GSE SYSTEMS INC
Form 10-Q
August 14, 2014
UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-Q

(Mark One)

x	Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934 for the Quarterly Period Ended June 30, 2014
	or
o	Transition Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934 for the transition period from ____ to ____

Commission File Number 001-14785

GSE Systems, Inc.
(Exact name of registrant as specified in its charter)

Delaware	52-1868008
(State of incorporation)	(I.R.S. Employer Identification Number)
1332 Londontown Blvd., Suite 200, Sykesville MD	21784
(Address of principal executive offices)	(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 [X] 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 [X] 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 o	Accelerated filer o	Non-accelerated filer o	Smaller reporting company x
		(Do not check if a smaller reporting company)	

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

There were 17,887,859 shares of common stock, with a par value of $.01 per share outstanding as of August 13, 2014.

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GSE SYSTEMS, INC.
QUARTERLY REPORT ON FORM 10-Q
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PART I - FINANCIAL INFORMATION
Item 1. Financial Statements

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

	Unaudited June 30, 2014	December 31, 2013
ASSETS		
Current assets:		
Cash and cash equivalents	$ 18,103	$ 15,643
Restricted cash	11	45
Contract receivables, net	14,419	24,557
Prepaid expenses and other current assets	3,646	3,699
Total current assets	36,179	43,944
Equipment, software and leasehold improvements	7,154	7,090
Accumulated depreciation	(5,366)	(5,175)
Equipment, software and leasehold improvements, net	1,788	1,915
Software development costs, net	1,274	1,020
Intangible assets, net	647	709
Long-term restricted cash	1,021	1,021
Other assets	177	218
Total assets	$ 41,086	$ 48,827
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	$ 1,309	$ 3,554
Accrued expenses	2,061	1,903
Accrued compensation and payroll taxes	2,571	2,497
Billings in excess of revenue earned	5,905	6,545
Accrued warranty	1,640	1,851
Other current liabilities	907	1,603
Total current liabilities	14,393	17,953
Other liabilities	78	487
Total liabilities	14,471	18,440
Stockholders' equity:		
Preferred stock $.01 par value, 2,000,000 shares authorized, shares issued and outstanding none in 2014 and 2013	-	-
Common stock $.01 par value, 30,000,000 shares authorized, shares issued 19,486,770 in 2014 and 2013	195	195
Additional paid-in capital	72,544	72,205
Accumulated deficit	(42,410)	(38,400)
Accumulated other comprehensive loss	(715)	(614)
Treasury stock at cost, 1,598,911 shares in 2014 and 2013	(2,999)	(2,999)

Total stockholders' equity	26,615	30,387
Total liabilities and stockholders' equity	$ 41,086	$ 48,827

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

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

	Three Months ended June 30,		Six Months ended June 30,	
	2014	2013	2014	2013
Contract revenue	$ 8,276	$ 11,034	$ 17,000	$ 23,417
Cost of revenue	5,629	8,219	12,129	17,521
Write-down of capitalized software development costs	-	2,174	-	2,174
Gross profit	2,647	641	4,871	3,722
Operating expenses:				
Selling, general and administrative	4,452	3,946	8,596	8,111
Goodwill impairment loss	-	4,462	-	4,462
Depreciation	134	146	273	299
Amortization of definite-lived intangible assets	36	52	72	104
Total operating expenses	4,622	8,606	8,941	12,976
Operating loss	(1,975)	(7,965)	(4,070)	(9,254)
Interest income, net	28	24	59	63
Gain (loss) on derivative instruments, net	5	(410)	109	(143)
Other income (expense), net	3	94	(7)	(11)
Loss before income taxes	(1,939)	(8,257)	(3,909)	(9,345)
Provision (benefit) for income taxes	47	(58)	101	9
Net loss	$ (1,986)	$ (8,199)	$ (4,010)	$ (9,354)
Basic loss per common share	$ (0.11)	$ (0.45)	$ (0.22)	$ (0.51)
Diluted loss per common share	$ (0.11)	$ (0.45)	$ (0.22)	$ (0.51)

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

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

	Three Months ended June 30,		Six Months ended June 30,	
	2014	2013	2014	2013
Net loss	$ (1,986)	$ (8,199)	$ (4,010)	$ (9,354)
Foreign currency translation adjustment, net of tax	(106)	(158)	(101)	(160)
Comprehensive loss	$ (2,092)	$ (8,357)	$ (4,111)	$ (9,514)

The accompanying notes are an integral part of these consolidated financial statements.
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GSE SYSTEMS, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENT OF CHANGES IN STOCKHOLDERS' EQUITY
(in thousands)
(Unaudited)

	Common Stock Shares	Amount	Additional Paid-in Capital	Accumulated Deficit	Accumulated Other Comprehensive Loss	Treasury Stock Shares	Amount	Total
Balance, December 31, 2013	19,487	$ 195	$ 72,205	$ (38,400)	$ (614)	(1,599)	$ (2,999)	$ 30,387
Stock-based compensation expense	-	-	339	-	-	-	-	339
Foreign currency translation adjustment, net of tax	-		-	-	(101)	-	-	(101)
Net loss	-	-	-	(4,010)	-	-	-	(4,010)
Balance, June 30, 2014	19,487	$ 195	$ 72,544	$ (42,410)	$ (715)	(1,599)	$ (2,999)	$ 26,615

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

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GSE SYSTEMS, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS
(in thousands)
(Unaudited)

	Six Months ended June 30,	
	2014	2013
Cash flows from operating activities:		
Net loss	$(4,010)	$(9,354)
Adjustments to reconcile net loss to net cash provided by operating activities:		
Goodwill impairment loss	-	4,462
Write-down of capitalized software development costs	-	2,174
Depreciation	273	299
Amortization of definite-lived intangible assets	72	104
Capitalized software amortization	95	478
Amortization of deferred financing costs	-	6
Change in fair value of contingent consideration	47	173
Stock-based compensation expense	339	438
Equity loss on investments	38	96
(Gain) loss on derivative instruments	(109)	143
Changes in assets and liabilities:		
Contract receivables	9,985	2,786
Prepaid expenses and other assets	268	215
Accounts payable, accrued compensation and accrued expenses	(2,006)	(562)
Billings in excess of revenue earned	(650)	716
Accrued warranty reserves	(211)	(329)
Other liabilities	(627)	(86)
Net cash provided by operating activities	3,504	1,759
Cash flows from investing activities:		
Capital expenditures	(141)	(142)
Capitalized software development costs	(349)	(995)
Restrictions of cash as collateral under letters of credit	-	(228)
Releases of cash as collateral under letters of credit	34	-
Net cash used in investing activities	(456)	(1,365)
Cash flows from financing activities:		
Proceeds from issuance of common stock	-	44
Payments of the liability-classified contingent consideration arrangements	(500)	(1,188)
Treasury stock purchases	-	(368)
Net cash used in financing activities	(500)	(1,512)
Effect of exchange rate changes on cash	(88)	(177)
Net increase (decrease) in cash and cash equivalents	2,460	(1,295)
Cash and cash equivalents at beginning of year	15,643	22,386
Cash and cash equivalents at end of period	$18,103	$21,091

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

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GSE SYSTEMS, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
For the Three and Six Months ended June 30, 2014 and 2013
(Unaudited)

1. Basis of Presentation and Revenue Recognition

Basis of Presentation

The consolidated interim 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 year ended December 31, 2013 filed with the Securities and Exchange Commission on March 26, 2014.

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 1 to 3 years.

