800,000 additionally and a royalty free license to use various GSE technology. The joint venture will be accounted for on the equity method of accounting as a single line entry on the Company's Statement of Operations indicating its share of GSE-UNIS's profit or loss.

**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

**GSE SYSTEMS, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**For the Three and Nine Months ended September 30, 2010 and 2009**  
*(Unaudited)*

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; TAS Holdings Ltd, a UK limited liability company; the company has a 49% minority interest in GSE-UNIS Simulation Technology Co., Ltd. a Chinese limited liability company, service contracts in both the fossil fueled as well as nuclear power markets in the Chinese market, 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 2009 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.

**GSE SYSTEMS, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**For the Three and Nine Months ended September 30, 2010 and 2009**  
*(Unaudited)*

Government and industry sources and trade journals report that up to 252 new nuclear plants could be built worldwide over the next 20 years. Currently, there are 60 plants in 15 countries under construction. In the U.S. some 16 companies and consortia are considering building 30 nuclear power plants. The U.S. Nuclear Regulatory Commission is actively reviewing 13 combined construction and operating license applications from 12 companies and consortia for 22 nuclear power reactors. 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 February 2010, President Obama announced that the federal government would provide \$8.33 billion in loan guarantees for a pair of nuclear reactors to be built in Georgia at the Alvin W. Vogtle Electric Generating Plant by Georgia Power, a subsidiary of Southern Company, and three other partners. Georgia Power received an early site permit from the U.S. Nuclear Regulatory Commission for the two additional units in 2009 and preliminary site work has begun. These are the first nuclear reactors to be built in the U.S. in over 30 years. Westinghouse Electric Company LLC (“Westinghouse”) and its consortium team member, The Shaw Group, are under contract to provide two Westinghouse AP1000™ nuclear power plants at the Vogtle site. The Company entered into an agreement with Westinghouse in 2005 in which GSE became Westinghouse’s preferred vendor for the development of simulators for their AP1000 reactor design. In July 2010, the Company received a contract from Westinghouse for the Vogtle Units 3 and 4 plant training simulator, and in August 2010, received a second contract from Westinghouse for the training simulator for the two new nuclear units being built by South Carolina Electric & Gas Company, a subsidiary of SCANA Corporation, and Santee Cooper, a state-owned electric and water utility in South Carolina, at its V.C. Summer Nuclear Station in South Carolina.

In 2009, the Company introduced its VPanel™ interactive visual training simulator. The advantage of the VPanel simulator is its scalability and ease of configuration for both team and individual training, plant specific or cross training. The VPanel allows customers to utilize their existing simulator load while bringing many full scope simulator capabilities directly into the classroom for a fraction of the cost. The Company’s “Operator Jump Start” training program, which utilizes the VPanel simulator, helps customers screen and train new operator candidates. This training program is designed to provide essential knowledge and skills to potential nuclear plant operators and to determine if candidates have the ability to successfully complete the customer’s own control operator training programs. The program includes instruction on fundamental sciences (including GFES), plant systems and operations.

The Company continues to develop its concept of integrating simulation with broader training programs and educational initiatives giving customers a turnkey alternative to traditional on-site operator and maintenance training. The Company’s nuclear power plant operator training program with Georgia Power, a subsidiary of Southern Company, continues in 2010 with three classes scheduled during the year. The scope of the training program includes modules on nuclear plant fundamentals, introduction to nuclear plant systems, human performance principles and team building, and an introduction to integrated nuclear plant operations.

On April 26, 2010, the Company completed the acquisition of TAS Holdings Ltd (“TAS”), acquiring 100% ownership in TAS for a purchase price of approximately \$2.3 million in cash, GSE Systems, Inc. common stock and contingent consideration. TAS, located in Stockton-on-Tees in the United Kingdom, provides engineering consulting, specializing in electrical system design, instrumentation and controls engineering and automation engineering. TAS also engages in the computer modeling of major electrical distribution systems containing variable sources of electric generation operating at different utilization voltages. The majority of TAS’s customers reside in the petroleum refining, oil and gas, chemical and petrochemical industries. The acquisition of TAS was strategically important for the Company for the following reasons. First, TAS’s expertise in electrical distribution system modeling with variable sources of power, such as renewable energy generation, will help GSE extend its capability into the modeling and simulation of electrical distribution and grid systems. Secondly, TAS routinely encounters training opportunities that coincide with their engineering and consulting projects thereby creating cross selling opportunities for GSE’s growing training organization. Third, the acquisition expands GSE’s

**GSE SYSTEMS, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**For the Three and Nine Months ended September 30, 2010 and 2009**  
*(Unaudited)*

presence in the UK through access to existing TAS clients such as British Petroleum and ConocoPhillips. Lastly, the acquisition of TAS, coupled with GSE's ongoing training activities at the University of Strathclyde, will enhance the Company's ability to support the UK's planned construction of eight new nuclear plants in the coming years through both our nuclear simulation and training businesses which are pursuing opportunities in those areas.

