

SI INTERNATIONAL INC  
Form 10-Q  
August 09, 2006

# UNITED STATES SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

## FORM 10-Q

(Mark One)

QUARTERLY REPORT PURSUANT TO SECTION 13 or 15(d) OF THE SECURITIES  
EXCHANGE ACT OF 1934

FOR THE QUARTER ENDED JULY 1, 2006

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

Commission File Number

000-50080

## SI International, Inc.

(Exact name of registrant as specified in its charter)

**Delaware**

(State or other jurisdiction of  
incorporation or organization)

**52-2127278**

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

**12012 Sunset Hills Road**

**Reston, Virginia**

(Address of principal executive offices)

**20190-5869**

(Zip Code)

Registrant's telephone number, including area code: **(703) 234-7000**

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer

Accelerated filer

Non-accelerated filer

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

As of August 1, 2006, 12,881,715 shares outstanding of the registrant's common stock.

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SI INTERNATIONAL, INC.

FORM 10-Q

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**PART I: FINANCIAL INFORMATION****Item 1. Financial Statements****SI International, Inc. and Subsidiaries****Consolidated Balance Sheets**

(Amounts in thousands, except share data)

|   | <b>July 1,<br/>2006<br/>(Unaudited)</b> | <b>December 31<br/>2005</b> |
|---|---|-----------------------------|
| <b>Assets</b>   |   |                             |
| <b>Current assets:</b>  |   |                             |
| Cash and cash equivalents   | \$ 6,283                                | \$ 26,160                   |
| Marketable securities   |   | 7,850                       |
| Accounts receivable, net  | 99,027                                  | 93,633                      |
| Deferred tax asset  | 422                                     | 422                         |
| Other current assets  | 7,759                                   | 6,276                       |
| Total current assets  | 113,491                                 | 134,341                     |
| <b>Property and equipment, net</b>  | 10,423                                  | 5,908                       |
| <b>Intangible assets, net</b>   | 22,063                                  | 16,483                      |
| <b>Other assets</b>   | 6,528                                   | 5,655                       |
| <b>Goodwill</b>   | 220,854                                 | 173,308                     |
| Total assets  | \$ 373,359                              | \$ 335,695                  |
| <b>Liabilities and stockholders' equity</b>   |   |                             |
| <b>Current liabilities:</b>   |   |                             |
| Current portion of long-term debt   | \$ 839                                  | \$ 1,000                    |
| Accounts payable  | 17,450                                  | 25,364                      |
| Accrued expenses and other current liabilities  | 28,814                                  | 29,674                      |
| Note payable - former owner of acquired business  | 5,614                                   | 2,280                       |
| Total current liabilities   | 52,717                                  | 58,318                      |
| <b>Long-term debt, net of current portion</b>   | 82,555                                  | 98,250                      |
| <b>Deferred income tax</b>  | 6,214                                   | 5,221                       |
| <b>Other long-term liabilities</b>  | 7,650                                   | 6,037                       |
| <b>Stockholders' equity:</b>  |   |                             |
| Common stock - \$0.01 par value per share; 50,000,000 shares authorized;<br>12,854,939 and 11,341,222 shares issued and outstanding as of<br>July 1, 2006 and December 31, 2005, respectively | 129                                     | 114                         |
| Additional paid-in capital  | 181,101                                 | 133,843                     |
| Accumulated other comprehensive income  | 325                                     |                             |
| Retained earnings   | 42,668                                  | 33,912                      |
| Total stockholders' equity  | 224,223                                 | 167,869                     |
| Total liabilities and stockholders' equity  | \$ 373,359                              | \$ 335,695                  |

See accompanying notes

## SI International, Inc. and Subsidiaries

## Consolidated Statements of Operations

(Amounts in thousands, except per share data)

## Unaudited

|   | Three Months Ended |                  | Six Months Ended |                  |
|---|--------------------|------------------|------------------|------------------|
|   | July 1,<br>2006    | June 25,<br>2005 | July 1,<br>2006  | June 25,<br>2005 |
| Revenue                                     | \$ 119,233         | \$ 95,983        | \$ 226,465       | \$ 179,700       |
| Operating costs and expenses:               |                    |                  |                  |                  |
| Cost of services                            | 74,968             | 58,598           | 141,577          | 111,201          |
| Selling, general and administrative         | 32,632             | 27,929           | 63,178           | 51,509           |
| Depreciation and amortization               | 673                | 531              | 1,221            | 1,082            |
| Amortization of intangible assets           | 823                | 611              | 1,470            | 1,068            |
| Total operating costs and expenses          | 109,096            | 87,669           | 207,446          | 164,860          |
| Income from operations                      | 10,137             | 8,314            | 19,019           | 14,840           |
| Other income (expense)                      | (101)              | 14               | (71)             | (85)             |
| Interest expense                            | (2,693)            | (1,659)          | (4,475)          | (2,756)          |
| Income before provision for income taxes    | 7,343              | 6,669            | 14,473           | 11,999           |
| Provision for income taxes                  | 2,901              | 2,633            | 5,717            | 4,739            |
| Net income                                  | 4,442              | \$ 4,036         | 8,756            | \$ 7,260         |
| Earnings per common share:                  |                    |                  |                  |                  |
| Basic                                       | \$ 0.35            | \$ 0.36          | \$ 0.72          | \$ 0.65          |
| Diluted                                     | \$ 0.34            | \$ 0.35          | \$ 0.70          | \$ 0.62          |
| Basic weighted-average shares outstanding   | 12,770             | 11,131           | 12,096           | 11,097           |
| Diluted weighted-average shares outstanding | 13,171             | 11,650           | 12,532           | 11,638           |

*See accompanying notes*

## SI International, Inc. and Subsidiaries

## Consolidated Statements of Cash Flows

(Amounts in thousands)

Unaudited

|   | Six Months Ended |                  |
|---|------------------|------------------|
|   | July 1,<br>2006  | June 25,<br>2005 |
| <b>Cash flows from operating activities:</b>                                      |                  |                  |
| Net income  | \$ 8,756         | \$ 7,260         |
| Adjustments to reconcile net income to net cash provided by operating activities: |                  |                  |
| Depreciation and amortization   | 1,221            | 1,082            |
| Amortization of intangible assets   | 1,470            | 1,068            |
| Loss on disposal of fixed assets  | 10               | 9                |
| Stock-based compensation  | 12               | 62               |
| Change in fair value of interest rate swap  | 325              |                  |
| Amortization of deferred financing costs  | 1,366            | 288              |
| Changes in operating assets and liabilities, net of effect of acquisitions:       |                  |                  |
| Accounts receivable, net  | 5,326            | 3,724            |
| Other current assets  | (1,354 )         | (1,360 )         |
| Other assets  | (1,586 )         | (658 )           |
| Accounts payable and accrued expenses   | (13,228 )        | 1,863            |
| Other long term liabilities   | 2,536            | 934              |
| Net cash provided by operating activities   | 4,854            | 14,272           |
| <b>Cash flows from investing activities:</b>                                      |                  |                  |
| Purchase of property and equipment  | (5,028 )         | (333 )           |
| Proceeds from sale of marketable securities                                       | 13,850           | 7,000            |
| Purchase of marketable securities   | (6,000 )         | (5,000 )         |
| Former owner payable  | (10,322 )        |                  |
| Cash paid for business acquisitions, net of cash assumed                          | (47,992 )        | (73,973 )        |
| Net cash used in investing activities   | (55,492 )        | (72,306 )        |
| <b>Cash flows from financing activities:</b>                                      |                  |                  |
| Proceeds from exercise of stock options   | 5,245            | 1,389            |
| Proceeds from issuance of common stock  | 40,402           |                  |
| Income tax benefit from stock option exercises                                    | 1,614            |                  |
| Repayments under line of credit   |                  | (28,954 )        |
| Proceeds from long-term debt  | 30,000           | 100,000          |
| Repayments of long-term debt  | (45,856 )        |                  |
| Payments of debt issuance costs   | (552 )           | (3,170 )         |
| Repayments of capital lease obligations   | (92 )            | (53 )            |
| Net cash provided by financing activities   | 30,761           | 69,212           |
| <b>Net change in cash and cash equivalents</b>                                    | <b>(19,877 )</b> | <b>11,178</b>    |
| <b>Cash and cash equivalents, beginning of period</b>                             | <b>26,160</b>    | <b>3,754</b>     |
| <b>Cash and cash equivalents, end of period</b>                                   | <b>6,283</b>     | <b>\$ 14,932</b> |
| <b>Supplemental disclosures of cash flow information:</b>                         |                  |                  |
| Cash payments for interest  | \$ 3,809         | \$ 1,916         |
| Cash payments for income taxes  | \$ 5,946         | \$ 2,458         |
| Cash payments for capital leases  | \$ 232           |                  |

See accompanying notes



**SI International, Inc. and Subsidiaries**

**Notes to consolidated financial statements**

**(Unaudited)**

**1. Basis of Presentation:**

The accompanying unaudited consolidated financial statements of SI International, Inc. and its subsidiaries have been prepared in accordance with accounting principles generally accepted in the United States for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and Notes required by accounting principles generally accepted in the United States for complete financial statements. In the opinion of management, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation have been included. Operating results for the quarter ended July 1, 2006 are not necessarily indicative of the results that may be expected for the year ending December 30, 2006. For further information, refer to the financial statements and Notes included in SI International's Annual Report on Form 10-K/A for the year ended December 31, 2005. References to the Company, we, us and our refer to SI International, Inc. and its subsidiaries.

**2. Summary of significant accounting policies:**

**Principles of consolidation**

The accompanying consolidated financial statements include the accounts of the Company and its wholly owned subsidiaries. All significant intercompany transactions and accounts have been eliminated in consolidation.

**Use of estimates**

The preparation of financial statements in conformity with accounting principles generally accepted in the United States 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 and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

**Reporting periods**

The Company's fiscal year is based on the calendar year and ends each year on the Saturday nearest, but not falling after, December 31 of that year. As a result, our fiscal year may be comprised of 52 or 53 weeks. Typically, fiscal quarters also end on the Saturday nearest, but not falling after, the end of the calendar quarter. However, we will end those fiscal quarters presented in our Forms 10-Q (the first three fiscal quarters) on the Saturday which provides us with a 13 week quarter even if that Saturday falls after the end of the calendar quarter. As a result, in the future, if our fiscal year comprises 53 weeks, the first three quarters shall each be comprised of 13 weeks and the fourth quarter shall be comprised of 14 weeks. Consistent with this policy, our second quarter ended July 1, 2006 was a 13 week quarter.