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements as well as reported amounts of revenues and expenses during the reporting period. The Company's most significant estimates relate to revenue recognition, product warranties, capitalization of software development costs, valuation of intangible assets acquired, contingent consideration issued in business acquisitions, 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 earnings earned to date, less amounts recognized in prior periods. The Company bases its estimate of the degree of completion of the contract by reviewing the relationship of costs incurred to date to the expected total costs that will be incurred on the project. Estimated contract earnings are reviewed and revised periodically as the work progresses, and the cumulative effect of any change in estimate is recognized in the period in which the change is identified. Estimated losses are charged against earnings in the period such losses are identified. The Company recognizes revenue arising from contract claims either as income or as an offset against a potential loss only when the amount of the claim can be estimated reliably and realization is probable and there is a legal basis for the claim.

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 experience and projected claims. The Company's long-term contracts generally provide for a one-year warranty on parts, labor and any bug fixes as it relates to software embedded in the systems.

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

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 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.

For the three and six months ended June 30, 2014 and 2013, the following customer provided more than 10% of the Company's consolidated revenue:

	Three Months ended June 30,		Six Months ended June 30,	
	2014	2013	2014	2013
Slovenské elektrárne, a.s.	0.6%	22.4%	4.5%	22.9%

2. Recently Adopted Accounting Pronouncements

In May 2014, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") 2014-09, Revenue from Contracts with Customers, which provides guidance for revenue recognition. The standard's core principle is that a company will recognize revenue when it transfers promised goods or services to customers in an amount that reflects the consideration to which the company expects to be entitled in exchange for those goods or services. In doing so, companies will need to use more judgment and make more estimates than under today's guidance. These may include identifying performance obligations in the contract, estimating the amount of variable consideration to include in the transaction price and allocating the transaction price to each separate performance obligation. This guidance will be effective for the Company in the first quarter of its fiscal year ending December 31, 2017. The Company is currently in the process of evaluating the impact of adoption of this ASU on the Company's consolidated financial statements.

3. Basic and Diluted Loss Per Common Share

Basic loss per share is based on the weighted average number of outstanding common shares for the period. Diluted loss per share adjusts the weighted average shares outstanding for the potential dilution that could occur if stock options were exercised into common stock.

The number of common shares and common share equivalents used in the determination of basic and diluted loss per share were as follows:

(in thousands, except for share amounts)	Three Months ended June 30,		Six Months ended June 30,	
	2014	2013	2014	2013
Numerator:				
Net loss	$(1,986)	$(8,199)	$(4,010)	$(9,354)
Denominator:				
Weighted-average shares outstanding for basic earnings per share	17,887,859	18,299,108	17,887,859	18,320,653
Effect of dilutive securities:				
Employee stock options	-	-	-	-
Adjusted weighted-average shares outstanding and assumed conversions for diluted earnings per share	17,887,859	18,299,108	17,887,859	18,320,653
Shares related to dilutive securities excluded because inclusion would be anti-dilutive	2,736,703	2,916,427	2,727,435	2,918,692

4. 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:

(in thousands)	June 30, 2014	December 31, 2013
Billed receivables	$8,472	$ 19,040
Recoverable costs and accrued profit not billed	5,972	5,519
Allowance for doubtful accounts	(25)	(2)
Total contract receivables, net	$14,419	$ 24,557

Recoverable costs and accrued profit not billed totaled $6.0 million and $5.5 million as of June 30, 2014 and December 31, 2013, respectively. During July 2014, the Company invoiced $1.2 million of the unbilled amounts.

The following customers account for more than 10% of the Company's consolidated contract receivables as of:

	June 30, 2014	December 31, 2013
China Nuclear Power Engineering Company	13.0%	4.9%
Slovenské elektrárne, a.s.	2.1%	35.9%

5. 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. On an annual basis, and more frequently as conditions indicate, the Company assesses the recovery of the unamortized software development costs by estimating the net undiscounted cash flows expected to be generated by the sale of the product. If the undiscounted cash flows are not sufficient to recover the unamortized software costs the Company will write-down the investment to its estimated fair value based on future undiscounted cash flows. The excess of any unamortized software development costs over the related net realizable value is written down and charged to cost of revenue.

Software development costs capitalized were $194,000 and $349,000 for the three and six months ended June 30, 2014, respectively, and $498,000 and $995,000 for the three and six months ended June 30, 2013, respectively. Total amortization expense was $63,000 and $95,000 for the three and six months ended June 30, 2014, respectively, and $302,000 and $478,000 for the three and six months ended June 30, 2013, respectively.

During the second quarter of 2013, the Company incurred a charge of $2.2 million related to the write-down of certain capitalized software development costs based on the net realizable value analysis. The Company did not recognize any write-downs of software development costs in 2014.

6. Goodwill and Intangible Assets

Goodwill

The Company reviews goodwill for impairment annually as of November 30 or whenever events or changes in circumstances indicate the carrying value of goodwill may not be recoverable in accordance with Accounting Standards Codification ("ASC") 350, Intangibles — Goodwill and Other. The provisions of ASC 350 require that we perform a two-step impairment test on goodwill. In the first step, we compare the fair value of our reporting unit to its carrying value. The Company has only one reporting unit. If the fair value of the reporting unit exceeds the carrying value of the net assets assigned to that unit, goodwill is not impaired, and we are not required to perform further testing. If the carrying value of the net assets assigned to the reporting unit exceeds the fair value of the reporting unit, then we must perform the second step of the impairment test in order to determine the implied fair value of the reporting unit's goodwill. The implied fair value of goodwill is determined by allocating the fair value of the reporting unit's assets and liabilities in a manner similar to a purchase price allocation, with any residual fair value allocated to goodwill. If the carrying value of the reporting unit's goodwill exceeds its implied fair value, then we record an impairment loss equal to the difference.

Based upon indicators of impairment in the second quarter of 2013, which included a substantial decrease in the Company's market capitalization following the announcement of the Company's first quarter 2013 earnings, and significantly lower than projected revenue and profits as a result of a change in market conditions, the Company performed an interim impairment test as of June 30, 2013.

The fair value of our reporting unit was estimated using a combination of appropriately weighted income and market approaches. The cash flows employed in the income approach were based on forecasts and business plans developed in the second quarter of 2013, as well as various growth rate assumptions for the years beyond the current business plan period, discounted using an estimated weighted average cost of capital ("WACC"). The WACC is comprised of (1) a risk free rate of return, (2) an equity and size risk premium that is based on the rate of return on equity of publicly traded companies with business characteristics comparable to our reporting unit, (3) the current after-tax market rate of return on debt of companies with business characteristics similar to our reporting unit, each weighted by the relative market value percentages of our equity and debt, and (4) an industry and specific company risk factor.

The results of the ASC 350 Step 1 goodwill impairment analysis indicated that the estimated fair value of our reporting unit was less than the carrying value. The reporting unit was unfavorably impacted by a combination of lower current and projected cash flows. Because our reporting unit's fair value estimate was lower than its carrying value, we applied the second step of the goodwill test, in accordance with ASC 350.

The second step of the goodwill impairment analysis indicated that the carrying value of the goodwill associated with the reporting unit exceeded its implied fair value resulting in a $4.5 million non-deductible goodwill impairment charge. As a result of the analysis, the Company recorded a full goodwill impairment. The impairment was non-cash in nature and did not affect the Company's liquidity nor impact the debt covenants under the Company's credit facility.

Intangible Assets Subject to Amortization

The Company's intangible assets include amounts recognized in connection with business acquisitions, including customer relationships, contract backlog and technology. Intangible assets are initially valued at fair market value using generally accepted valuation methods appropriate for the type of intangible asset. Amortization is recognized on a straight-line basis over the estimated useful life of the intangible assets, except for contract backlog and contractual customer relationships which are recognized in proportion to the related projected revenue streams. Intangible assets with definite lives are reviewed for impairment if indicators of impairment arise. The failure of step 1 of the goodwill impairment analysis was an impairment indicator in the second quarter of 2013, but the

undiscounted cash flows associated with the other intangible assets were greater than the carrying value, and therefore, no impairment was present.