On July 28, 2010, the Company received a formal business license from the Chinese government for the Chinese joint venture, GSE-UNIS Simulation Technology Co., Ltd. ("GSE-UNIS"), a limited liability company. As of September 30, 2010, the joint-venture has yet to commence operations. GSE-UNIS is 51% owned by Beijing UNIS Investment Co., Ltd. ("UNIS") and 49% owned by GSE. On October 1, 2010, the Company contributed \$587,000 in cash, as its initial investment to GSE-UNIS. In September 2010, UNIS contributed approximately \$600,000 in cash as its initial investment to GSE-UNIS. Additionally, UNIS will contribute approximately \$900,000, to the joint venture as well as various software platforms and tools for fossil fuel power plant simulation; GSE will contribute approximately \$800,000, additionally and a royalty free license to use various GSE technology. The largest shareholder of UNIS is Tsinghua University, a prestigious technology university in China. Established in 1988, UNIS has been acting as an incubator company transferring new technologies from the University's research laboratory to the commercial sector. The origin of its simulation platform can be traced back to 1984, a national award-winning technology developed by Tsinghua University. Over the past 20 years, hundreds of simulators have been built based upon this technology for approximately 200 customers in the fossil fueled electric power industry, accounting for about 50% of the total Chinese fossil fueled power market. Its solid customer base and strong relationships with the academic and government sector will help GSE-UNIS service contracts in both the fossil fueled as well as nuclear power markets in the Chinese market.

## 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:

*(in thousands)*

	Three months ended September 30,				Nine months ended September 30,			
	2010	%	2009	%	2010	%	2009	%
Contract revenue	\$ 11,904	100.0 %	\$ 10,217	100.0 %	\$ 34,886	100.0 %	\$ 28,995	100.0 %
Cost of revenue	9,503	79.8 %	7,662	75.0 %	25,691	73.6 %	21,398	73.8 %
Gross profit	2,401	20.2 %	2,555	25.0 %	9,195	26.4 %	7,597	26.2 %
Operating expenses:								
Selling, general and administrative	2,545	21.4 %	2,000	19.6 %	7,837	22.4 %	5,611	19.4 %
Depreciation	146	1.2 %	127	1.2 %	418	1.2 %	369	1.3 %
Amortization of definite-lived intangible assets	38	0.3 %	-	0.0 %	63	0.2 %	-	0.0 %
Total operating expenses	2,729	22.9 %	2,127	20.8 %	8,318	23.8 %	5,980	20.6 %
Operating income (loss)	(328)	(2.8)%	428	4.2 %	877	2.5 %	1,617	5.6 %
Interest income, net	29	0.3 %	16	0.1 %	48	0.1 %	50	0.2 %
Gain (loss) on derivative instruments	47	0.4 %	523	5.1 %	(631)	(1.8)%	730	2.5 %
Other income (expense), net	27	0.2 %	(97)	(0.9)%	65	0.2 %	(318)	(1.1)%
Income (loss) before income taxes	(225)	(1.9)%	870	8.5 %	359	1.0 %	2,079	7.2 %
Provision for income taxes	323	2.7 %	412	4.0 %	88	0.2 %	717	2.5 %
Net income (loss)	\$ (548)	(4.6)%	\$ 458	4.5 %	\$ 271	0.8 %	\$ 1,362	4.7 %

**GSE SYSTEMS, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**For the Three and Nine Months ended September 30, 2010 and 2009**  
*(Unaudited)*

**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, 2009 is included in Note 2 to the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2009. 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 2009 Annual Report on Form 10-K for the fiscal year ended December 31, 2009.