**Cash and cash equivalents**

We consider cash on deposit and all highly liquid investments with original maturities of three months or less to be cash and cash equivalents.

**Revenue Recognition**

Our accounting policy regarding revenue recognition complies with the following criteria: (1) a contract has been executed; (2) the contract price is fixed and determinable; (3) delivery of services or products has occurred; and (4) collectibility is considered probable and can be reasonably estimated. Compliance with these criteria may require us to make significant judgments and estimates.





**Significant customers**

Revenue generated from contracts with the Federal government or prime contractors doing business with the Federal government accounted for a significant percent of revenues in the fiscal quarters ending July 1, 2006 and June 25, 2005.

|                           | Three Months Ended |   |               |   | Six Months Ended |   |               |   |
|---------------------------|--------------------|---|---------------|---|------------------|---|---------------|---|
|                           | July 1, 2006       |   | June 25, 2005 |   | July 1, 2006     |   | June 25, 2005 |   |
| Department of Defense     | 47.3               | % | 44.2          | % | 47.6             | % | 46.2          | % |
| Federal civilian agencies | 51.0               |   | 54.3          |   | 50.6             |   | 52.0          |   |
| Commercial entities       | 1.7                |   | 1.5           |   | 1.8              |   | 1.8           |   |
| Total revenue             | 100.0              | % | 100.0         | % | 100.0            | % | 100.0         | % |

For the quarter ended July 1, 2006, we had one contract that generated in excess of 10% of our revenue; whereas, for the quarter ended June 25, 2005, we had two contracts that generated in excess of 10% of our revenue. Our C4I2TSR contract with the U.S. Air Force Space Command is an ID/IQ contract which is utilized by different Federal Government agencies. Historically, we have reported revenue under the C4I2TSR contract using revenue generated by task orders issued to our Network and Telecom Business Unit. In the future, however, we will be reporting revenue generated from any task order issued under the C4I2TSR contract to any Company business unit. Under this approach, for the three and six months ended July 1, 2006, revenue from the C4I2TSR contract represented approximately 20.1% and 21.1% of our revenue, respectively. For the three and six months ended June 25, 2005, our C4I2TSR contract represented approximately 18.1% and 18.8% of our revenue, respectively. Our SCOT contract with the Department of Homeland Security represented approximately 10.4% of our revenue for the three months ended June 25, 2005.

**Deferred financing costs**

Costs incurred in establishing our credit facility are deferred and amortized as interest expense over the term of the related debt using the effective interest method. These deferred costs are reflected as a component of other assets in the accompanying consolidated balance sheets. The deferred financing costs consist of the following (in thousands):

|                          | July 1,<br>2006 | December 31,<br>2005 |
|--------------------------|-----------------|----------------------|
| Deferred loan costs      | \$ 5,527        | \$ 4,975             |
| Accumulated amortization | (2,812 )        | (1,542 )             |
|                          | \$ 2,715        | \$ 3,433             |

**Intangible assets**

Intangible assets from acquisitions, which consist primarily of contractual customer relationships, are amortized utilizing an accelerated method over 6 to 14 years, based on their estimated useful lives. The accumulated amortization of intangible assets is \$4.4 million and \$3.0 million, respectively, as of July 1, 2006 and December 31, 2005. Amortization expense is estimated to be \$3.1 million, \$2.8 million, \$2.5 million, \$2.2 million and \$2.2 million for the years 2006, 2007, 2008, 2009 and 2010, respectively.

**Fair value of financial instruments**

The Company's financial instruments consist primarily of cash and cash equivalents, accounts receivable, accounts payable, credit facilities, and notes payable. In management's opinion, the carrying amounts of these financial instruments approximate their fair values at July 1, 2006 and December 31, 2005.

**Stock-based compensation**

Effective January 1, 2006, the Company adopted the provisions of SFAS No. 123R using the modified prospective transition method. Due to the use of the modified prospective method, prior interim periods and fiscal years will not reflect any restated amounts. As disclosed in the stock

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option plans in Note 9, the Company accelerated the vesting of unvested stock options previously awarded to employees, officers and directors in December 2005. The Company had no unvested stock options on January 1, 2006. The Company issued insignificant stock options in the quarters ended April 1, 2006 and July 1, 2006. Accordingly, no significant stock compensation expense was recognized during the first and second quarters.

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Prior to the adoption of SFAS No. 123R, the Company accounted for stock-based compensation using the intrinsic value method prescribed in APB Opinion No. 25 and related interpretations. Accordingly, compensation expense for stock options was measured as the excess, if any, of the fair market value of the Company's stock at the date of the grant over the exercise price of the related option. The following table illustrates the effect on net income and earnings per share if the compensation costs for the Company's stock options had been determined based on SFAS No. 123.

|   | Three Months Ended |                  | Six Months Ended |                  |
|---|--------------------|------------------|------------------|------------------|
|   | July 1,<br>2006    | June 25,<br>2005 | July 1,<br>2006  | June 25,<br>2005 |
| Net income - as reported  | \$ 4,442           | \$ 4,036         | \$ 8,756         | \$ 7,260         |
| Add: total stock-based employee compensation expense as reported under intrinsic value method (APB No. 25) for all awards, net of tax |                    | 19               |                  | 38               |
| Deduct: Total stock-based compensation expense determined under fair value based method (SFAS No. 123) for all awards, net of tax     |                    | (734 )           |                  | (1,376 )         |
| Net income - pro forma  | 4,442              | 3,321            | 8,756            | \$ 5,922         |
| Basic earnings per share - as reported  | \$ 0.35            | \$ 0.36          | \$ 0.72          | \$ 0.65          |
| Diluted earnings per share - as reported  | \$ 0.34            | \$ 0.35          | \$ 0.70          | \$ 0.62          |
| Basic earnings per share - pro forma  | \$ 0.35            | \$ 0.30          | \$ 0.72          | \$ 0.53          |
| Diluted earnings per share - pro forma  | \$ 0.34            | \$ 0.29          | \$ 0.70          | \$ 0.51          |

The fair value of each option is estimated on the date of grant using the Black-Scholes option-pricing model with the following assumptions used for grants during the fiscal periods ended July 1, 2006 and June 25, 2005:

|                                 | Fiscal Year  |   |               |   |
|---------------------------------|--------------|---|---------------|---|
|                                 | July 1, 2006 |   | June 25, 2005 |   |
| Risk-free interest rate         | 5.07         | % | 3.99          | % |
| Expected life of options        | 5 years      |   | 6 years       |   |
| Expected stock price volatility | 42.3         | % | 50.0          | % |
| Expected dividend yield         | 0            | % | 0             | % |

The risk-free interest is based on U.S. Treasury yields in effect at the time of grant over the expected term of the option. The expected life of options is derived from the Company's historical option exercise data. The expected stock price volatility is based on the historical volatility of the Company's common stock.

As of July 1, 2006, the total remaining unrecognized compensation expense related to unvested options was \$0.2 million which will be recognized over the weighted average period of 3 years.

Prior to the adoption of SFAS No. 123R, the Company presented all tax benefits related to the exercise of stock options as operating cash flows in the consolidated statement of cash flows. SFAS No. 123R requires the cash flows resulting from the tax benefits generated from tax deductions in excess of the compensation costs recognized for those options to be classified as financing cash flows.

**Earnings per share**

Basic earnings per share is computed by dividing reported earnings available to common stockholders by the weighted average number of shares outstanding without consideration of common stock equivalents or other potentially dilutive securities. Diluted earnings per share gives effect to common stock equivalents and other potentially dilutive securities outstanding during the period.

The following details the computation of net income per common share (in 000s):

|   | Three Months Ended |                  | Six Months Ended |                  |
|---|--------------------|------------------|------------------|------------------|
|   | July 1,<br>2006    | June 25,<br>2005 | July 1,<br>2006  | June 25,<br>2005 |
| Net Income Basic and Diluted                | \$ 4,442           | \$ 4,036         | \$ 8,756         | \$ 7,260         |
| <b>Weighted average share calculation:</b>  |                    |                  |                  |                  |
| Basic weighted-average shares outstanding   | 12,770             | 11,131           | 12,096           | 11,097           |
| Treasury stock effect of stock options      | 401                | 519              | 436              | 541              |
| Diluted weighted-average shares outstanding | 13,171             | 11,650           | 12,532           | 11,638           |

**Reclassifications**

Certain prior year balances have been reclassified to conform to the presentation of the current year.

**New accounting pronouncements**

In December 2004, the FASB issued FASB Statement No. 123(R) (revised 2004), *Share Based Payment*. Statement 123(R) addresses the accounting for share-based payment transactions in which an enterprise receives employee services in exchange for (a) equity instruments of the enterprise or (b) liabilities that are based on the fair value of the enterprise's equity instruments or that may be settled by the issuance of such equity instruments. Statement 123(R) requires an entity to recognize the grant-date fair-value of stock options and other equity-based compensation issued to employees in the income statement. The revised Statement generally requires an entity to account for those transactions using the fair-value-based method, and eliminates the intrinsic value method of accounting in APB Opinion No. 25, *Accounting for Stock Issued to Employees*, which was permitted under Statement 123, as originally issued. The revised Statement requires entities to disclose information about the nature of the share-based payment transactions and the effects of those transactions on the financial statements. Statement 123(R) is effective for the Company as of its fiscal year beginning January 1, 2006. All public companies must use either the modified prospective or the modified retrospective transition method.

Effective January 1, 2006, the Company adopted the provisions of SFAS No. 123R using the modified prospective transition method. Due to the use of the modified prospective method, prior interim periods and fiscal years will not reflect any restated amounts. As disclosed in the stock option plans in Note 9, the Company accelerated the vesting of unvested stock options previously awarded to employees, officers and directors in December 2005. The Company had no unvested stock options on January 1, 2006. The Company issued insignificant stock options in the quarters ended April 1, 2006 and July 1, 2006. Accordingly, no significant stock compensation expense was recognized during the first and second quarters. However, had we adopted Statement 123(R) in prior periods, the impact of that standard would have approximated the impact of Statement 123 as described in the disclosure of pro forma net income and pro forma earnings per share in the Stock-Based Compensation section of this note to our consolidated financial statements. Statement 123(R) also requires the benefits of tax deductions in excess of recognized compensation cost to be reported as a financing cash flow, rather than as an operating cash flow as required under APB No. 25. The adoption of this requirement reduced net operating cash flows and increased net financing cash flows in periods after adoption.