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7. Fair Value of Financial Instruments

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 accounts receivable and accounts payable, to approximate the fair value of the respective assets and liabilities at June 30, 2014 and December 31, 2013 based upon the short-term nature of the assets and liabilities.

The following table presents assets and liabilities measured at fair value at June 30, 2014:

(in thousands)	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Total
Money market fund	$ 12,261	$ -	$ -	$12,261
Foreign exchange contracts	-	3	-	3
Total assets	$ 12,261	$ 3	$ -	$12,264
Foreign exchange contracts	$ -	$ (48)	$ -	$(48)
Total liabilities	$ -	$ (48)	$ -	$(48)

The following table presents assets and liabilities measured at fair value at December 31, 2013:

(in thousands)	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Total
Money market fund	$ 10,553	$ -	$ -	$10,553
Foreign exchange contracts	-	142	-	142
Total assets	$ 10,553	$ 142	$ -	$10,695

Foreign exchange contracts	$ -	$ (655)	$ -	$(655)
Total liabilities	$ -	$ (655)	$ -	$(655)

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8. 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 June 30, 2014, the Company had foreign exchange contracts outstanding of approximately 0.1 million Pounds Sterling and 1.3 million Euro at fixed rates. The contracts expire on various dates through May 2016. At December 31, 2013, the Company had contracts outstanding of approximately 0.2 million Pounds Sterling, 13.3 million Euro, and 10.1 million Japanese Yen at fixed rates.

The Company has not designated any of the foreign exchange contracts outstanding as hedges and has recorded the estimated fair value of the contracts in the consolidated balance sheets as follows:

(in thousands)	June 30, 2014	December 31, 2013
Asset derivatives		
Prepaid expenses and other current assets	$ 3	$ 140
Other assets	-	2
	3	142
Liability derivatives		
Other current liabilities	(37)	(637)
Other liabilities	(11)	(18)
	(48)	(655)
Net fair value	$ (45)	$ (513)

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

The foreign currency denominated contract receivables, billings in excess of revenue earned and subcontractor accruals 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 net gain on derivative instruments in the consolidated statements of operations.

For the three and six months ended June 30, 2014 and 2013, the Company recognized a net gain (loss) on its derivative instruments as outlined below:

(in thousands)	Three Months ended June 30, 2014	2013	Six Months ended June 30, 2014	2013
Foreign exchange contracts- change in fair value	$ 11	$ (548)	$ 254	$ 1
Remeasurement of related contract receivables, billings in excess of revenue earned, and subcontractor accruals	(6)	138	(145)	(144)

Gain (loss) on derivative instruments, net	$ 5	$ (410)	$ 109	$ (143)

9. 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 $161,000 and $214,000 of stock-based compensation expense for the three months ended June 30, 2014 and 2013, respectively, under the fair value method and recognized $339,000 and $438,000 of stock-based compensation expense for the six months ended June 30, 2014 and 2013, respectively. The Company granted 0 and 60,000 stock options for the three and six months ended June 30, 2014, respectively. The fair value of the options granted for the six months ended June 30, 2014 was $56,000. The Company granted 0 and 64,500 stock options for the three and six months ended June 30, 2013, respectively. The fair value of the granted options at the grant date was $78,000.

10. Long-Term Debt

At June 30, 2014 and December 31, 2013, the Company had no long-term debt outstanding.

Line of Credit

The Company has a Master Loan and Security Agreement and Revolving Credit Note with Susquehanna Bank ("Susquehanna"). The Company and its subsidiaries, GSE Power Systems, Inc., and GSE EnVision LLC, are jointly and severally liable as co-borrowers. The Loan Agreement provides a $7.5 million revolving line of credit for the purpose of (i) issuing stand-by letters of credit and (ii) providing working capital. Working capital advances bear interest at a rate equal to the Wall Street Journal Prime Rate of Interest, floating with a floor of 4.5%.

As collateral for the Company's obligations, the Company granted a first lien and security interest in all of the assets of the Company, including but not limited to, accounts receivable, inventory, proceeds and products, intangibles, trademarks, intellectual property, and machinery and equipment.

Issuances of stand-by letters of credit, negative foreign exchange positions, and advances of working capital (collectively referred to as the "Advances") require that the Company maintain a minimum cash balance of $3.0 million at all times (the "Cash Balance Requirement"). The Cash Balance Requirement will remain at the minimum amount as long as the Company's quarterly net income (exclusive of gains and losses on derivative instruments and stock option expense) as defined ("Net Income") remains positive and the Company is in compliance with the covenants. If the Company's quarterly consolidated Net Income is negative or the Company is not in compliance with the covenants, the Cash Balance Requirement will revert to the amount of the Advances, until the Company attains positive Net Income for two consecutive quarters.

In June 2014, Susquehanna extended the Revolving Credit Expiration Date to March 31, 2015. Per the extension letter, the Bank will require that the Cash Balance Requirement be maintained in a segregated account at Susquehanna. As of June 30, 2014, Susquehanna has not segregated the Cash Balance Requirement, however, the Company expects Susquehanna to restrict $3.0 million based on the current amount of outstanding Advances as of June 30, 2014.

The credit agreements contain certain restrictive covenants regarding future acquisitions and incurrence of debt. In addition, the credit agreements contain financial covenants with respect to the Company's cash flow coverage ratio, minimum tangible capital base, quick ratio, and tangible capital base ratio. At June 30, 2014, the Company had not paid any interest or principal payments related to any borrowings for over one year. As such, the cash flow coverage ratio is not applicable at June 30, 2014.

	Covenant	As of June 30, 2014
Minimum tangible capital base	Must Exceed $26.0 million	$24.7 million
Quick ratio	Must Exceed 2.00 : 1.00	2.51 : 1.00
Tangible capital base ratio	Not to Exceed .75 : 1.00	.59 : 1.00

As of June 30, 2014, the Company was not in compliance with its "After Tax Net Income" financial covenant and its "Minimum Tangible Capital Base" covenant, as defined above. As a result, the Company will be required to maintain a cash balance of $3.0 million at Susquehanna which is equivalent to its outstanding Advances at June 30, 2014. All of the Company's outstanding Advances consisted of stand-by letters of credit.

As of June 30, 2014, the Company was contingently liable for twelve standby letters of credit and two surety bonds totaling $4.3 million which represent advance payment and performance bonds on twelve contracts. The Company has deposited the full value of four standby letters of credit in escrow accounts, amounting to $1.0 million, which have been restricted in that the Company does not have access to these funds until the related letters of credit have expired. The cash has been recorded on the Company's balance sheet at June 30, 2014 as restricted cash.

11. 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, 2013	$1,851
Warranty provision	418
Warranty claims	(623)
Currency adjustment	(6)
Balance at June 30, 2014	$1,640

12. Contingent Consideration

ASC 805 requires that contingent consideration be recognized at fair value on the acquisition date and be remeasured each reporting period with subsequent adjustments recognized in the consolidated statement of operations.

As of June 30, 2014 and December 31, 2013, contingent consideration included in the other current liabilities on the consolidated balance sheet totaled $449,000 and $492,000, respectively. As of June 30, 2014 and December 31, 2013, the Company also had accrued contingent consideration totaling $0 and $409,000, respectively, which is included in other long-term liabilities on the consolidated balance sheet and represents the portion of contingent consideration estimated to be payable greater than twelve months from the balance sheet date. During the three and six months ended June 30, 2014, the Company made payments of $0 and $500,000 related to the liability-classified contingent consideration arrangements. During the three and six months ended June 30, 2013, the Company made payments of $200,000 and $1.2 million related to the liability-classified contingent consideration arrangements.