**Results of Operations - Three and Nine Months ended September 30, 2010 versus Three and Nine Months ended September 30, 2009**

*Contract Revenue.* Total contract revenue for the quarter ended September 30, 2010 totaled \$11.9 million, which was 16.5% higher than the \$10.2 million total revenue for the quarter ended September 30, 2009. For the nine months ended September 30, 2010, contract revenue totaled \$34.9 million, a 20.3% increase from the \$29.0 million for the nine months ended September 30, 2009. The Company recorded total orders of \$38.2 million in the nine months ended September 30, 2010 versus \$47.3 million in the nine months ended September 30, 2009. 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 included approximately \$12.0 million for hardware, the largest portion being a digital control system from Siemens that the customer requested be a part of the contract in addition to approximately \$6.0 million related specifically to the simulator. In the second and third quarters of 2010, the Company received three change orders totaling \$5.4 million for this contract which included approximately \$4.4 million for a revision to the Siemens digital control system. 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 nine months ended September 30, 2010, the Company recognized \$3.6 million and \$8.1 million, respectively, of contract revenue on this project using the percentage-of-completion method, which accounted for 30.2% and 23.3%, respectively, of the Company's consolidated revenue. For the three and nine months ended September 30, 2009, the Company recognized \$1.9 million and \$3.7 million, respectively, of contract revenue on this project using the percentage-of-completion method, which accounted for 18.9% and 12.8%, respectively, of the Company's consolidated revenue. On April 26, 2010, the Company completed its acquisition of TAS Holdings Ltd. For the three months ended September 30, 2010 and for the period commencing on the closing date of the acquisition and ending on September 30, 2010, TAS generated revenues of \$866,000 and \$1.5 million, respectively. At September 30, 2010, the Company's backlog was \$59.1 million, of which \$10.2 million related to the Slovak nuclear power plant simulator contract.

*Gross Profit.* Gross profit totaled \$2.4 million for the quarter ended September 30, 2010 versus \$2.6 million for the same quarter in 2009. As a percentage of revenue, gross profit decreased from 25.0% for the three months ended September 30, 2009 to 20.2% for the three months ended September 30, 2010. For the nine months ended September 30, 2010, gross profit increased \$1.6 million from the same period in 2009 to \$9.2 million, and

**GSE SYSTEMS, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**For the Three and Nine Months ended September 30, 2010 and 2009**  
*(Unaudited)*

as a percentage of revenue, gross profit increased from 26.2% to 26.4%. The Company's subcontract with Siemens to provide a digital control system for the Slovak nuclear power plant simulator is denominated in Euro. During the three and nine months ended September 30, 2010, the Company recognized an unrealized currency loss of \$506,000 and an unrealized currency gain of \$105,000, respectively, on the accrued costs of this subcontract which was recorded in cost of revenue. The Company recognized an unrealized currency gain of \$47,000 on the accrued costs of this subcontract for both the three and nine months ended September 30, 2009.

*Selling, General and Administrative Expenses.* Selling, general and administrative ("SG&A") expenses totaled \$2.5 million in the quarter ended September 30, 2010, a 27.3% increase from the \$2.0 million for the same period in 2009. For the nine months ended September 30, 2010 and 2009, SG&A expenses totaled \$7.8 million and \$5.6 million, respectively. The spending variances reflect the following:

- ◆ Business development and marketing costs increased from \$801,000 in the third quarter 2009 to \$1.1 million in the third quarter of 2010 and increased from \$2.3 million to \$3.1 million for the nine months ended September 30, 2009 and 2010, respectively. Bidding and proposal costs, which are the costs of operations personnel in assisting with the preparation of contract proposals, increased by \$56,000 in the third quarter 2010 to \$350,000 as compared to the third quarter 2009, and increased by \$288,000 in the nine months ended September 30, 2010 to \$1.1 million as compared to the nine months ended September 30, 2009. TAS, which was acquired on April 26, 2010, incurred \$69,000 of business development expenses for the three months ended September 30, 2010 and incurred \$104,000 for the period commencing on the date of acquisition and ending on September 30, 2010. The Company also hired a business development manager in the United Kingdom during the second quarter 2010. During 2009, the Company hired business development managers for both its process simulation business (second quarter 2009) and its education and training business (third quarter 2009) and a marketing specialist for the nuclear simulation business (fourth quarter 2009). Additionally, the Company saw an increase in business development and travel expenses related to hosting the Company's September 2010 Simworld user's conference in Stockholm, Sweden. The Company did not host a Simworld conference in 2009.
- ◆ The Company's general and administrative expenses increased from \$1.0 million in the third quarter 2009 to \$1.3 million in the third quarter 2010, and increased from \$3.1 million for the nine months ended September 30, 2009 to \$4.3 million for the nine months ended September 30, 2010. The increases are due to the following:
  - TAS, which was acquired on April 26, 2010, incurred \$161,000 of G&A expenses for the three months ended September 30, 2010 and incurred \$273,000 for the period commencing on the closing date of the acquisition and ending on September 30, 2010.
  - The Company incurred approximately \$51,000 and \$274,000 of expenses related to its acquisition efforts in the three and nine months ended September 30, 2010, respectively. These expenses were composed mainly of legal, travel and audit expenses.
  - The Company's Chief Operating Officer, Mr. Eberle started with the Company on June 1, 2010. The Company's Chief Executive Officer, Mr. Moran, retired from the company on November 1, 2010, and Mr. Eberle was promoted to Chief Executive Officer.
  - The Company recognized approximately \$62,000 of foreign currency translation gains for the three months ended September 30, 2010 and \$184,000 of foreign currency translation losses for the nine months ended September 30, 2010. The losses were mainly related to the Company's Bank of America Euro denominated operating account, intercompany receivable/payable accounts, and a euro-denominated value added tax receivable. For the three months and nine months ended September 30, 2009, the Company had recognized foreign currency translation gains of \$98,000 and \$163,000, respectively.

**GSE SYSTEMS, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**For the Three and Nine Months ended September 30, 2010 and 2009**  
*(Unaudited)*

- ◆ Gross spending on software product development (“development”) totaled \$428,000 in the quarter ended September 30, 2010 as compared to \$484,000 in the same period of 2009. For the three months ended September 30, 2010, the Company expensed \$162,000 and capitalized \$266,000 of its development spending while in the three months ended September 30, 2009, the Company expensed \$151,000 and capitalized \$333,000 of its development spending. For the nine months ended September 30, 2010, gross development spending totaled \$1.2 million versus \$724,000 in the same period of 2009. The Company expensed \$473,000 and capitalized \$741,000 of its development spending in the nine months ended September 30, 2010 and expensed \$248,000 and capitalized \$476,000 of its development spending in the same period of 2009. The Company’s capitalized software development expenditures in 2010 were mainly related to the customization of RELAP5-HD software (which simulates transient fluid dynamics, neutronics and heat transfer in nuclear power plants) to run on the Company’s real-time executive software; the replacement of the current Graphic User Interface of SimSuite Pro with JADE Designer; and feature enhancements to Jtopmeret, a model tool that generates two phase network dynamic models. The Company anticipates that its total gross development spending in 2010 will approximate \$1.6 million.

*Depreciation.* Depreciation expense totaled \$146,000 and \$127,000 during the quarters ended September 30, 2010 and 2009, respectively. For the nine months ended September 30, 2010 and 2009, depreciation expense totaled \$418,000 and \$369,000, respectively. The increase is a result of the Company’s capital purchases of computers for new hires and upgraded servers.

*Amortization of definite-lived intangible assets.* Amortization expense related to definite-lived intangible assets totaled \$38,000 and \$0 for the quarters ended September 30, 2010 and 2009, respectively. For the nine months ended September 30, 2010 and 2009, amortization expense related to definite-lived intangible assets totaled \$63,000 and \$0, respectively. The increase in amortization expense related to definite-lived intangibles is a direct result of the TAS acquisition in the second quarter of 2010.

*Operating Income (loss).* The Company had an operating loss of \$328,000 (2.8% of revenue) in the third quarter 2010, as compared with operating income of \$428,000 (4.2% of revenue) for the same period in 2009. For the nine months ended September 30, 2010 and 2009, the Company had operating income of \$877,000 (2.5% of revenue) and operating income of \$1.6 million (5.6% of revenue), respectively. The variances were due to the factors outlined above.

*Interest Income, Net.* Net interest income totaled \$29,000 in the quarter ended September 30, 2010 versus net interest income of \$16,000 in the quarter ended September 30, 2009. For the nine months ended September 30, 2010 and 2009, net interest income totaled \$48,000 and \$50,000, respectively.