In July 2006, the FASB issued Interpretation No. 48 (FIN 48), *Accounting for Uncertainty in Income Taxes, an interpretation of FASB Statement No. 109, Accounting for Income Taxes*. FIN 48 clarifies the accounting for income taxes by prescribing the minimum recognition threshold a tax position is required to meet before being recognized in the financial statements. FIN 48 also provides guidance on derecognition, measurement, classification, interest and penalties, accounting in interim periods, disclosure and transition. In addition, FIN 48 scopes out income taxes from Financial Accounting Standards Board Statement No. 5, *Accounting for Contingencies*. FIN 48 is effective for fiscal years beginning after December 15, 2006. Management is in the process of determining the effect of this proposal on its financial statements.

### 3. Acquisitions:

On February 27, 2006, we closed the acquisition of Zen Technology, Inc., or Zen, a Virginia corporation pursuant to a Stock Purchase Agreement dated February 8, 2006 (the Zen Agreement). Zen is a provider of critical IT services, specializing in managed network services, information assurance, software development and systems engineering, database and systems administration and IT consulting to various U.S. Government agencies. Pursuant to the terms of the Zen Agreement we acquired all of the outstanding capital stock of Zen for \$60 million in cash, of which we are withholding \$6 million for 15 months in order to secure post-closing indemnity obligations of the sellers.

Approximately \$47.8 million of the purchase consideration has been allocated to goodwill based primarily on the excess of the purchase price over the estimated fair value of net assets acquired and approximately \$6.9 million and \$0.2 million of the purchase price has been assigned to identifiable intangible assets of contractual customer relationships and non-compete agreements, respectively. Each customer relationship, which includes each customer's contract, is being amortized on an accelerated basis over their remaining useful life of 9 years. The non-compete agreements are amortized on a straight-line basis over a 3-year period.

The total purchase price paid, including transaction costs of \$0.8 million, has been preliminarily allocated as follows (in thousands):

|                                       |           |
|---------------------------------------|-----------|
| Cash and cash equivalents             | \$ 2,542  |
| Accounts receivable                   | 10,720    |
| Other current assets                  | 129       |
| Property and equipment                | 491       |
| Accounts payable and accrued expenses | (12,485)  |
| Other long term liabilities           | (41)      |
| Intangible assets                     | 7,050     |
| Goodwill                              | 47,847    |
| Total consideration                   | \$ 56,253 |

Similarly, in the first quarter of 2005, we completed the purchase of Shenandoah Electronic Intelligence, Inc. (SEI). SEI provides critical business process outsourcing primarily for the Department of Homeland Security (DHS), including services such as: data and records management; applications processing; file and mail management; analytical support services; and secure optical card processing. On February 9, 2005, the acquisition of SEI closed pursuant to the terms of the definitive stock purchase agreement. The purchase price was \$75 million in cash, subject to certain adjustments totaling approximately \$0.6 million.

Approximately \$52.6 million of the purchase consideration has been allocated to goodwill based primarily on the excess of the purchase price over the estimated fair value of net assets acquired, and approximately \$12.2 million of the purchase price has been assigned to identifiable intangible assets on the basis of contractual customer relationships. The contractual customer relationships are being amortized using an accelerated method over their estimated useful life of 14 years.

The following unaudited proforma combined condensed statements of operations (in thousands, except per share) set forth the consolidated results of operations of the Company for the six months ended July 1, 2006 and June 25, 2005 as if the above described acquisitions had occurred at the beginning of each period presented. This unaudited proforma information does not purport to be indicative of the actual financial position or the results that would actually have occurred if the combination had been in effect for the six months ended July 1, 2006 and June 25, 2005.





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|                            | Six Months Ended |               |
|----------------------------|------------------|---------------|
|                            | July 1, 2006     | June 25, 2005 |
| Revenue                    | \$ 234,007       | \$ 206,194    |
| Net income                 | \$ 9,044         | \$ 8,412      |
| Diluted earnings per share | \$ 0.72          | \$ 0.72       |

In accordance with the purchase accounting method, the operations of Zen and SEI have been included in the Company's statement of operations since their respective dates of acquisition.

**4. Accounts receivable:**

Accounts receivable consists of the following (in thousands):

|   | July 1, 2006 | December 31, 2005 |
|---|--------------|-------------------|
| Billed accounts receivable  | \$ 41,723    | \$ 47,939         |
| Unbilled accounts receivable:   |              |                   |
| Currently billable  | 49,605       | 40,094            |
| Unbilled retainages and milestone payments expected to be billed within the next 12 months        | 8,153        | 5,546             |
| Indirect costs incurred and charged to cost-plus contracts in excess of provisional billing rates | 994          | 1,563             |
| Total unbilled accounts receivable  | 58,752       | 47,203            |
| Allowance for doubtful accounts   | (1,448)      | (1,509)           |
| Accounts receivable, net  | \$ 99,027    | \$ 93,633         |

The currently billable amounts included as unbilled accounts receivable as of July 1, 2006 represent amounts that are billed during the following quarter of the current year. They are billings for services rendered prior to quarter-end, which are billed once necessary billing data has been collected and an invoice is produced.

**5. Property and equipment:**

Property and equipment consist of the following (in thousands):

|  | July 1, 2006 | December 31, 2005 |
|--|--------------|-------------------|
| Computers and equipment                        | \$ 9,635     | \$ 8,691          |
| Software                                       | 2,793        | 2,623             |
| Furniture and fixtures                         | 4,783        | 2,356             |
| Leasehold improvements                         | 3,682        | 1,581             |
|  | 20,893       | 15,251            |
| Less Accumulated depreciation and amortization | (10,470)     | (9,343)           |
| Property and equipment, net                    | \$ 10,423    | \$ 5,908          |

Property and equipment includes assets financed under capital lease obligations of approximately \$404,000 and \$273,000, net of accumulated amortization, as of July 1, 2006 and December 31, 2005, respectively. The increase in the value of Property and Equipment is primarily related to the furnishings in our new Colorado Springs Campus a 123,000 square foot facility that replaces two other locations nearby.



**6. Accrued expenses and other current liabilities:**

Accrued expenses and other current liabilities consist of the following (in thousands):

|  | July 1,<br>2006 | December 31,<br>2005 |
|--|-----------------|----------------------|
| Accrued vacation                               | \$ 7,879        | \$ 6,183             |
| Accrued compensation                           | 11,099          | 9,638                |
| Accrued bonus                                  | 1,924           | 6,755                |
| Other accrued liabilities                      | 7,912           | 7,098                |
| Accrued expenses and other current liabilities | \$ 28,814       | \$ 29,674            |

**7. Debt:**

Debt consists of the following (in thousands):

|   | July 1,<br>2006 | December 31,<br>2005 |
|---|-----------------|----------------------|
| <b>Credit facilities:</b>   |                 |                      |
| Line of credit bears interest at LIBOR plus 200 to 275 base points or a specified base rate plus 100 to 175 basis points, interest due monthly, principal due February 9, 2010  | \$              | \$                   |
| Term loan, pursuant to the First Amendment, as of July 1, 2006 bears interest at LIBOR plus 200 basis points or a specified base rate plus 100 basis points, with nineteen consecutive quarterly principal and interest payments of \$209,816 starting on June 30, 2006, with the unpaid principal and interest of approximately \$79.6 million due on February 9, 2011 | 83,394          | 99,250               |
| Total debt*   | \$ 83,394       | \$ 99,250            |

\* Excludes approximately \$6.0 million (including imputed interest) and \$2.3 million note payable in connection with the Zen and Bridge acquisitions as July 1, 2006 and December 31, 2005, respectively.

On February 9, 2005, contemporaneously with the closing of our acquisition of SEI, the Company entered into an Amended and Restated Credit Agreement (the *Credit Agreement*) which increased its borrowing capacity to \$160 million, which is comprised of a \$60 million five-year revolving credit facility and a \$100 million six-year term loan facility. Additionally, the *Credit Agreement* provides that up to an additional \$75 million in uncommitted incremental term loan funds are available to the Company upon its request at any time for up to two years from one or more of the lenders under the *Credit Agreement*. The annual maturity of long-term debt under the *Credit Agreement* was \$1.0 million for each of the five fiscal years subsequent to December 31, 2005 and approximately \$94.3 million thereafter.

On February 27, 2006, contemporaneously with the closing of our acquisition of Zen, we entered into a First Amendment to the *Credit Agreement* (the *First Amendment*). The *Credit Agreement*, as amended by the *First Amendment*, is referred to herein as the *Amended Credit Agreement*. The funds borrowed under the *First Amendment* were used to (i) refinance the approximately \$99.3 million in principal outstanding under the then existing term loan under the *Credit Agreement* and to pay any and all fees and expenses related thereto; (ii) to finance the acquisition of Zen and pay any and all fees and expenses related thereto; and (iii) to provide for working capital expenditures, and other general corporate uses.

The Company had approximately \$129.3 million of outstanding debt under our *First Amendment* on February 27, 2006 following the closing of our acquisition of Zen. As with the previous credit facilities, we are required to maintain compliance with financial and non-financial covenants including, maintaining certain leverage and fixed charge ratios, as well as certain annual limits on our capital expenditures. The *First Amendment* amended the leverage ratio that requires us to maintain a ratio of funded debt to consolidated EBITDA for such period as follows:

| Period  | New Maximum Ratio | Prior Maximum Ratio |
|---|-------------------|---------------------|
| July 1, 2006 through fiscal quarter ending June 29, 2007  | 3.50 to 1.00      | 3.25 to 1.00        |
| June 30, 2007 through fiscal quarter ending June 27, 2008 | 3.00 to 1.00      | 3.00 to 1.00        |
| June 28, 2008 and thereafter                              | 2.75 to 1.00      | 2.75 to 1.00        |

These ratios will be calculated in accordance with the definitions and terms contained in the Amended Credit Agreement, which may be different than calculations pursuant to GAAP.

In connection with the Credit Agreement, the Company incurred approximately \$3.2 million financing costs. With respect to the First Amendment, the Company incurred approximately \$0.5 million in financing costs. Such costs associated with the Credit Agreement were capitalized as deferred financing costs on the balance sheet and amortized over the six year term of the Credit Agreement. Such costs associated with the First Amendment are being amortized over five year term of the First Amendment.

At the time the Company borrows funds from either the loan facilities under the Amended Credit Agreement, it may choose from two interest rate options. The Company may elect to have the borrowings bear interest at floating rates equal to LIBOR plus a spread ranging from 200 to 270 basis points or an alternative base rate plus a spread ranging from 100 to 175 basis points. Under either the LIBOR or alternative base rate option, the exact interest rate spread will be determined based upon the Company's leverage ratio as defined in the Amended Credit Agreement.