13. 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 2007 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.

An uncertain tax position taken or expected to be taken in a tax return is recognized in the financial statements when it is more likely than not (i.e., a likelihood of more than fifty percent) that the position would be sustained upon examination by tax authorities that have full knowledge of all relevant information. A recognized tax position is then measured at the largest amount of benefit that is greater than fifty percent likely of being realized upon ultimate settlement. Interest and penalties related to income taxes are accounted for as income tax expense. The Company has appropriately accounted for its uncertain tax positions.

The Company expects to pay income taxes in India in 2014. In 2013, the Company paid income taxes in the UK and India. The Company has a full valuation allowance on its U.S., Chinese and Swedish net deferred tax assets at June 30, 2014.

14. Preferred Stock Rights

On March 21, 2011, the Board of Directors of the Company declared a dividend, payable to holders of record as of the close of business on April 1, 2011, of one preferred stock purchase right (a "Right") for each outstanding share of common stock, par value $0.01 per share, of the Company (the "Common Stock"). In addition, the Company will issue one Right with each new share of Common Stock issued. In connection therewith, on March 21, 2011, the Company entered into a Stockholder Protection Rights Agreement (as amended from time to time, the Rights Agreement) with Continental Stock Transfer & Trust Company, as Rights Agent, which has a term of three years, unless amended by the Board of Directors in accordance with the terms of the Rights Agreement. On March 21, 2014, the Rights Agreement was amended to extend the term an additional two years. The Rights Agreement will now expire on March 21, 2016. The Rights trade with and are inseparable from the Common Stock and are not evidenced by separate certificates unless they become exercisable. Each Right entitles its holder to purchase from the Company one-hundredth of a share of participating preferred stock having economic and voting terms similar to the Common Stock at an exercise price of $8.00 per Right, subject to adjustment in accordance with the terms of the Rights Agreement, once the Rights become exercisable. Under the Rights Agreement, the Rights become exercisable if any person or group acquires 20% or more of the Common Stock or, in the case of any person or group that owned 20% or more of the Common Stock as of March 21, 2011, upon the acquisition of any additional shares by such person or group. The Company, its subsidiaries, employee benefit plans of the Company or any of its subsidiaries and any entity holding Common Stock for or pursuant to the terms of any such plan are accepted. Upon exercise of the Right in accordance with the Rights Agreement, the holder would be able to purchase a number of shares of Common Stock from the Company having an aggregate market price (as defined in the Rights Agreement) equal to twice the then-current exercise price for an amount in cash equal to the then-current exercise price. In addition, the Company may, in certain circumstances and pursuant to the terms of the Rights Agreement, exchange the Rights for one share of Common Stock or an equivalent security for each Right or, alternatively, redeem the Rights for $0.001 per Right. The Rights will not prevent a takeover of our Company, but may cause substantial dilution to a person that acquires 20% or more of the Company's Common Stock.

15. Share Repurchase Plan

On March 21, 2011, the Board of Directors authorized the purchase of up to $3.0 million of the Company's common stock in accordance with the safe harbor provisions of Rule 10b-18 of the Securities Exchange Act of 1934. The Company completed the share repurchase program in October 31, 2013 and thus will not be repurchasing shares during 2014. During the three and six months ended June 30, 2013 the Company repurchased 216,399 and 217,499 shares, respectively, at an aggregate cost of $366,000 and $368,000, respectively.

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

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.

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 Scottish limited liability company;
- GSE EnVision, LLC, a New Jersey limited-liability company; and
- EnVision Systems (India) Pvt. Ltd., an Indian limited liability company.

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 2012 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

In today's market, nuclear power players hold differing viewpoints on the state of the industry. The nuclear power industry continues to be heavily influenced by the local political environment and the individual circumstances of the country or location. The emphasis on safety has been an overriding theme among nations, especially in the aftermath of the explosions and reactor meltdown in Fukushima, Japan, but most companies have made a strategic refocus based on the current economic environment. In response to changes in the nuclear simulation market, the Company is repositioning itself to actively pursue business and develop strategic partnerships in those areas of the world where the construction of additional nuclear power plants is expected to grow.

- Even following a temporary slowdown to revamp safety regulations following the Fukushima Daiichi accidents in Japan, China remains to be an ambitious country in the field of nuclear power energy. According to reports from China Daily, China has approved construction of 8.6 gigawatts ("GW") of new nuclear generation this year, following the approval of 2.1 GW last year. With 20 nuclear reactors and another 28 reactors under construction, China plans to build nuclear power plants as a key part of curbing demand on fossil fuels. By 2020, China plans to increase its nuclear capacity three fold to at least 58 GW according to the World Nuclear Association. As reported by Businessweek.com, Chinese engineers have adapted the Westinghouse Electric Company's AP1000 reactor technology into a larger design, called the CAP1400, which increases the power the reactor can produce from 1,000 megawatts to 1,400 megawatts. Most recently, Westinghouse announced that it is in advanced talks to build 8 additional AP1000 reactors in China for an estimated $24 billion. GSE's business in China remains strong and is working to strengthen its relationships with the Chinese nuclear utilities and is developing plans to grow its Chinese subsidiary. At June 30, 2014, we have backlog from Chinese end customers of $9.8 million.

- South Korea, who ranks fifth globally in nuclear power generation, has largely developed its own nuclear power industry, building and operating its reactors through state-run utility Korea Electric Power Corp. In January 2014, South Korea approved a $7 billion project to build two nuclear plants. According to the World Nuclear Association, nuclear energy remains a strategic priority for South Korea and capacity is planned to increase by 59% to 32.9 GW in 2022. Additionally, South Korea is seeking to export its nuclear technology with a goal of exporting 80 nuclear reactors by 2030. The Company has hired an agent in Korea and is working to strengthen its relationships with the Korean nuclear utilities. At June 30, 2014, we have backlog from South Korean customers of $1.4 million.

- Germany was the first major industrial power to announce that it would phase out nuclear power following the events in Fukushima, Japan. Pre-Fukushima, Germany obtained about one quarter of its electricity from nuclear energy, using 17 reactors, per the World Nuclear Association. Following the Fukushima disaster, all of the country's nuclear power reactors which began operation in 1980 or earlier were shut down. The remaining nine reactors will be closed by the end of 2022. Germany's politicians are striving to switchover to renewable energy and want renewable power to contribute 35% of the country's electricity consumption in 2020 and 80% by 2050 as part of its clean energy drive. At June 30, 2014, we have backlog from German customers of $1.5 million. We anticipate some future orders from our German customers.

- Despite Russia moving forward with plans to expand the role of nuclear energy with an expected 50% increase in output by 2020, Russia has been a difficult landscape to navigate. The Company had done extensive upgrade work for the Leningrad Nuclear Power Plant prior to the consolidation of Russian nuclear power plants under Rosenergoatom in 2001 and received some additional work thereafter, but has received no additional work since 2008. Currently, Russia remains to be an unproven market for business opportunity.