The Company has two separate revolving credit agreements for revolving lines of credit with BOA which expire on May 31, 2012. The first line of credit is in the principal amount of up to \$5.0 million and is guaranteed by the U.S. Export-Import Bank. The second 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, although the lines are being utilized to collateralize letters of credit which have been issued as performance bonds.

The deferred financing costs incurred when the BOA lines of credit were first established in 2008 were amortized over the original two-year term of the lines of credit. Amortization began in April 2008 and ended March 31, 2010. The deferred financing costs incurred in conjunction with the extension of the BOA lines of credit until May 31, 2012 are being amortized over the 25 month period of the lines of credit beginning as of April 1, 2010. Amortization totaled \$10,000 and \$29,000 for the three and nine months ended September 30, 2010, respectively, and \$10,000 and \$37,000 for the three and nine months ended September 30, 2009.

**GSE SYSTEMS, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**For the Three and Nine Months ended September 30, 2010 and 2009**  
*(Unaudited)*

At September 30, 2010 and 2009, the Company had approximately \$179,000 and \$2.9 million, respectively, of cash in Certificates of Deposit with BOA that were being used as collateral for various performance bonds. The Company recorded interest income of \$3,000 and \$15,000 from the Certificates of Deposit in the three and nine months ended September 30, 2010, respectively, versus \$22,000 and \$50,000 of interest income in the three and nine months ended September 30, 2009, respectively.

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 interest earned on the restricted cash is part of the pledged deposit. ESA was delinquent in paying both principal and interest and in January 2010, UNB drew upon GSE's guarantee. GSE established a full reserve against the restricted cash balance at December 31, 2009 and accordingly, stopped accruing interest income. The Company recorded interest income of \$2,000 and \$22,000 in the three and nine months ended September 30, 2009 respectively.

Interest income earned on short-term investments of the Company's operating cash totaled \$34,000 for the three months ended September 30, 2010 versus \$0 for the three months ended September 30, 2009 and totaled \$59,000 for the nine months ended September 30, 2010 versus \$4,000 for the nine months ended September 30, 2009. The Company's money market account at September 30, 2010 had a balance of \$25.2 million versus \$0 at September 30, 2009.

*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 September 30, 2010, the Company had foreign exchange contracts outstanding of approximately 1.6 million Pounds Sterling, 11.7 million Euro and 968 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 \$412,000 for the three months ended September 30, 2010 and a loss of \$470,000 for the nine months ended September 30, 2010.

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 nine months ended September 30, 2010, the Company recognized a gain of \$459,000 and a loss of \$161,000, respectively, from the remeasurement of such contract receivables and billings in excess of revenue earned.

At September 30, 2009, the Company had contracts outstanding of approximately 2.0 million Euro, 3.1 million Pounds Sterling and 870 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 gain on the change in the estimated fair value of the contracts of \$705,000 for the three months ended September 30, 2009 and a gain of \$806,000 for the nine months ended September 30, 2009. For the three and nine months ended September 30, 2009, the Company recognized a loss of \$182,000 and a loss of \$76,000, respectively, from the remeasurement of foreign denominated contract receivables and billings in excess of revenue earned.

*Other income (expense), net.* For the three and nine months ended September 30, 2010, other income, net was \$27,000 and \$65,000, respectively. For the three and nine months ended September 30, 2009, other expense, net was \$97,000 and \$318,000, respectively. The major components of other income (expense), net included the following items:

**GSE SYSTEMS, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**For the Three and Nine Months ended September 30, 2010 and 2009**  
*(Unaudited)*

- ◆ For the three and nine months ended September 30, 2009, the Company recognized a \$45,000 and \$136,000 gain on the amortization of the deferred profit of the ESA training simulators. The Company also recognized a \$153,000 and \$466,000 equity loss, respectively, on its investment in ESA over the same period. On December 31, 2009, the Company wrote off the remaining balance of its investment in ESA and the remaining deferred profit in conjunction with its determination that its investment in ESA had been impaired.
- ◆ The Company had other miscellaneous income for the three and nine months ended September 30, 2010 of \$27,000 and \$65,000, respectively and \$11,000 and \$12,000 for the three and nine months ended September 30, 2009, 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 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 September 30, 2010, 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 2010 and to pay income taxes in Sweden, China, and the United Kingdom. In addition, the Company will pay foreign income tax withholding on several non-U.S. contracts. In the first quarter 2010, the Company reversed a \$400,000 accrual for foreign income tax withholding on a contract that it completed in China. The Company has a full valuation allowance on its U.S. net deferred tax assets at September 30, 2010.