During the quarter ended July 1, 2006, the Company used the net proceeds from its April 2006 common stock offering as described under Note 9 below, combined with cash on hand to pay down approximately \$45.0 million of outstanding term debt under the First Amendment, after which the remaining principal balance as of July 1, 2006, was approximately \$83.4 million. As a result of the pay down of principal, the Company's quarterly payment was reduced from \$323,125 to \$209,816 in consecutive quarterly payments starting from June 30, 2006 through December 30, 2010, and a final payment of approximately \$79.6 million on February 9, 2011. The amount of deferred loan origination fees written off in connection with the pay down in the quarter ended July 1, 2006 was \$0.9 million.

The Company also had a note payable outstanding in the amount of \$2.3 million, which was paid in June 2006 for the acquisition of Bridge, and a note payable with a face value of \$6.0 million including imputed interest, to be paid in May 2007 for the acquisition of Zen.

## 8. Commitments and contingencies:

### Leases

As of July 1, 2006, the Company has noncancelable operating leases, primarily for real estate, that expire over the next ten years. Rental expense during the quarter ended July 1, 2006 was approximately \$2.3 million, compared to rental expense of approximately \$1.9 million during the quarter ended June 25, 2005.

### Contract cost audits

Payments to the Company on government cost reimbursable contracts are based on provisional, or estimated indirect rates, which are subject to audit on an annual basis by the Defense Contract Audit Agency (DCAA). The cost audits result in the negotiation and determination of the final indirect cost rates that the Company may use for the period(s) audited. The final rates, if different from the provisional rates, may create an additional receivable or liability for the Company. The Company's revenue recognition policy calls for revenue recognized on all cost reimbursable government contracts to be recorded at actual rates unless collectibility is not reasonably assured. To the extent the indirect rate differential creates a liability for the Company, the differential is recognized as a reduction to revenue when identified.

### Litigation and claims

We are a party to litigation and legal proceedings that we believe to be a part of the ordinary course of our business. While we cannot predict the ultimate outcome of these matters, we currently believe that any ultimate liability arising out of these proceedings will not have a material adverse effect on our financial position. We may become involved in other legal and governmental, administrative or contractual proceedings in the future.

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The SEI acquisition agreement provides for a purchase price adjustment based upon the working capital of SEI as of the closing date. Subsequent to the closing date, we received a payment of \$1.6 million in connection with services performed prior to the closing date that SEI had not previously billed, and was not authorized to bill, its customer as of the closing date.

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The SEI selling stockholders have asserted that they are entitled to a credit in connection with the calculation of working capital adjustment in an amount equal to the amount received by us for this post-closing payment. We believe that, in accordance with GAAP, the SEI selling stockholders should not receive the benefit of the post-closing payment. In accordance with the terms of the SEI acquisition agreement, the parties have jointly submitted the issue to an independent accounting firm for resolution. We anticipate that this matter will be resolved before the end of 2006.

In June 2006, the Company, through one of its subsidiaries, was awarded a judgment in a lawsuit filed in the Circuit Court of Fairfax County, Virginia against National Technologies Associates, Inc. ( NTA ) in the amount of \$841,612. The Company's claims arose out of the Company's allegation that NTA breached a contract which obligated NTA to subcontract certain work to the Company's subsidiary. The Company has not recorded the judgment because the judgment is presently subject to NTA's motion for reconsideration before the trial court and, in the event that NTA does not succeed in its motion for reconsideration, the Company anticipates that NTA will seek to appeal the judgment to the Virginia Supreme Court. While the Company cannot presently determine the ultimate outcome of this matter, management believes that it will prevail on NTA's motion to reconsider the matter and that the judgment in its favor will be upheld or affirmed.

## **9. Stockholders' equity:**

### **April 2006 common stock offering**

On April 7, 2006, we issued 1,200,000 shares of common stock in an underwritten public offering at an initial price to the public of \$34.00 per share under our shelf registration statement on Form S-3 (No. 333-113827) declared effective by the SEC on May 21, 2004. Net sale proceeds to the Company, after deducting underwriting discounts and commissions, but before other expenses relating to the sale, totaled approximately \$40.5 million. The Company used the net proceeds from the sale together with cash on hand to pay down outstanding term debt under the First Amendment.

### **Stock option plans**

In April 2005, the Board of Directors voted to adopt the 2002 Amended and Restated Omnibus Stock Incentive Plan (the Amended and Restated Plan ), and the Amended and Restated Plan was approved by our stockholders at the annual meeting of stockholders held in June 2005. The Amended and Restated Plan amends and restates the Company's prior 2002 Stock Incentive Plan, or the Plan , by (i) increasing the number of shares of common stock reserved and available under the Plan by 1,000,000 shares to a total share allocation of 2,920,000, (ii) permitting the grant of deferred shares, performance shares and performance units, (iii) prohibiting repricing of options without prior stockholder approval, (iv) limiting the number of shares of common stock and performance units subject to awards a participant may receive in any calendar year to 300,000 and 500,000, respectively, and adding other administrative provisions to comply with the performance-based compensation exception to the deduction limit of Section 162(m) of the Internal Revenue Code of 1986, as amended; (v) eliminating the provision that previously provided for an automatic increase in the number of shares reserved for issuance under the Amended and Restated Plan each fiscal year by a number equal to the lesser of 160,000 shares or an amount determined by the Board of Directors, (vi) providing that non-qualified stock option grants will be priced at one hundred percent (100%) of fair market value; (vii) providing for minimum vesting periods of stock bonus awards, restricted common stock awards, stock appreciation rights, deferred shares, and other stock awards subject to the possible acceleration of the vesting schedule at the discretion of the administrator; (viii) providing that future amendments to the Amended and Restated Plan that increase the number of shares allocated, modify participation requirements, or materially increase benefits accruing to the participants under the Plan will be subject to stockholder approval; and (ix) making other technical changes to the Plan.

On December 13, 2005, the Board of Directors announced the accelerated vesting of unvested stock options previously awarded to employees, officers and directors as of December 7, 2005 in light of a new accounting regulation that came into effect on January 1, 2006. Based on the Statement of Financial Accounting Standards No. 123R, Share-Based Payment (SFAS 123R), the Board took the action to accelerate the unvested stock with the belief that it was in the best interest of stockholders, as it will reduce the Company's reported compensation expense in future periods.

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A summary of option activity under the plan as of July 1, 2006, is presented below:

|                                     | Options   | Shares<br>exercisable | Weighted-average<br>exercise price |
|-------------------------------------|-----------|-----------------------|------------------------------------|
| Outstanding at December 31, 2005    | 1,750,937 |                       | \$ 20.29                           |
| 2006 grants                         | 13,900    |                       | 32.38                              |
| 2006 exercises                      | (313,717  | )                     | 16.66                              |
| 2006 forfeitures                    | (15,263   | )                     | 26.34                              |
| Balance, July 1, 2006               | 1,435,857 |                       | \$ 21.42                           |
| Options exercisable at July 1, 2006 |           | 1,424,457             | \$ 21.33                           |

The following table shows the number of options outstanding, the weighted average exercise price, the weighted average remaining life, and the options exercisable for each range of exercise prices of options outstanding at July 1, 2006.

|              | Number of<br>Options<br>Outstanding | Range of<br>Exercise<br>Price | Weighted<br>Avg. Exercise<br>Price | Weighted<br>Average<br>Remaining Life | Options<br>Exercisable | Weighted<br>Avg. Exercise<br>Price |
|--------------|-------------------------------------|-------------------------------|------------------------------------|---------------------------------------|------------------------|------------------------------------|
|              | 66,730                              | \$ 1.58 - 9.27                | \$ 9.06                            | 2.6                                   | 66,730                 | \$ 9.06                            |
|              | 350,933                             | \$ 10.81 - 14.00              | \$ 13.80                           | 6.4                                   | 350,933                | \$ 13.80                           |
|              | 318,229                             | \$ 16.40 - 19.26              | \$ 16.68                           | 7.1                                   | 318,229                | \$ 16.68                           |
|              | 197,639                             | \$ 20.55 - 26.60              | \$ 25.71                           | 8.1                                   | 197,639                | \$ 25.71                           |
|              | 332,478                             | \$ 26.80 - 29.87              | \$ 28.14                           | 8.8                                   | 332,478                | \$ 28.14                           |
|              | 169,300                             | \$ 30.46 - 32.83              | \$ 31.02                           | 9.3                                   | 157,900                | \$ 30.92                           |
|              | 548                                 | \$ 556.26                     | \$ 556.26                          | 1.5                                   | 548                    | \$ 556.26                          |
| <b>Total</b> | <b>1,435,857</b>                    |                               | <b>\$ 21.42</b>                    | <b>7.5</b>                            | <b>1,424,457</b>       | <b>\$ 21.33</b>                    |

Each stock option grant establishes the vesting schedule applicable to the grant. The weighted-average remaining contractual life of the stock options outstanding and exercisable as of July 1, 2006 was 7.5 years with the maximum contractual term of 10 years.

The weighted-average grant-date fair value of options granted during the quarters ended July 1, 2006 and June 25, 2005 were \$14.24 and \$14.10, respectively. The total intrinsic value of options exercised during the quarters ended July 1, 2006, and June 25, 2005 was \$1.1 million and \$1.0 million, respectively. The total intrinsic value of options outstanding and exercisable as of July 1, 2006 was \$13.6 million.

### Stock repurchase program

In December 2005 the Company's Board of Directors authorized the repurchase of up to 300,000 shares of its common stock up to an aggregate maximum dollar amount of \$8 million. The Company had 12,881,715 shares outstanding as of August 1, 2006. Timing and volume of any purchases will be guided by management's assessment of market conditions, securities law limitations, the number of shares of common stock outstanding, and alternative, potentially higher value uses for cash resources. The repurchase plan may be suspended or discontinued at any time without prior notice.