- In the U.S., prior to the Fukushima disaster, much of the nuclear power industry was anticipating a nuclear "renaissance." GSE received contracts in 2010 from Westinghouse Electric Company LLC to provide operator training simulators for the first nuclear reactors to be built in the U.S. in over 30 years at the Vogtle and VC Summer nuclear power plants. The U.S. Nuclear Regulatory Commission was reviewing 13 combined construction and operating license ("CCOL") applications from 12 companies and consortia for 22 nuclear power reactors. In February 2012, the NRC voted to issue the first three new rules to deal with safety issues based on eight changes identified by the NRC's Fukushima task force, with implementation expected by the end of 2016. The three orders require safety enhancements of operating reactors, construction permit holders, and combined license holders. These orders require nuclear power plants to implement safety enhancements related to (1) mitigation strategies to respond to extreme natural events resulting in the loss of power at plants, (2) ensuring reliable hardened containment vents, and (3) enhancing spent fuel pool instrumentation. In addition, the NRC requested each reactor reevaluate the seismic and flooding hazards at their site using present-day methods and information. Of the 13 combined construction and operating license applications under review by the NRC at the time of the Fukushima disaster, 2 licenses have been issued (for the Vogtle and VC Summer plants), 2 have been suspended and 9 are still under review. No new CCOL's have been filed with the NRC since the Fukushima disaster and the nuclear "renaissance" has not materialized.

Through the nuclear power industry slow-down, GSE has remained focused on its products and product development. Certain products continue to do well in the nuclear power upgrade market.

- GSE is selling its RELAP5-HD advanced thermohydraulic model for plants in Europe, Asia and the U.S. GSE has successfully sold its first two domestic upgrade programs using RELAP5-HD, and believes the success of these projects will help convince domestic customers of the value of this advanced model. To date, GSE has sold 23 RELAP5-HD projects around the world.

- As evidenced by the new safety rules that the NRC has recently issued, the Chinese State Council's Safety Plan, and the creation in Japan of the Nuclear Regulatory Authority, there will be additional governmental regulations requiring plant modifications and new testing scenarios that will result in the need for higher fidelity simulation. According to Platts.com, U.S. nuclear plant operators estimate they will spend $3.6 billion in post-Fukushima upgrades. GSE has developed PSA-HD™ and DesignEP™, which are engineering-grade nuclear simulation solutions for both full-scope simulator and desktop simulator applications. PSA-HD allows operating personnel to train for and develop responses to severe accident scenarios based on the operations of their specific facility. DesignEP provides a desktop solution that allows engineers, safety analysis specialists, emergency planners and plant operating personnel all to experiment with new designs and procedures to address severe accident conditions. Both solutions utilize MAAP as the calculation engine, with GSE's real-time executive and graphical interface to provide a dynamic, real-time solution for severe accident analysis. MAAP is an Electric Power Research Institute (EPRI) software program that performs severe accident analysis for nuclear power plants including assessments of core damage and radiological transport. A valid license to MAAP from EPRI is required to use MAAP with PSA-HD and DesignEP. PSA-HD's real-time code can be integrated with a nuclear plant's existing full-scope training simulator and is applicable to all current nuclear plant designs. GSE's solutions can be used to validate the utility's severe accident management guidelines (SAMGs), demonstrate the safety of current plant designs to regulators and stakeholders, and identify potential issues with existing plant design that may require modification. The solutions include high-fidelity models of the plant's reactor core, containment structures and spent fuel pool. The models simulate severe accident conditions which mirror those that occurred at the Fukushima facility, such as the release of radioactive materials due to overheating of the core, exposure of the fuel rods in the spent fuel pool, and hydrogen build up in the containment building.

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 June 30,				Six Months ended June 30,			
	2014	%	2013	%	2014	%	2013	%
Contract revenue	$8,276	100.0%	$11,034	100.0%	$17,000	100.0%	$23,417	100.0%
Cost of revenue	5,629	68.0%	8,219	74.5%	12,129	71.3%	17,521	74.8%
Write-down of capitalized software development costs	-	0.0%	2,174	19.7%	-	0.0%	2,174	9.3%
Gross profit	2,647	32.0%	641	5.8%	4,871	28.7%	3,722	15.9%
Operating expenses:								
Selling, general and administrative	4,452	53.8%	3,946	35.8%	8,596	50.6%	8,111	34.6%
Goodwill impairment loss	-	0.0%	4,462	40.4%	-	0.0%	4,462	19.1%
Depreciation	134	1.6%	146	1.3%	273	1.6%	299	1.3%
Amortization of definite-lived intangible assets	36	0.5%	52	0.5%	72	0.4%	104	0.4%
Total operating expenses	4,622	55.9%	8,606	78.0%	8,941	52.6%	12,976	55.4%
Operating loss	(1,975)	(23.9)%	(7,965)	(72.2)%	(4,070)	(23.9)%	(9,254)	(39.5)%
Interest income, net	28	0.4%	24	0.2%	59	0.3%	63	0.3%
Gain (loss) on derivative instruments, net	5	0.1%	(410)	(3.7)%	109	0.6%	(143)	(0.6)%
Other income (expense), net	3	0.0%	94	0.9%	(7)	(0.1)%	(11)	(0.1)%
Loss before income taxes	(1,939)	(23.4)%	(8,257)	(74.8)%	(3,909)	(23.0)%	(9,345)	(39.9)%
Provision (benefit) for income taxes	47	0.6%	(58)	(0.5)%	101	0.6%	9	0.0%
Net loss	$(1,986)	(24.0)%	$(8,199)	(74.3)%	$(4,010)	(23.6)%	$(9,354)	(39.9)%

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, 2013 is included in the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2013. 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, contingent consideration issued in business acquisitions, and the recoverability of deferred tax assets. 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 2013 Annual Report on Form 10-K for the fiscal year ended December 31, 2013.

Results of Operations - Three and Six Months ended June 30, 2014 versus Three and Six Months ended June 30, 2013

Contract Revenue. Total contract revenue for the three months ended June 30, 2014 totaled $8.3 million, which was 25.0% less than the $11.0 million total revenue for the three months ended June 30, 2013. For the six months ended June 30, 2014, contract revenue totaled $17.0 million, a $6.4 million decrease from the $23.4 million revenue for the six months ended June 30, 2013. The Company recorded total orders of $15.9 million in the six months ended June 30, 2014 compared to $9.6 million for the six months ended June 30, 2013. Revenue related to the $36.6 million full scope simulator and digital control system order from Slovenské elektrárne, a.s. ("SE") was $47,000 (0.6% of revenue) and $2.5 million (22.4% of revenue) for the three months ended June 30, 2014 and 2013, respectively. For the six months ended June 30, 2014 and 2013, revenue from SE was $770,000 (4.5% of revenue) and $5.4 million (22.9% of revenue), respectively. The SE project was completed and entered the warranty period in April 2014. During the three and six months ended June 30, 2014, the Company's fossil fuel simulation revenue has decreased $1.0 million and $2.2 million, respectively, as compared to the same period in the prior year. The decrease in the fossil fuel simulation revenue is attributable to both the completion of several large fossil fuel simulation projects in 2013 and the delay of capital expenditures by fossil fueled power generation companies due to the economic and regulatory uncertainty regarding coal-fired power plants. At June 30, 2014, the Company's backlog was $36.1 million. At December 31, 2013, the Company's backlog totaled $38.0 million.

Write-down of capitalized software development costs. The Company makes ongoing evaluations of the recoverability of its capitalized software projects by comparing the unamortized amount for each product to the estimated net realizable value of the product. If such evaluations indicate that the unamortized software development costs exceed the net realizable value, we write off the amount by which the unamortized software development costs exceed net realizable value. During the quarter ended June 30, 2013, we incurred a charge of $2.2 million related to the write-off of certain capitalized software development costs. No capitalized software development costs were written-off during 2014.