### **Liquidity and Capital Resources**

As of September 30, 2010, the Company's cash and cash equivalents totaled \$33.8 million compared to \$25.3 million at December 31, 2009.

*Cash provided by (used in) operating activities.* For the nine months ended September 30, 2010, net cash provided by operations totaled \$9.0 million. Significant changes in the Company's assets and liabilities in the nine months ended September 30, 2010 included:

- ◆ A \$2.3 million decrease in the Company's contract receivables. The Company's trade receivables, net of allowance for doubtful accounts, decreased from \$6.4 million at December 31, 2009 to \$3.6 million at September 30, 2010 while the Company's unbilled receivables increased by \$939,000 to \$10.4 million at September 30, 2010. At September 30, 2010, trade receivables outstanding for more than 90 days totaled \$300,000 versus \$1.4 million at December 31, 2009. The increase in the Company's unbilled receivables balance is due to the timing of contracted billing milestones of the Company's current projects.
- ◆ A \$2.1 million increase in the Company's other assets. The increase is primarily due to a \$1.3 million increase in the value added tax (VAT) receivable. This amount relates to vendor invoices received by GSE, which included VAT. In these instances GSE is entitled to reclaim the VAT and expects collection of this amount during the fourth quarter 2010.
- ◆ A \$6.5 million increase in accounts payable, accrued compensation and accrued expenses. The Company's accounts payable and accrued liabilities have increased primarily due to two invoices

**GSE SYSTEMS, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**For the Three and Nine Months ended September 30, 2010 and 2009**  
*(Unaudited)*

received from Siemens for \$7.8 million. These invoices were for milestones completed on the digital control system of our Slovak utility project. The Company paid these invoices in October 2010.

For the nine months ended September 30, 2009, net cash used in operations totaled \$657,000. Significant changes in the Company's assets and liabilities in the nine months ended September 30, 2009 included:

- ◆ A \$5.0 million increase in the Company's contract receivables. The Company's unbilled receivables increased by \$5.2 million to \$8.8 million at September 30, 2009. The increase in the unbilled receivables is due to the timing of contracted billing milestones of the Company's current projects. In October 2009, the Company invoiced \$2.2 million of the unbilled amounts; the balance of the unbilled amounts is expected to be invoiced and collected within one year. At September 30, 2009, trade receivables outstanding for more than 90 days totaled \$1.9 million. Included in the over 90 day balance at September 30, 2009 was \$1.6 million due from ESA. At December 31, 2009 the Company established an allowance for doubtful accounts for the total ESA receivable balance.
- ◆ A \$2.1 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.
- ◆ A \$1.1 million reduction in billings in excess of revenue earned. The reduction is due to the timing of contracted billing milestones of the Company's current projects.

*Cash used in investing activities.* Net cash used in investing activities totaled \$593,000 for the nine months ended September 30, 2010. Capital expenditures totaled \$325,000 and capitalized software development costs totaled \$741,000. Cash used as collateral for standby letters of credit decreased by \$638,000.

Effective April 26, 2010, GSE Systems Inc., through its wholly owned subsidiary GSE Systems, Ltd. (GSE UK), completed the acquisition of TAS Holdings Ltd. The purchase price totaled approximately \$2.3 million with approximately \$500,000 paid in cash at closing, \$689,000 paid post-closing in GSE common stock, approximately \$100,000 was paid during September 2010, and the balance deferred until the first and second anniversary of the closing date. TAS had approximately \$68,000 cash on their balance sheet as of the acquisition date.

On the closing date, TAS entered into a sale and leaseback agreement with the former TAS shareholders. Under the terms of the agreement, the TAS shareholders purchased the building occupied by TAS for approximately \$377,000 in cash and TAS entered into a five-year lease for approximately \$31,000 per year, payable in equal monthly installments. TAS may terminate the lease after April 26, 2013 upon six months' written notice.

Net cash used in investing activities totaled \$1.4 million for the nine months ended September 30, 2009. Capital expenditures totaled \$256,000 and capitalized software development costs totaled \$476,000. The Company deposited \$566,000 in a restricted bank account as collateral for foreign currency contracts and increased the cash used as collateral for stand-by letters of credit and bank guarantees by \$60,000.