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

*The following discussion and analysis should be read in conjunction with the consolidated financial statements and related notes included elsewhere in this Form 10-Q. This discussion and analysis contains forward-looking statements that involve known and unknown risks, uncertainties, and other factors that may cause our actual results, level of activity, performance or achievements to be materially different from any future results, levels of activity, performance or achievements expressed or implied by such forward-looking statements. In some cases, you can identify these statements by forward-looking words such as*





*anticipate, believe, could, estimate, expect, intend, may, plan, potential, should, will, and would or similar words. You should read statements that contain these words carefully because they discuss our future expectations, contain projections of our future results of operations or of our financial position, or state other forward-looking information. We believe that it is important to communicate our future expectations to our investors. However, there may be events in the future that we are not able to predict accurately or control. In particular, statements that we make in this section relating to the sufficiency of anticipated sources of capital to meet our cash requirements are forward-looking statements. Our actual results could differ materially from those anticipated in these forward-looking statements for many reasons, including as a result of some of the factors described below, elsewhere in this Form 10-Q and in the section entitled Risk Factors in our Form 10-K/A for the fiscal year ended December 31, 2005. You should not place undue reliance on these forward-looking statements, which apply only as of the date of the filing of this Form 10-Q.*

*The Company's fiscal year is based on the calendar year and ends each year on the Saturday nearest, but not falling after, December 31 of that year. Typically, fiscal quarters also end on the Saturday nearest, but not falling after, the end of the calendar quarter. However, in order to ensure that the fiscal quarters presented in this Form 10-Q include 13 weeks, we ended the second quarter on Saturday, July 1, 2006. Similarly, we will end future fiscal quarters on the Saturday which provides us with a 13 week quarter to compare with the previous year's quarterly results even if that Saturday falls after the end of the calendar quarter. As a result, our fiscal year may be comprised of 52 or 53 weeks.*

*References to the Company, we, us and our refer to SI International, Inc. and its subsidiaries.*

## **Overview**

We are, first and foremost, a provider of information technology and network solutions (IT) to the Federal Government. Our clients include the U.S. Air Force, U.S. Army, U.S. Navy, Department of State, Missile Defense Agency, Department of Homeland Security, Department of Energy, Department of Agriculture, National Institutes of Health, Federal Retirement Thrift Investment Board, National Guard Bureau, and the Intelligence community. We combine our technology and industry expertise to provide a full spectrum of state-of-the-practice solutions and services, from design and development to implementation and operations, which assist our clients in achieving mission success. We believe that our Company is distinguishable from our peers within the federal IT sector in several important respects.

We employ a Rapid Response Rapid Deployment® methodology that enables the rapid standing up of innovative solutions and the incorporation of additional capabilities in rapid succession. This capability allows us to respond to urgent IT imperatives quickly, often in a matter of months, and within a well defined budget. We can, therefore, provide solutions for current IT needs, while establishing a platform for advancing long-term transformational objectives. We possess a proven ability to respond to high priority information technology and network needs through innovation, and an enviable reputation for timely delivery of robust solutions on assignments where failure is not an option. Our Mission Critical Mission Accomplished solutions enable clients to respond to new mandates, expand the scope of their missions, and reengineer underlying business processes. We have a demonstrated ability of turning troubled IT projects into winning outcomes and realized exceptional growth from high-quality client engagements. We also utilize mature and proven processes to manage and market large-scale ID/IQ contracts, such as C4I2TSR. We employ a diverse, innovative team that effectively utilizes small business partners' unique skills and expertise for mission critical IT projects.

For the fiscal quarters ended July 1, 2006 and June 25, 2005, we received 98.3% and 98.5%, respectively, of our revenues from services we provided to various departments and agencies of the Federal Government, both directly and through other prime contractors. Additionally, for the fiscal quarters ended July 1, 2006 and June 25, 2005, 1.7% and 1.5%, respectively, of our total revenues from work performed for commercial entities. The following table shows our revenues from the client groups listed as a percentage of total revenue. Revenue data for the DoD includes revenue generated from work performed under engagements for both the DoD and the Intelligence community.

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|                           | Three Months Ended |   |               |   | Six Months Ended |   |               |   |
|---------------------------|--------------------|---|---------------|---|------------------|---|---------------|---|
|                           | July 1, 2006       |   | June 25, 2005 |   | July 1, 2006     |   | June 25, 2005 |   |
| Department of Defense     | 47.3               | % | 44.2          | % | 47.6             | % | 46.2          | % |
| Federal civilian agencies | 51.0               | % | 54.3          | % | 50.6             | % | 52.0          | % |
| Commercial entities       | 1.7                | % | 1.5           | % | 1.8              | % | 1.8           | % |
| Total revenue             | 100.0              | % | 100.0         | % | 100.0            | % | 100.0         | % |

We have derived a substantial majority of our revenues from governmental contracts under which we act as a prime contractor. We also provide services indirectly as a subcontractor. The following table shows our revenues as prime contractor and as subcontractor as a percentage of our total revenue for the following periods:

|                        | Three Months Ended |   |               |   | Six Months Ended |   |               |   |
|------------------------|--------------------|---|---------------|---|------------------|---|---------------|---|
|                        | July 1, 2006       |   | June 25, 2005 |   | July 1, 2006     |   | June 25, 2005 |   |
| Prime contract revenue | 77.9               | % | 73.6          | % | 77.8             | % | 74.9          | % |
| Subcontract revenue    | 22.1               | % | 26.4          | % | 22.2             | % | 25.1          | % |
| Total revenue          | 100.0              | % | 100.0         | % | 100.0            | % | 100.0         | % |

Our services are provided to clients pursuant to three types of contracts: cost reimbursable, time and materials and fixed price contracts. The following table shows our revenues from each of these types of contracts as a percentage of our total revenue for the following periods:

|                    | Three Months Ended |   |               |   | Six Months Ended |   |               |   |
|--------------------|--------------------|---|---------------|---|------------------|---|---------------|---|
|                    | July 1, 2006       |   | June 25, 2005 |   | July 1, 2006     |   | June 25, 2005 |   |
| Cost reimbursable  | 29.6               | % | 27.0          | % | 30.7             | % | 27.9          | % |
| Time and materials | 40.0               | % | 45.2          | % | 40.4             | % | 45.6          | % |
| Fixed price        | 30.4               | % | 27.8          | % | 28.9             | % | 26.5          | % |
| Total              | 100.0              | % | 100.0         | % | 100.0            | % | 100.0         | % |

Under cost reimbursable contracts, we are reimbursed for costs that are determined to be reasonable, allowable and allocable to the contract, and paid a fee representing the profit margin negotiated between us and the contracting agency, which may be fixed or performance based. Under cost reimbursable contracts we recognize revenues and an estimate of applicable fees earned as costs are incurred. We consider fixed fees under cost reimbursable contracts to be earned in proportion to the allowable costs incurred in performance of the contract. For performance-based fees under cost reimbursable contracts, we recognize the relevant portion of the expected fee to be awarded by the client at the time such fee can be reasonably estimated, based on factors such as our prior award experience and communications with the client regarding performance. In general, cost reimbursable contracts are the least profitable of our government contracts.

Under time and materials contracts, we are reimbursed for labor at fixed hourly rates and generally reimbursed separately for allowable materials, costs and expenses. To the extent that our actual labor costs under a time and materials contract are higher or lower than the billing rates under the contract, our profit under the contract may either be greater or less

than we anticipated or we may suffer a loss under the contract. We recognize revenues under time and materials contracts by multiplying the number of direct labor hours expended by the contract billing rates and adding the effect of other billable direct costs. In general, we realize a higher profit margin on work performed under time and materials contracts than cost reimbursable contracts.

Under fixed price contracts, we perform specific tasks for a fixed price. Compared to cost reimbursable and time and materials contracts, fixed price contracts generally offer higher profit margin opportunities but involve greater financial risk because we bear the impact of cost overruns in return for the full benefit of any cost savings. We generally do not undertake complex, high-risk work, such as long-term software development, under fixed price terms. Fixed price contracts may include either a product delivery or specific service performance over a defined period. Revenue on fixed price contracts that provide for the Company to render services throughout a period is recognized as earned according to contract terms as the service is provided on a proportionate performance basis. While a substantial number of these contracts are generally less than six months in duration, we have several multi-year contracts of this type in which the customer has the option to extend the contractual term beyond the current term.

If we anticipate a loss on a contract, we provide for the full amount of anticipated loss at the time of that determination.

Our most significant expense is direct cost, which consists primarily of direct labor costs for program personnel and direct expenses incurred to complete contracts, including cost of materials and subcontract efforts. Our ability to predict accurately the number and types of personnel, their salaries, and other costs, can have a significant impact on our direct cost.

The allowance of certain direct and indirect costs in federal contracts is subject to audit by the client, usually through the DCAA. Certain indirect costs are charged to contracts and paid by the client using provisional, or estimated, indirect rates, which are subject to later revision, based on the government audits of those costs.

#### **Recent Events**

*Stock Issuance.* On April 7, 2006, we issued 1,200,000 shares of common stock in an underwritten public offering at an initial price of \$34.00 per share under our shelf registration statement on Form S-3 (No. 333-113928) declared effective by the SEC on May 31, 2004. Net sale proceeds to the Company, after deducting underwriting discounts and commissions, but before other expenses relating to the sale, totaled approximately \$40.5 million. The Company used the net proceeds from the sale to pay down outstanding term debt under the First Amendment, after which the remaining principal balance is approximately \$83.4 million.

#### **Liquidity and Capital Resources**

*General.* Short-term liquidity requirements are created by our use of funds for working capital, capital expenditures, and the need to provide debt service. We expect to meet these requirements through a combination of cash flow from operations and borrowings under our Amended Credit Agreement.

We anticipate that our long-term liquidity requirements, including any further acquisitions, will be funded through a combination of cash flow from operations, borrowings under our Amended Credit Agreement, additional secured or unsecured debt or the issuance of common or preferred stock, each of which may be initially funded through borrowings under our Amended Credit Agreement.

Under the terms of our Amended Credit Agreement, the Company is required to maintain compliance with financial and non-financial covenants. The Company is in compliance with all such covenants as of July 1, 2006.

*Cash and Cash Equivalents.* We consider cash on deposit and all highly liquid investments with original maturities of three months or less to be cash and cash equivalents. Cash and cash equivalents, including marketable securities, as of the end of three months ending July 1, 2006 and June 25, 2005 was \$6.3 million and \$14.9 million, respectively.



*Cash Flow.* The following table sets forth our sources and uses of cash for the six months ended July 1, 2006 and June 25, 2005.

|   | <b>Six Months Ended<br/>July 1, 2006<br/>(in thousands)</b> | <b>June 25, 2005</b> |
|---|---|----------------------|
| Net cash provided by operations           | \$ 4,854  | \$ 14,272            |
| Net cash used in investing activities     | (55,492 )   | (72,306 )            |
| Net cash provided by financing activities | 30,761  | 69,212               |
| Net (decrease) increase in cash           | \$ (19,877 )  | \$ 11,178            |

Our operating cash flow is primarily affected by the overall profitability of our contracts, our ability to invoice and collect from our clients in a timely manner, and our ability to manage our vendor payments. We bill most of our clients monthly after services are rendered. Cash provided by operations in the six months ended July 1, 2006 was attributable to net income of \$8.8 million, plus depreciation, amortization and other non-cash items of \$4.4 million, net of an increase in working capital and other operating assets and liabilities of \$8.3 million. Cash provided by operations in the six months ended June 25, 2005 was attributable to net income of \$7.3 million, depreciation, amortization, and other non-cash items of \$2.5 million, and a decrease in working capital and other operating assets and liabilities of \$4.5 million.