Gross Profit. Excluding the $2.2 million non-cash write down of capitalized software development costs in the second quarter of 2013 as discussed above, gross profit totaled $2.6 million for the three months ended June 30, 2014 compared to $2.8 million for the same period in 2013. As a percentage of revenue, gross profit increased from 25.5% for the three months ended June 30, 2013 to 32.0% for the three months ended June 30, 2014. For the six months ended June 30, 2014, gross profit was $4.9 million which was a 17.4% decrease from the $5.9 million recognized during the same period in 2013. As a percentage of revenue, gross profit increased from 25.2% to 28.7% for the six months ended June 30, 2013 and 2014, respectively. The decrease in revenue on the Slovakia contract, which has an overall gross profit lower than the Company's normal gross profits, has contributed to the increase in gross profit percentage for the three and six months ended June 30, 2014.

Selling, General and Administrative Expenses. Selling, general and administrative ("SG&A") expenses totaled $4.5 million in the three months ended June 30, 2014, a 12.8% increase from the $3.9 million for the same period in 2013. For the six months ended June 30, 2014 and 2013, SG&A expenses totaled $8.6 million and $8.1 million, respectively. The increases reflect the following spending variances:

- Business development and marketing costs increased slightly to $1.2 million from $1.1 million for the three months ended June 30, 2014 and 2013, respectively, but decreased to $2.2 million from $2.4 million for the six months ended June 30, 2014 and 2013, respectively. Bidding and proposal costs, which are the costs of operations personnel assisting with the preparation of contract proposals, decreased slightly year over year. Bidding and proposal costs were $392,000 and $533,000 for the three months ended June 30, 2014 and 2013, respectively, and $769,000 and $970,000 for the six months ended June 30, 2014 and 2013, respectively.

- The Company's general and administrative expenses ("G&A") increased to $2.1 million from $2.0 million for the three months ended June 30, 2014 and 2013, respectively, and remained flat at $4.2 million for the six months ended June 30, 2014 and 2013, respectively. Some components of G&A are as follows:
  - The Company incurred foreign currency translation gains of $56,000 for the three months ended June 30, 2014 compared to losses of $73,000 for the three months ended June 30, 2013. For the six months ended June 30, 2014 and 2013, the Company incurred foreign currency translation losses of $114,000 and $137,000, respectively.
  - The Company implemented a global Enterprise Resource Planning system during the third quarter 2012. Costs related to support and maintenance of this implementation totaled $59,000 and $144,000 for the three and six months ended June 30, 2014 as compared to $104,000 and $289,000 for both the three and six months ended June 30, 2013, respectively.
  - During the three and six months ended June 30, 2014, the Company incurred severance costs of $193,000 and $474,000, respectively, associated with the downsizing of our Swedish operations. In addition, we recorded a $137,000 charge in the second quarter of 2014 related to the renegotiation of our Swedish office lease to downsize the size of the office. The Company incurred $121,000, in severance costs in the first quarter of 2013.

- Gross spending on software product development ("development") expenses for the three and six months ended June 30, 2014 totaled $1.0 million and $1.8 million, respectively, as compared to $765,000 and $1.5 million for the three and six months ended June 30, 2013, respectively. The Company capitalized $194,000 (19.2% of development expenses) and $349,000 (19.4% of development expenses) of product development expenses for the three and six months ended June 30, 2014, respectively, and $498,000 (65.1% of development expenses) and $995,000 (66.9% of development expenses) for the same periods in 2013, respectively. Net development spending increased from $267,000 for the three months ended June 30, 2013 to $816,000 for the three months ended June 30, 2014 and from $492,000 for the six months ended June 30, 2013 to $1.5 million for the six months ended June 30, 2014.
  - The Company's 3D visualization team, which develops 3D technology to add to our training programs, incurred $89,000 and $135,000 of costs related to this effort during the three and six months ended June 30, 2014, respectively, as compared to $13,000 and $69,000 for the same periods in 2013, respectively.
  - During the three months ended June 30, 2014, EnVision completed its new gas-oil separation process simulation training tool and tutorial and continued its development of a new upstream amine treatment unit training tool. Development expense related to the EnVision product line totaled $138,000 and $108,000 for the three months ended June 30, 2014 and 2013, respectively. For the six months ended June 30, 2014 and 2013, EnVision incurred $222,000 and $241,000 of development expense, respectively.
  - Spending on other software product development totaled $783,000 and $1.4 million for the three and six months ended June 30, 2014, respectively. Spending on other software product development totaled $644,000 and $1.2 million for the three and six months ended June 30, 2013, respectively. The Company's development expenses were mainly related to ISIS™, our configuration management system, and maintenance of our JADE™ applications.

Goodwill impairment loss. The Company incurred a goodwill impairment loss of $4.5 million during the second quarter of 2013. Refer to the Liquidity and Capital Resources section below for further discussion regarding the

factors leading to the impairment loss and the valuation methodologies and assumptions used in the goodwill impairment test.

Depreciation. Depreciation expense totaled $134,000 and $146,000 during the quarters ended June 30, 2014 and 2013, respectively. For the six months ended June 30, 2014 and 2013, depreciation expense totaled $273,000 and $299,000, respectively.

Amortization of definite-lived intangible assets. Amortization expense related to definite-lived intangible assets totaled $36,000 and $52,000 for the three months ended June 30, 2014 and 2013, respectively. For the six months ended June 30, 2014 and 2013, amortization expense related to definite-lived intangible assets totaled $72,000 and $104,000, respectively.

Operating Loss. The Company had an operating loss of $2.0 million (23.9% of revenue) during the three months ended June 30, 2014, as compared with an operating loss of $8.0 million (72.2% of revenue) for the same period in 2013. For the six months ended June 30, 2014 and 2013, the Company had an operating loss of $4.1 million (23.9 % of revenue) and an operating loss of $9.3 million (39.5% of revenue), respectively. Excluding the impact of the second quarter 2013 $2.2 million capitalized software write down and the $4.5 million goodwill impairment, the Company generated operating losses of $1.3 million (11.9% of revenue) and $2.6 million (11.1% of revenue) during the three and six months ended June 30, 2013, respectively. The variances were due to the factors outlined above.

Interest Income, Net. Net interest income totaled $28,000 and $24,000 for the three months ended June 30, 2014 and 2013, respectively. For the six months ended June 30, 2014 and 2013, net interest income totaled $59,000 and $63,000, respectively.

Gain (Loss) on Derivative Instruments, Net. The Company periodically enters into forward foreign exchange contracts to manage market risks associated with the fluctuations in foreign currency exchange rates on foreign-denominated trade receivables. As of June 30, 2014, the Company had foreign exchange contracts outstanding of approximately 0.1 million Pounds Sterling and 1.3 million Euro at fixed rates. The contracts expire on various dates through May 2016. The Company has not designated the contracts as hedges and has recognized gains on the change in the estimated fair value of the contracts of $11,000 and $254,000 for the three and six months ended June 30, 2014, respectively.

As of June 30, 2013, the Company had foreign exchange contracts outstanding of approximately 0.4 million Pounds Sterling, 14.0 million Euro, and 60.4 million Japanese Yen at fixed rates. The contracts expire on various dates through May 2016. The Company had not designated the contracts as hedges and had recognized a loss on the change in the estimated fair value of the contracts of $548,000 and a gain of $1,000 for the three and six months ended June 30, 2013, respectively.

The foreign currency denominated contract receivables, billings in excess of revenue earned, and subcontractor accruals that are related to the outstanding foreign exchange contracts were remeasured into the functional currency using the current exchange rate at the end of the period. For the three and six months ended June 30, 2014, the Company recognized losses of $6,000 and $146,000, respectively, from the remeasurement of such contract receivables, billings in excess of revenue earned and subcontractor accruals. For the same periods in 2013, the Company recognized a gain of $138,000 and a loss of $144,000, respectively.