*Cash provided by (used in) financing activities.* For the nine months ended September 30, 2010, net cash used in financing activities totaled \$8,000. The Company received \$74,000 from the issuance of common stock in the nine months ended September 30, 2010. In the nine months ended September 30, 2010, the Company spent \$82,000 on deferred financing costs in conjunction with the Bank of America lines of credit.

**GSE SYSTEMS, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**For the Three and Nine Months ended September 30, 2010 and 2009**  
*(Unaudited)*

At September 30, 2010, the Company had cash of \$33.8 million and another \$4.1 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.

For the nine months ended September 30, 2009, net cash provided by financing activities totaled \$15.4 million. On September 4, 2009, the Company raised \$15.0 million through the sale of 2.5 million shares of its common stock, \$.01 par value per share. The shares were sold under a shelf registration statement which was declared effective by the Securities and Exchange Commission on August 21, 2009. On September 23, 2009, the Company raised an additional \$2,250,000 when the Company's underwriter exercised an over-allotment option in full to purchase an additional 375,000 shares of the Company's common stock at the public offering price of \$6.00 per share. The aggregate net proceeds received by the Company from the two transactions was approximately \$15.9 million. The Company received \$121,000 from the issuance of common stock for employee stock options and warrants exercised in the nine months ended September 30, 2009. 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. In the nine months ended September 30, 2009, the Company spent \$20,000 on deferred financing costs in conjunction with the Bank of America lines of credit.

*Credit Facilities*

The Company has two separate revolving credit agreements for revolving lines of credit with BOA which expire on May 31, 2012. 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 which was in the principal amount of up to \$3.5 million was amended on March 29, 2010 to increase the principal amount to \$5.0 million. This revolving line of credit 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 is in the principal amount of up 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. The credit agreements contain certain restrictive covenants regarding future acquisitions, incurrence of debt and the payment of dividends. In addition, 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 September 30, 2010, the Company had not paid any interest or principal payments related to any borrowings for over one year. As such the debt service coverage ratio is not applicable at September 30, 2010. At September 30, 2010, the Company was in compliance with all of these financial covenants as shown below:

	Covenant	As of Sept. 30, 2010
Tangible net worth	Must Exceed \$15.0 million	\$33.5 million
Funded debt to EBITDA ratio	Not to Exceed 2.50 : 1.00	1.64 : 1.00

**GSE SYSTEMS, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**For the Three and Nine Months ended September 30, 2010 and 2009**  
*(Unaudited)*

In addition, the credit agreements contain certain restrictive covenants regarding future acquisitions, incurrence of debt and the payment of dividends. At September 30, 2010, the Company's available borrowing base under the two lines of credit was \$4.1 million.

**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 September 30, 2010, the Company had foreign exchange contracts outstanding of approximately 1.6 million Pounds Sterling, 11.7 million Euro and 968 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 \$412,000 for the three months ended September 30, 2010 and a loss of \$470,000 for the nine months ended September 30, 2010. A 10% fluctuation in the foreign currency exchange rates up or down as of September 30, 2010 would have increased/decreased the change in estimated fair value of the contracts by \$39,000.

As of September 30, 2009, the Company had foreign exchange contracts outstanding of approximately 2.0 million Pounds Sterling, 3.1 million Euro and 870 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 gain on the change in the estimated fair value of the contracts of \$705,000 for the three months ended September 30, 2009 and a gain of \$806,000 for the nine months ended September 30, 2009. A 10% fluctuation in the foreign currency exchange rates up or down as of September 30, 2009 would have increased/decreased the change in estimated fair value of the contracts by \$81,000.

The Company is also subject to market risk related to the interest rate on its existing lines of credit. However, during the first nine months of 2010, 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

**GSE SYSTEMS, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**For the Three and Nine Months ended September 30, 2010 and 2009**  
*(Unaudited)*

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 September 30, 2010 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 September 30, 2010 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, 2009.

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

None

**GSE SYSTEMS, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**For the Three and Nine Months ended September 30, 2010 and 2009**  
*(Unaudited)*

**Item 3. Defaults Upon Senior Securities**

None

**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.

**GSE SYSTEMS, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**For the Three and Nine Months ended September 30, 2010 and 2009**  
*(Unaudited)*

**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 9, 2010

GSE SYSTEMS, INC.

/S/ JAMES A. EBERLE

James A. Eberle  
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)