Our cash flow used in investing activities consists primarily of capital expenditures, the purchase and sale of marketable securities, and acquisitions. In the six months ended July 1, 2006, we paid \$48.0 million for business acquisitions, net of cash assumed, repaid a contract settlement to a former owner for \$10.3 million, and purchased capital assets totaling \$5.0 million. We partially offset the cash use with \$7.9 million of proceeds from the sale of marketable securities, net of purchases. During the six months ended June 25, 2005, we paid \$74.0 million for business acquisitions, net of cash assumed, invested \$0.3 million in capital assets, and we partially offset the cash use with \$2.0 million of proceeds from the sale of marketable securities, net of purchases.

For the six months ended July 1, 2006, cash flow provided by financing activities was attributed to proceeds of \$40.4 million from the sale of common stock, \$30 million of proceeds from the issuance of term debt, \$5.2 million of proceeds from the exercise of stock options and \$1.1 million from other sources, net of \$45.9 million repayment of term debt. For the six months ended June 25, 2005, cash flow provided by financing activities was attributed to proceeds of \$100 million from the issuance of term debt and \$1.4 million of proceeds from the exercise of stock options, net of a \$29 million repayment of revolving debt and a \$3.2 million payment of debt issuance fees and other items.

**Results of Operations**

The following table sets forth certain items from our consolidated statements of operations as a percentage of revenues for the periods indicated.

|  | Three Months Ended |   |                  |   | Six Months Ended |   |                  |   |
|--|--------------------|---|------------------|---|------------------|---|------------------|---|
|  | July 1,<br>2006    |   | June 25,<br>2005 |   | July 1,<br>2006  |   | June 25,<br>2005 |   |
| Revenue                                  | 100.0              | % | 100.0            | % | 100.0            | % | 100.0            | % |
| Operating costs and expenses:            |                    |   |                  |   |                  |   |                  |   |
| Cost of services                         | 62.9               |   | 61.1             |   | 62.5             |   | 61.9             |   |
| Selling, general and administrative      | 27.4               |   | 29.1             |   | 27.9             |   | 28.7             |   |
| Depreciation and amortization            | 0.5                |   | 0.6              |   | 0.5              |   | 0.6              |   |
| Amortization of intangible assets        | 0.7                |   | 0.6              |   | 0.7              |   | 0.6              |   |
| Total operating costs and expenses       | 91.5               |   | 91.4             |   | 91.6             |   | 91.8             |   |
| Income from operations                   | 8.5                |   | 8.6              |   | 8.4              |   | 8.2              |   |
| Other income (expense)                   |                    |   |                  |   |                  |   |                  |   |
| Interest expense                         | (2.3               | ) | (1.7             | ) | (2.0             | ) | (1.5             | ) |
| Income before provision for income taxes | 6.2                |   | 6.9              |   | 6.4              |   | 6.7              |   |
| Provision for income taxes               | 2.4                |   | 2.7              |   | 2.5              |   | 2.7              |   |
| Net income                               | 3.8                | % | 4.2              | % | 3.9              | % | 4.0              | % |

**Three months ended July 1, 2006 compared with three months ended June 25, 2005**

*Revenue.* Substantially all of our revenue is derived from services and solutions provided to the Federal Government, primarily by our employees and, to a lesser extent, our subcontractors. For the three months ended July 1, 2006, our revenues increased 24.2% to \$119.2 million from \$96.0 million for the three months ended June 25, 2005. Revenues from work under Federal Government contracts increased 24.0% to \$117.2 million for the three months ended July 1, 2006 from \$94.5 million for the three months ended June 25, 2005. This increase was attributable to the acquisition and integration of Zen in the first quarter of 2006, new contract awards, successful recompetition wins on existing programs, new contracts from and growth within existing programs in our four focus areas: Federal IT Modernization, Defense Transformation, Homeland Defense, and Mission-Critical Outsourcing. Commercial revenues increased to \$2.1 million in the three months ended July 1, 2006 from \$1.5 million in the three months ended June 25, 2005. We continue to focus primarily on opportunities for the Federal government.

*Cost of services.* Cost of services includes direct labor and other direct costs such as materials and subcontracts, incurred to provide our services and solutions to our customers. Generally, changes in cost of services are correlated to changes in revenue as resources are consumed in the production of that revenue. Please note that in prior period financial statements, we referred to cost of services as direct costs. We expect to use the term cost of services in all future periods. For the three months ended July 1, 2006, cost of services increased 27.9% to \$75.0 million from \$58.6 million for the three months ended June 25, 2005. This increase was attributable primarily to the increase in revenue. As a percentage of revenue, cost of services were 62.9% for the three months ended July 1, 2006 as compared to 61.1% for the three months ended June 25, 2005.

*Selling, general and administrative expenses.* Selling, general and administrative expenses include facilities, selling, bid and proposal, indirect labor, fringe benefits and other discretionary costs. Please note that in prior period financial

statements, we referred to selling, general and administrative expenses as indirect costs . We expect to use the term selling, general and administrative expenses in all future periods. For the three months ended July 1, 2006, selling, general and administrative expenses increased 16.8% to \$32.6 million from \$27.9 million for the three months ended June 25, 2005. This \$4.7 million increase was primarily attributable to the expected growth of support functions necessary to facilitate and administer the growth in cost of services as well as the integration of Zen. As a percentage of revenue, selling, general and administrative expenses were 27.4% for the three months ended July 1, 2006 as compared to 29.1% for the three months ended June 25, 2005.

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*Depreciation and amortization.* Depreciation and amortization includes the depreciation of computers, furniture and other equipment, the amortization of third party software we use internally, and leasehold improvements. For the three months ended July 1, 2006, depreciation and amortization expense was \$0.7 million, a slight increase compared to \$0.5 million for the three months ended June 25, 2005. However, as a percentage of revenue, depreciation and amortization expense was 0.5% for the three months ended July 1, 2006 compared to 0.6% for the three months ended June 25, 2005.

*Amortization of intangible assets.* Amortization of intangible assets includes the amortization of intangible assets acquired in connection with acquisitions in accordance with SFAS 142, Goodwill and Other Intangible Assets. We discontinued the amortization of goodwill effective December 30, 2001. Identifiable intangible assets are amortized over their estimated useful lives. Non-compete agreements are generally amortized straight-line over the term of the agreement, while contracts and related client relationships are amortized using an accelerated method over their estimated remaining lives. For the three months ended July 1, 2006, amortization of intangible assets was \$0.8 million, compared to \$0.6 million for the three months ended June 25, 2005. This increase was attributed primarily to the Zen acquisition. As a percentage of revenue amortization of intangible assets was 0.7% for the three months ended July 1, 2006 compared to 0.6 % for the three months ended June 25, 2005.

*Income from operations.* For the three months ended July 1, 2006, income from operations increased 21.9% to \$10.1 million from \$8.3 million for the three months ended June 25, 2005. This increase was attributable primarily to increased revenues. As a percentage of revenue, income from operations was 8.5% for the three months ended July 1, 2006 compared to 8.7% for the three months ended June 25, 2005.

*Interest expense.* Interest expense increased 62.3% to \$2.7 million for the three months ended July 1, 2006 from \$1.7 million for the three months ended June 25, 2005. This increase was attributable primarily to the \$0.9 million write off of loan origination fees due to the prepayment of term debt. As a percentage of revenue, interest expense was 2.3% for the three months ended July 1, 2006 as compared to 1.7% for the three months ended June 25, 2005. We anticipate interest expense to remain at the same levels throughout the rest of fiscal year 2006 as compared to the same periods in 2005.

*Provision for income taxes.* The provision for income taxes was \$2.9 million in the three months ended July 1, 2006, compared to \$2.6 million for the three months ended June 25, 2005. Our second quarters of 2006 and 2005 tax provision, represents an estimated annual effective tax rate of 39.5%. Our estimated annual effective tax rate is greater than the federal statutory rate of 34% due primarily to state income taxes.

#### **Six months ended July 1, 2006 compared with six months ended June 25, 2005**

*Revenue.* Substantially all of our revenue is derived from services and solutions provided to the Federal Government, primarily by our employees and, to a lesser extent, our subcontractors. For the six months ended July 1, 2006, our revenues increased 26.0% to \$226.5 million from \$179.7 million for the six months ended June 25, 2005. Revenues from work under Federal Government contracts increased 26.1% to \$222.5 million for the six months ended July 1, 2006 from \$176.4 million for the six months ended June 25, 2005. This increase was attributable to the acquisition of Zen and SEI in the first quarters of 2006 and 2005, respectively, new contract awards, successful recompetition wins on existing programs, new contracts from and growth within existing programs in our four focus areas: Federal IT Modernization, Defense Transformation, Homeland Defense, and Mission-Critical Outsourcing. Commercial revenues increased 21.2% to \$4.0 million in the six months ended July 1, 2006 from \$3.3 million in the six months ended June 25, 2005. We continue to focus primarily on opportunities for the Federal government.



*Cost of services.* Cost of services includes direct labor and other direct costs such as materials and subcontracts, incurred to provide our services and solutions to our customers. Generally, changes in costs of services are correlated to changes in revenue as resources are consumed in the production of that revenue. Please note that in prior period financial statements, we referred to cost of services as direct costs . We expect to use the term cost of services in all future periods. For the six months ended July 1, 2006, costs of services increased 27.3% to \$141.6 million from \$111.2 million for the six months ended June 25, 2005. This increase was attributable primarily to the increase in revenue. As a percentage of revenue, costs of services were 62.5% for the six months ended July 1, 2006 as compared to 61.9% for the six months ended June 25, 2005.

*Selling, general and administrative expenses.* Selling, general and administrative expenses include facilities, selling, bid and proposal, indirect labor, fringe benefits and other discretionary costs. Please note that in the prior period financial statements, we referred to selling, general and administrative expenses as indirect costs . We expect to use the term selling, general and

administrative expenses in all future periods. For the six months ended July 1, 2006, selling, general and administrative expenses increased 22.7% to \$63.2 million from \$51.5 million for the six months ended June 25, 2005. This \$11.7 million increase was primarily attributable to the expected growth of support functions necessary to facilitate and administer the growth in costs of services as well as the integration of Zen. As a percentage of revenue, selling, general and administrative expenses were 27.9% for the six months ended July 1, 2006 as compared to 28.7% for the six months ended June 25, 2005.