Other Income (Expense), net. For the three and six months ended June 30, 2014, the Company recognized other income, net of $3,000 and other expense, net of $7,000, respectively. For the three and six months ended June 30, 2013, the Company recognized other income, net of $94,000 and other expense, net of $11,000, respectively. The major components of other income (expense), net included the following items:

- On May 22, 2013, the Company and Electrobalt Holding, a Russian Federation closed joint-stock company, created a 50/50 joint venture called General Simulation Engineering RUS Limited Liability Company ("GSE RUS"). For the three and six months ended June 30, 2014, the Company recognized losses of $10,000 and $38,000, respectively, relating to its pro rata share of operating results from GSE-RUS. No equity gains or losses on the GSE RUS investment were recorded in the first two quarters of 2013.
- For the three and six months ended June 30, 2013, the Company recognized a gain of $18,000 and a loss of $96,000, respectively, relating to its pro rata share of operating results from GSE-UNIS Simulation Technology Co., Ltd. The Company and its joint venture partner, Beijing Unis Investment Co., Ltd., (UNIS) agreed in principal to terminate the GSE-UNIS joint venture as of July 31, 2013. As a result of UNIS agreeing in principal to purchase GSE's 49% ownership interest in the joint venture, the Company reclassified its $1.2 million investment to Other Current Assets.
- As a 10% owner of the Emirates Simulation Academy ("ESA") in the UAE, the Company was required to provide a guarantee of 10% of ESA's credit facility. The Company provided the guarantee by depositing cash into an interest bearing, restricted account with the Union National Bank ("UNB"). In 2009, the Company wrote off the entire balance in this account. In the second quarter of 2013, the Company was notified by UNB that the ESA line of credit had been paid off by utilizing the guarantees from the three owners. The balance remaining in our account after the settlement of the guarantee, $82,000, was transferred to us and the UNB account was closed.
- The Company had other miscellaneous income of $13,000 and $31,000 for the three and six months ended June 30, 2014, respectively. For the three and six months ended June 30, 2013, the Company had other miscellaneous expense of $6,000 and other miscellaneous income of $3,000, respectively.

Provision (benefit) 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 2007 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.

An uncertain tax position taken or expected to be taken in a tax return is recognized in the financial statements when it is more likely than not (i.e., a likelihood of more than fifty percent) that the position would be sustained upon examination by tax authorities that have full knowledge of all relevant information. A recognized tax position is then measured at the largest amount of benefit that is greater than fifty percent likely of being realized upon ultimate settlement. Interest and penalties related to income taxes are accounted for as income tax expense. The Company has appropriately accounted for its uncertain tax positions.

The Company expects to pay income taxes in India in 2014. In 2013, the Company paid income taxes to the UK and India. The Company has a full valuation allowance on its U.S., Chinese and Swedish net deferred tax assets at June 30, 2014.

Liquidity and Capital Resources

As of June 30, 2014, the Company's cash and cash equivalents totaled $18.1 million compared to $15.6 million at December 31, 2013.

Cash provided by operating activities. For the six months ended June 30, 2014, net cash provided by operations totaled $3.5 million. Significant changes in the Company's assets and liabilities in the six months ended June 30, 2014 included:

- A $10.0 million decrease in the Company's contract receivables, excluding any gains or losses on derivatives. The Company's trade receivables, net of the allowance for doubtful accounts, decreased from $19.0 million at December 31, 2013 to $8.4 million at June 30, 2014. At June 30, 2014, trade receivables outstanding for more than 90 days, net of the bad debt reserve, totaled approximately $2.5 million as compared to $0.6 million at December 31, 2013. The Company believes the entire 90-day balance at June 30, 2014 will be received. The Company's unbilled receivables increased by approximately $0.5 million to $6.0 million at June 30, 2014 as compared to December 31, 2013. The increase in the unbilled receivables is due to the timing of contracted billing milestones of the Company's current projects. In July 2014, the Company invoiced $1.2 million of the unbilled amounts; the balance is expected to be invoiced and collected within one year.
- A $2.0 million decrease in accounts payable, accrued compensation and accrued expenses. The decrease was due to the timing of payments made by the Company to vendors and subcontractors.

For the six months ended June 30, 2013, net cash provided by operations totaled $1.8 million. Significant changes in the Company's assets and liabilities in the six months ended June 30, 2013 included:

- A $2.8 million decrease in the Company's contract receivables. The Company's trade receivables, net of the allowance for doubtful accounts, decreased from $12.4 million at December 31, 2012 to $10.0 million at June 30, 2013. At June 30, 2013, trade receivables outstanding for more than 90 days, net of the bad debt reserve, totaled approximately $3.3 million versus $2.5 million at December 31, 2012. Included in the over 90 day balance at June 30, 2013 and December 31, 2012 was $2.3 million due from Shandong Nuclear Power Co. Ltd. which has since been collected. The Company's unbilled receivables decreased by approximately $500,000 to $10.8 million at June 30, 2013. The decrease in the unbilled receivables was due to the timing of contracted billing milestones of the Company's current projects.
- A $716,000 increase in billings in excess of revenue earned. The increase was due to the timing of contracted billing milestones of the Company's projects.

Cash used in investing activities. Net cash used in investing activities totaled $456,000 for the six months ended June 30, 2014. Capital expenditures totaled $141,000 and capitalized software development costs totaled $349,000 for the six months ended June 30, 2014. Releases of restricted cash as collateral under letters of credit totaled $34,000 for the six months ended June 30, 2014.

Net cash used in investing activities totaled $1.4 million for the six months ended June 30, 2013. Capital expenditures totaled $142,000 and capitalized software development costs totaled $995,000 for the six months ended June 30, 2013.

Cash used in financing activities. Net cash used in financing activities totaled $500,000 for the six months ended June 30, 2014. During the six months ended June 30, 2014, the Company made payments of $500,000 in relation to the liability classified contingent-consideration associated with the acquisition of EnVision Systems, Inc.

Net cash used in financing activities totaled $1.5 million for the six months ended June 30, 2013. During the six months ended June 30, 2013, the Company made payments of $1.2 million in relation to the liability classified contingent-consideration associated with the acquisition of EnVision. The Company repurchased 217,499 shares of

the Company's common stock at an aggregate cost of $368,000 for the six months ended June 30, 2013. Proceeds from the issuance of common stock for the six months ended June 30, 2013 totaled $44,000.

At June 30, 2014, the Company had cash and cash equivalents of $18.1 million. In Q3 2014, the Company expects Susquehanna Bank to restrict $3.0 million based on the current amount of outstanding Advances as of June 30, 2014. The Company believes that its (i) cash and cash equivalents and (ii) cash generated from normal operations will be sufficient to fund its working capital and other requirements for at least the next twelve months.

Credit Facilities

The Company has a Master Loan and Security Agreement and Revolving Credit Note with Susquehanna. The Company and its subsidiaries, GSE Power Systems, Inc., and GSE EnVision LLC, are jointly and severally liable as co-borrowers. The Loan Agreement provides a $7.5 million revolving line of credit for the purpose of (i) issuing stand-by letters of credit and (ii) providing working capital. Working capital advances bear interest at a rate equal to the Wall Street Journal Prime Rate of Interest, floating with a floor of 4 ½%.

As collateral for the Company's obligations, the Company granted a first lien and security interest in all of the assets of the Company, including but not limited to, accounts receivable, inventory, intangibles, trademarks, intellectual property, machinery and equipment, and the proceeds and products from these assets.