*Depreciation and amortization.* Depreciation and amortization includes the depreciation of computers, furniture and other equipment, the amortization of third party software we use internally, and leasehold improvements. For the six months ended July 1, 2006, depreciation expense was \$1.2 million, a slight increase compared to \$1.1 million for the six months ended June 25, 2005. However, as a percentage of revenue, depreciation expense was 0.7% for the six months ended July 1, 2006 compared to 0.6% for the six months ended June 25, 2005.

*Amortization of intangible assets.* Amortization of intangible assets includes the amortization of intangible assets acquired in connection with acquisitions in accordance with SFAS 142, Goodwill and Other Intangible Assets. We discontinued the amortization of goodwill effective December 30, 2001. Identifiable intangible assets are amortized over their estimated useful lives. Non-compete agreements are generally amortized straight-line over the term of the agreement, while contracts and related client relationships are amortized using an accelerated method over their estimated remaining lives. For the six months ended July 1, 2006, amortization of intangible assets was \$1.5 million, compared to \$1.1 million for the six months ended June 25, 2005. This increase was attributed primarily to the Zen acquisition. As a percentage of revenue amortization of intangible assets was 0.6% for the six months ended July 1, 2006 compared to 0.6 % for the six months ended June 25, 2005.

*Income from operations.* For the six months ended July 1, 2006, income from operations increased 28.2% to \$19.0 million from \$14.8 million for the six months ended June 25, 2005. This increase was attributable primarily to increased revenues. As a percentage of revenue, income from operations was 8.4% for the six months ended July 1, 2006 compared to 8.3% for the six months ended June 25, 2005.

*Interest expense.* Interest expense increased 62.4% to \$4.5 million for the six months ended July 1, 2006 from \$2.8 million for the six months ended June 25, 2005. This increase was attributable primarily to the \$0.9 million write off of loan origination fees due to the prepayment of term debt. As a percentage of revenue, interest expense was 2.0% for the six months ended July 1, 2006 as compared to 1.5% for the six months ended June 25, 2005. We anticipate interest expense to remain at the same levels throughout the rest of fiscal year 2006 as compared to the same periods in 2005.

*Provision for income taxes.* The provision for income taxes was \$5.7 million in the six months ended July 1, 2006, compared to \$4.7 million for the six months ended June 25, 2005. Our second quarters of 2006 and 2005 tax provision, represents an estimated annual effective tax rate of 39.5%. Our estimated annual effective tax rate is greater than the federal statutory rate of 34% due primarily to state income taxes.

#### **Off-Balance Sheet Arrangements**

As of July 1, 2006, we have no off-balance sheet arrangements that are reasonably likely to have a current or future material effect on our financial condition, revenues, or expenses, result of operations, liquidity, capital expenditures, or capital resources.

#### **Critical Accounting Policies and Estimates**

Our significant accounting policies are described in Note 2 to our accompanying consolidated financial statements. We consider the accounting policies related to revenue recognition to be critical to the understanding of our results of operations. Our critical accounting policies also include the areas where we have made what we consider to be particularly difficult, subjective or complex judgments in making estimates, and

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where these estimates can significantly impact our financial results under different assumptions and conditions. We prepare our financial statements in conformity with accounting principles generally accepted in the United States. As such, we are required to make certain estimates, judgments and assumptions that we believe are reasonable based upon the information available. These estimates, judgments and assumptions affect the reported amounts of assets and liabilities at the date of the financial statements and the reported amounts of revenue and expenses during the periods presented. Actual results could be different from these estimates.

### *Revenue Recognition*

We recognize revenue under its contracts when a contract has been executed, the contract price is fixed and determinable, delivery of services or products has occurred, and collectibility of the contract price is considered probable and can be reasonably estimated. Revenue is earned under cost reimbursable, time and materials and fixed price contracts. Direct contract costs are expensed as incurred.

Under cost reimbursable contracts, we are reimbursed for allowable costs, and paid a fee, which may be fixed or performance-based. Revenues on cost reimbursable contracts are recognized as costs are incurred plus an estimate of applicable fees earned. We consider fixed fees under cost reimbursable contracts to be earned in proportion of the allowable costs incurred in performance of the contract. For cost reimbursable contracts that include performance based fee incentives, we recognize the relevant portion of the expected fee to be awarded by the customer at the time such fee can be reasonably estimated, based on factors such as our prior award experience and communications with the customer regarding performance.

Revenue on time and materials contracts are recognized based on direct labor hours expended at contract billing rates and adding other billable direct costs.

Fixed price contracts may include either a product delivery or specific service performance throughout a period. For fixed price contracts that are based on unit pricing, we recognize revenue for the number of units delivered in any given fiscal period. For fixed price contracts that are based on the proportionate performance method and involve a specified number of similar acts, we recognize revenue based on the proportion of those acts completed compared to the number of total specified acts required by the contract. For fixed price contracts that are based on the proportionate performance method and involve a specified number of defined but not similar acts, we recognize revenue based on the proportion of the project's percentage total costs incurred compared to the estimated total costs associated with the entire transaction. For fixed price contracts that provide for the delivery of a specific product with related customer acceptance provisions, revenues and associated contract costs are recognized upon product delivery and customer acceptance.

Our contracts with agencies of the government are subject to periodic funding by the respective contracting agency. Funding for a contract may be provided in full at inception of the contract or ratably throughout the contract as the services are provided. In evaluating the probability of funding for purposes of assessing collectibility of the contract price, we consider our previous experiences with our customers, communications with our customers regarding funding status, and our knowledge of available funding for the contract or program. If funding is not assessed as probable, revenue recognition is deferred until realization is deemed probable.

Contract revenue recognition inherently involves estimation, including the contemplated level of effort to accomplish the tasks under contract, the cost of the effort, and an ongoing assessment of progress toward completing the contract. From time to time, as part of the normal management processes, new information comes to light that require revisions to estimated total costs or revenues expected. The cumulative impact of any revisions to estimates and the full impact of anticipated losses on any type of contract are recognized in the period in which they become known.

The allowance of certain costs under government contracts is subject to audit by the government. Certain indirect costs are charged to contracts using provisional or estimated indirect rates, which are subject to later revision based on government audits of those costs. Management is of the opinion that costs subsequently disallowed, if any, would not be significant.

### *Stock Based Compensation*

In December 2004, the FASB issued FASB Statement No. 123(R) (revised 2004), *Share Based Payment*. Statement 123(R) addresses the accounting for share-based payment transactions in which an enterprise receives employee services in exchange for (a) equity instruments of the enterprise or (b) liabilities that are based on the fair value of the enterprise's equity instruments or that may be settled by the issuance of such equity instruments. Statement 123(R) requires an entity to recognize the grant-date fair-value of stock options and other equity-based compensation issued to employees in the income statement. The revised Statement generally requires that an entity account for those transactions using the fair-value-based method, and eliminates the intrinsic value method of accounting in APB Opinion No. 25, *Accounting for Stock Issued to Employees*, which was permitted under Statement 123, as originally issued. The revised Statement requires entities to disclose information about the nature of the share-based payment transactions and the effects of those transactions on the financial statements. All public companies must use either the modified prospective or the modified retrospective transition method.

Effective January 1, 2006, the Company adopted the provisions of SFAS No. 123R using the modified prospective transition method. Due to the use of the modified prospective method, prior interim periods and fiscal years will not reflect any restated amounts. As disclosed in the stock

option plans in Note 9, the Company accelerated the vesting of unvested stock

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options previously awarded to employees, officers and directors in December 2005. The Company had no unvested stock options on January 1, 2006. The Company issued an insignificant number of stock options in the quarters ended April 1, 2006 and July 1, 2006. Accordingly, no significant stock compensation expense was recognized during the first and second quarters.

### **Item 3. Quantitative and Qualitative Disclosures About Market Risk.**

We are exposed to certain financial market risks, the most predominant being fluctuations in interest rates for borrowings under our credit facility. Interest rate fluctuations are monitored by our management as an integral part of our overall risk management program, which recognizes the unpredictability of financial markets and seeks to reduce the potentially adverse effect on our results of operations. As part of this strategy, we may use interest rate swap arrangements to manage or hedge our interest rate risk. We do not use derivative financial instruments for speculative or trading purposes.

As of July 1, 2006, we had \$83.4 million outstanding under our Amended Credit Agreement. A 1% change in interest rates would have resulted in our interest expense fluctuating by approximately \$208,500 for the three months ended July 1, 2006.

Effective February 14, 2006, an interest swap agreement came into effect which reduced our exposure associated with the market volatility of floating LIBOR interest rates. This agreement has a notional principal amount of \$30.0 million and, as of July 1, 2006, had a rate ranging from 4.05% to 4.74%. This agreement is a hedge against term debt, which bears interest at LIBOR plus a margin which has a current overall rate of 6.97%. At stated monthly intervals the difference between the interest on the floating LIBOR-based debt and the interest calculated in the swap agreement are settled in cash. The estimated value of the swap at July 1, 2006 was \$0.5 million.

In addition, historically, our investment positions have been relatively small and short-term in nature. We have typically made investments in a fund with an effective average maturity of fewer than 40 days and a portfolio make-up consisting primarily of commercial paper and notes, variable rate instruments, and, to a lesser degree, overnight securities and bank instruments. Since our initial public offering, the Board of Directors approved an investment policy that requires us to invest in relatively short-term, high quality, and high liquidity obligations.

### **Item 4. Controls and Procedures.**

*Evaluation of Disclosure Controls and Procedures.* The Company performed an evaluation under the supervision and with the participation of management, including the Company's Chief Executive Officer and Chief Financial Officer, of the design and operation of the Company's disclosure controls and procedures as of July 1, 2006. Based upon the evaluation, the Company's Chief Executive Officer and Chief Financial Officer have concluded that, as of July 1, 2006, the Company's disclosure controls and procedures were effective.

*Changes in Internal Control Over Financial Reporting.* During the three months ended July 1, 2006, there were no significant changes in the Company's internal control over financial reporting that have materially affected, or are reasonably likely to materially affect, the Company's internal control for financial reporting.

## **PART II: OTHER INFORMATION**

### **Item 1. Legal Proceedings**

We are a party to litigation and legal proceedings that we believe to be a part of the ordinary course of our business. While we cannot predict the ultimate outcome of these matters, we currently believe that any ultimate liability arising out of these proceedings will not have a material adverse effect on our financial position. We may become involved in other legal and governmental, administrative or contractual proceedings in the future.

The SEI acquisition agreement provides for a purchase price adjustment based upon the working capital of SEI as of the closing date. Subsequent to the closing date, we received a payment of \$1.6 million in connection with services performed prior to the closing date that SEI had not previously billed, and was not authorized to bill its customer as of the closing date. The SEI selling stockholders have asserted that they are entitled to a credit in connection with the calculation of working capital adjustment in an amount equal to the amount received by us for this post-closing payment. We believe that, in accordance with GAAP, the SEI selling stockholders should not receive the benefit of the post-closing payment. In accordance with the terms of the SEI acquisition agreement, the parties have jointly submitted the issue to an independent

accounting firm for resolution. We anticipate that this matter will be resolved before the end of 2006.

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In June 2006, the Company, through one of its subsidiaries, was awarded a judgment in a lawsuit filed in the Circuit Court of Fairfax County, Virginia against National Technologies Associates, Inc. ( NTA ) in the amount of \$841,612. The Company's claims arose out of the Company's allegation that NTA breached a contract which obligated NTA to subcontract certain work to the Company's subsidiary. The Company has not recorded the judgment because the judgment is presently subject to NTA's motion for reconsideration before the trial court and, in the event that NTA does not succeed in its motion for reconsideration, the Company anticipates that NTA will seek to appeal the judgment to the Virginia Supreme Court. While the Company cannot presently determine the ultimate outcome of this matter, management believes that it will prevail on NTA's motion to reconsider the matter and that the judgment in its favor will be upheld or affirmed.

**Item 1A. Risk Factors**

There are no material updates to the risk factors previously disclosed in our Form 10-K/A for the year ended December 31, 2005.

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

None.

**Item 3. Defaults Upon Senior Securities**

None.

**Item 4. Submission of Matters To a Vote of Security Holders**

During the fiscal quarter ended July 1, 2006, we submitted certain matters to a vote of our stockholders through the notice of annual meeting of stockholders and the solicitation of proxies related thereto. The proxy materials related to the Registrant's Third Annual Meeting of Stockholders were distributed on or about May 22, 2006 and the annual meeting of stockholders was held on June 28, 2006, in Colorado Springs, Colorado. As of the record date prior to such meeting, 12,833,232 shares of our common stock were outstanding and entitled to vote at the meeting. At the annual stockholders meeting of June 28, 2006, 12,267,189 shares of our common stock were present on person or by proxy, representing 95.59% of our outstanding shares of common stock.

The following sets forth the matters presented for a vote by the stockholders and the votes cast for, withheld, abstained, and broker non-votes:

| Matter  | Votes For  | Votes Withheld | Abstentions | Broker Non-Votes |
|---|------------|----------------|-------------|------------------|
| (1) Election of Mr. Charles A. Bowsher as a Class I director with a term serving until the 2009 Annual Meeting      | 11,961,081 | 306,108        |             |                  |
| (2) Election of Mr. Walter J. Culver, Ph.D. as a Class I director with a term serving until the 2009 Annual Meeting | 11,898,008 | 369,181        |             |                  |
| (3) Election of General Dennis J. Reimer as a Class I director with a term serving until the 2009 Annual Meeting    | 11,960,391 | 306,798        |             |                  |
| (4) Election of Mr. Edward H. Sproat as a Class I director with a term serving until the 2009 Annual Meeting        | 11,624,813 | 642,376        |             |                  |
| (5) Ratification of the appointment of Ernst & Young LLP as our independent auditors for the current fiscal year    | 12,110,552 | 147,247        | 9,390       |                  |



**Item 5. Other Information**

None.

**Item 6. Exhibits**

The exhibits required by this item are set forth on the Index to Exhibits attached hereto.

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SIGNATURES

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

SI INTERNATIONAL, INC.

/s/ Thomas E. Dunn  
Thomas E. Dunn  
Executive Vice President and  
Chief Financial Officer

Date: August 9, 2006

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**INDEX TO EXHIBITS**

**Exhibit**

| <b>No.</b> | <b>Description</b>  |
|------------|---|
| 1.1        | Underwriting Agreement with Wachovia Capital Markets, LLC dated April 4, 2006 (filed as Exhibit 1.1 to the Company's Current Report on Form 8-K filed April 7, 2006 and incorporated by reference).   |
| 2.1        | Stock Purchase Agreement among the Company, Shenandoah Electronic Intelligence, Inc. ( SEI ), and the stockholders of SEI dated January 12, 2005 (filed as Exhibit 99.1 to the Company's Current Report on Form 8-K filed March 1, 2005 and incorporated by reference). (The appendices and exhibits have been omitted pursuant to Item 601(b)(2) of Regulation S-K. SI International, Inc. hereby undertakes to furnish supplementally to the Securities and Exchange Commission copies of any omitted appendices and exhibits upon request by the Securities and Exchange Commission).  |
| 2.2        | Stock Purchase Agreement among the Company, Zen Technology, Inc., and the stockholders of Zen Technology, Inc. dated February 8, 2006 (filed as Exhibit 2.2 to the Company's Annual Report on Form 10-K/A for the fiscal year ended December 31, 2005 and filed May 12, 2006 and incorporated herein by reference). (The appendices and exhibits have been omitted pursuant to Item 601(b)(2) of Regulation S-K. SI International, Inc., hereby undertakes to furnish supplementally to the Securities and Exchange Commission copies of any omitted appendices and exhibits upon request by the Securities and Exchange Commission). |
| 3.1        | Second Restated Certificate of Incorporation (filed as Exhibit 3.1 to the Company's Registration Statement on Form S-1/A (File No. 333-87964) filed on October 25, 2002 (the Third Amendment ) and incorporated herein by reference).   |
| 3.2        | Amended and Restated Bylaws, as amended (filed as Exhibit 3.2 to the Company's Current Report on Form 8-K filed October 11, 2005 and incorporated herein by reference).   |
| 4.1        | Registration Rights Agreement, as amended (filed as Exhibit 4.1 to the Third Amendment and incorporated herein by reference).   |
| 4.2        | Specimen Certificate of our common stock (filed as Exhibit 4.2 to the Company's Registration Statement on Form S-1/A (File No. 333-87964) filed on November 5, 2002 (the Fourth Amendment) and incorporated herein by reference).   |
| 4.3        | Stock Purchase Agreement, as amended (filed as Exhibit 4.3 to the Fifth Amendment and incorporated herein by reference).  |
| 4.4        | Amendment to Stock Purchase Agreements (filed as Exhibit 4.4 to the Fourth Amendment and incorporated herein by reference).   |
| 10.1       | 2002 Amended and Restated Omnibus Stock Incentive Plan (filed as Annex B to the Company's Proxy Statement on Schedule 14A for the 2005 Annual Meeting of Stockholders filed on April 21, 2005 and incorporated herein by reference).  |
| 10.2       | January 2001 Nonqualified Stock Option Plan (filed as Exhibit 10.2 to the Company's Registration Statement on Form S-1/A (File No. 333-87964) filed on June 24, 2002 (the First Amendment) and incorporated herein by reference).   |
| 10.3       | SI International, Inc. 2001 Service Award Stock Option Plan (filed as Exhibit 10.3 to the First Amendment and incorporated herein by reference).  |
| 10.4       | 1998 Stock Option Plan (filed as Exhibit 10.5 to the First Amendment and incorporated herein by reference).   |
| 10.5       | Non-Qualified Deferred Compensation Plan, as amended (filed as Exhibit 10.13 to the 2004 10-K and incorporated herein by reference).  |
| 10.6       | Form of SI International, inc. Stock Option Agreement Evidencing Grant of Stock Options Under the SI International, inc. 2002 Amended and Restated Omnibus Stock Incentive Plan, Including Notice of Stock Option Grant (filed as Exhibit 99.1 to the Company's Current Report on Form 8-K filed on March 17, 2005 and incorporated herein by reference).   |
| 10.7       | Notice of Stock Option Acceleration of Vesting (filed as Exhibit 10.1 to the Company's Current Report on Form 8-K filed on December 13, 2005 and incorporated herein by reference).   |
| 10.8       | Amended and Restated Credit Agreement, dated as of February 9, 2005 (filed as Exhibit 99.1 to the Company's Current Report on Form 8-K filed February 15, 2005 and incorporated herein by reference).   |

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- 10.9 First Amendment to Amended and Restated Credit Agreement, dated February 27, 2006 (filed as Exhibit 10.1 to the Company's Current Report on Form 8-K filed March 3, 2006 and incorporated herein by reference).
- 10.10 Executive Employment Agreement with S. Bradford Antle (filed as Exhibit 10.6 to the Third Amendment and incorporated herein by reference) with updated information included in the Company's Current Report on Form 8-K filed on June 21, 2006..
- 10.11 Executive Employment Agreement with Thomas E. Dunn (filed as Exhibit 10.8 to the Third Amendment and incorporated herein by reference) with updated information included in the Company's Current Report on Form 8-K filed on June 21, 2006..
- 10.12 Executive Employment Agreement with Thomas E. Lloyd (filed as Exhibit 10.9 to the Third Amendment and incorporated herein by reference) with updated information included in the Company's Current Report on Form 8-K filed on June 21, 2006..
- 10.13 Executive Employment Agreement with Ray J. Oleson (filed as Exhibit 10.10 to the Third Amendment and incorporated herein by reference) with updated information included in the Company's Current Report on Form 8-K filed on June 21, 2006..
- 10.14 Executive Employment Agreement with Harry D. Gatanas (filed as Exhibit 10.1 to the Company's Current Report on Form 8-K/A filed November 15, 2005 and incorporated herein by reference) with updated information included in the Company's Current Report on Form 8-K filed on June 21, 2006..
- 10.15 Executive Employment Agreement with Marylynn Stowers (filed as Exhibit 10.1 to the Company's Current Report on Form 8-K/A filed February 2, 2006 and incorporated herein by reference with updated information included in the Company's Current Report on Form 8-K filed on June 21, 2006..)
- 10.16 Executive Employment Agreement with P. Michael Becraft (filed as Exhibit 10.1 to the Company's Current Report on Form 8-K/A filed February 24, 2006 and incorporated herein by reference) with updated information included in the Company's Current Report on Form 8-K filed on June 21, 2006..
- 10.17 Form of Indemnification Agreement (filed as Exhibit 10.11 to the Third Amendment and incorporated herein by reference).
- 10.18 Consulting Services Agreement with Walter J. Culver (filed as Exhibit 10.12 to the 2004 10-K and incorporated herein by reference).
- 31.1 Certifications of Chief Executive Officer and Chief Financial Officer pursuant to Rule 13a-14(a) as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 (\*).
- 32.1 Certifications of Chief Executive Officer and Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes Oxley Act of 2002 (\*).

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\* Indicates filed herewith.