Issuances of stand-by letters of credit and advances of working capital (collectively referred to as the "Advances") require that the Company maintain a minimum cash balance of $3.0 million at all times (the "Cash Balance Requirement"). The Cash Balance Requirement will remain at the minimum amount as long as the Company's quarterly consolidated net income (exclusive of gains and losses on derivative instruments and stock option expense) as defined ("Net Income"), remains positive and the Company is in compliance with the covenants. If the Company's quarterly Net Income is negative or the Company is not in compliance with the covenants, the Cash Balance Requirement will revert to the amount of the Advances, until the Company attains positive Net Income for two consecutive quarters. The credit agreements contain certain restrictive covenants regarding future acquisitions, and incurrence of debt. In addition, the credit agreements contain financial covenants with respect to the Company's cash flow coverage ratio, minimum tangible capital base, quick ratio, and tangible capital base ratio. At June 30, 2014, the Company had not paid any interest or principal payments related to any borrowings for over one year. As such the cash flow coverage ratio is not applicable at June 30, 2014.

In June 2014, Susquehanna extended the Revolving Credit Expiration Date to March 31, 2015. Per the extension letter, the Bank will require that the Cash Balance Requirement be maintained in a segregated account at Susquehanna. As of June 30, 2014, Susquehanna has not segregated the Cash Balance Requirement, however, the Company expects Susquehanna to restrict $3.0 million based on the current amount of outstanding Advances as of June 30, 2014.

	Covenant	As of June 30, 2014
Minimum tangible capital base	Must Exceed $26.0 million	$24.7 million
Quick ratio	Must Exceed 2.00 : 1.00	2.51 : 1.00
Tangible capital base ratio	Not to Exceed .75 : 1.00	.59 : 1.00

As of June 30, 2014, the Company was not in compliance with its "After Tax Net Income" financial covenant and its "Minimum Tangible Capital Base" covenant, as defined above. As a result, the Company will be required to maintain a cash balance of $3.0 million at Susquehanna which is equivalent to its outstanding Advances at June 30, 2014. All of the Company's outstanding Advances consisted of stand-by letters of credit.

As of June 30, 2014, the Company was contingently liable for twelve standby letters of credit and two surety bonds totaling $4.3 million which represent advance payment and performance bonds on twelve contracts. The Company has deposited the full value of four standby letters of credit in escrow accounts, amounting to $1.0 million, which have been restricted in that the Company does not have access to these funds until the related letters of credit have expired. The cash has been recorded on the Company's balance sheet at June 30, 2014 as restricted cash.

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 customer contracts that are denominated in currencies other than the Company's functional currency as well as from inter-company accounts in which costs incurred in one entity are charged to other entities in different foreign jurisdictions. The Company is also exposed to foreign exchange rate fluctuations as the financial results of all foreign subsidiaries are translated into U.S. dollars in consolidation. As exchange rates vary, those results when translated may vary from expectations and adversely impact overall expected profitability.

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

As of June 30, 2014, the Company had foreign exchange contracts outstanding of approximately 0.1 million Pounds Sterling and 1.3 million Euro at fixed rates. The contracts expire on various dates through May 2016. 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 $254,000 for the three months ended June 30, 2014. A 10% fluctuation in the foreign currency exchange rates up or down as of June 30, 2014 would have increased/decreased the change in the estimated fair value of the contracts by $4,500.

As of June 30, 2013, the Company had foreign exchange contracts outstanding of approximately 0.4 million Pounds Sterling, 14.0 million Euro, and 60.4 million Japanese Yen at fixed rates. The contracts expire on various dates through May 2016. The Company had not designated the contracts as hedges and had recognized a gain on the change in the estimated fair value of the contracts of $1,000 for the six months ended June 30, 2013. A 10% fluctuation in the foreign currency exchange rates up or down as of June 30, 2013 would have increased/decreased the change in the estimated fair value of the contracts by $2,300.

Item 4. Controls and Procedures

(a) Evaluation of Disclosure Controls and Procedures

The Company maintains disclosure controls and procedures that are designed to ensure that information required to be disclosed by it in its reports filed or submitted pursuant to the Securities Exchange Act of 1934, as amended (the "Exchange Act"), is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange 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. At the end of the period covered by this report, an evaluation was performed under the supervision and with the participation of our management including our CEO and our CFO, of the effectiveness of the design and operation of our disclosure controls and procedures pursuant to Rule 13-15(e) of the Exchange Act. Based on the evaluation of our disclosure controls and procedures as of June 30, 2014, our Chief Executive Officer and Chief Financial Officer concluded that, as of such date, our disclosure controls and procedures were effective.

(b) Changes in internal control

Management is responsible for establishing and maintaining adequate internal control over financial reporting as defined in Rule 13a-15(f) under the Exchange Act. Internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with U.S GAAP. The effectiveness of any system of internal control over financial reporting is subject to inherent limitations, including the exercise of judgment in designing, implementing, operating and evaluating the controls and procedures. Because of these inherent limitations, internal control over financial reporting cannot provide absolute assurance regarding the reliability of financial reporting and the preparation of financial statements in accordance with U.S. GAAP and may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that internal controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

A "material weakness" as defined by Public Company Accounting Oversight Board ("PCAOB") Auditing Standard No. 5, "An Audit of Internal Control over Financial Reporting That is Integrated with an Audit of Financial Statements" ("Auditing Standard No. 5") is "a deficiency, or a combination of deficiencies, in internal control over financial reporting, such that there is a reasonable possibility that a material misstatement of the annual or interim financial statements will not be prevented or detected on a timely basis." A "deficiency" in internal control over financial reporting as defined by Auditing Standard No. 5 "exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis." Set forth below were the Company's material weaknesses in internal control over financial reporting.

As of December 31, 2013 it was determined that the Company's control over expense cut-off was not designed appropriately to prevent or detect errors that could be material to the Company's financial statements. The Company had one employee who was responsible for both review of the vendor invoices for appropriate accounting treatment as well as recording the invoices in the appropriate period. This was considered to be a material weakness in our internal control over financial reporting as of December 31, 2013. As a result of this material weakness in the design of our internal control over financial reporting, we performed additional review and analysis over our consolidated financial statements for the year ended December 31, 2013. During the first quarter of 2014, we redesigned our control over expense cut-off to include an additional employee who now reviews the invoices for appropriate accounting treatment before the invoices are recorded. As a result of these procedures, we believe that we have remediated the material

weakness described above.

(c) Limitation of Effectiveness of Controls

Internal control over financial reporting has inherent limitations. Internal control over financial reporting is a process that involves human diligence and compliance and is subject to lapses in judgment and breakdowns resulting from human failures. Internal control over financial reporting also can be circumvented by collusion or improper management override. Because of such limitations, there is a risk that material misstatements will not be prevented or detected on a timely basis by internal control over financial reporting. However, these inherent limitations are known features of the financial reporting process. Therefore, it is possible to design into the process safeguards to reduce, though not eliminate this risk.

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, 2013.

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

None

Item 3. Defaults Upon Senior Securities

None

Item 4. Mine Safety Disclosures

Not applicable.

Item 5. Other Information

None

Item 6. Exhibits

10.1	Extension of the $7,500,000 Revolving Credit Note, dated June 30, 2014, filed herewith.
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.
101.INS*	XBRL Instance Document
101.SCH*	XBRL Taxonomy Extension Schema
101.CAL*	XBRL Taxonomy Extension Calculation Linkbase
101.DEF*	XBRL Taxonomy Extension Definition Linkbase
101.LAB*	XBRL Taxonomy Extension Label Linkbase
101.PRE*	XBRL Taxonomy Extension Presentation Linkbase

SIGNATURES

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

Date: August 14, 2014 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)