

SRA INTERNATIONAL INC  
Form 10-Q  
November 03, 2006  
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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

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**FORM 10-Q**

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(Mark One)

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

**FOR THE QUARTERLY PERIOD ENDED SEPTEMBER 30, 2006**

**OR**

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

**Commission File Number: 001-31334**

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**SRA International, Inc.**

(Exact name of Registrant as Specified in its Charter)

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**Delaware**  
(State or Other Jurisdiction of

Incorporation or Organization)

**4300 Fair Lakes Court, Fairfax, Virginia**  
(Address of Principal Executive Offices)

**54-1360804**  
(I.R.S. Employer

Identification No.)

**22033**  
(Zip Code)

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Registrant's telephone number, including area code: (703) 803-1500

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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.

Large accelerated filer  Accelerated filer  Non-accelerated filer

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

As of October 27, 2006, there were 41,827,190 shares outstanding of the registrant's class A common stock and 14,399,828 shares outstanding of class B common stock.

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**SRA INTERNATIONAL, INC.**

**QUARTERLY REPORT ON FORM 10-Q FOR THE THREE MONTHS**

**ENDED SEPTEMBER 30, 2006**

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**Table of Contents****Part I. FINANCIAL INFORMATION****Item 1. Financial Statements****SRA INTERNATIONAL, INC. AND SUBSIDIARIES****CONDENSED CONSOLIDATED BALANCE SHEETS (UNAUDITED)****(in thousands)****Assets**

	<b>September 30, 2006</b>	<b>June 30, 2006</b>
<b>Current assets:</b>		
Cash and cash equivalents	\$ 222,139	\$ 173,564
Short-term investments	4,912	9,834
Accounts receivable, net	252,861	266,160
Prepaid expenses and other	21,394	23,382
Deferred income taxes, current	3,950	4,839
<b>Total current assets</b>	<b>505,256</b>	<b>477,779</b>
<b>Total property and equipment, net</b>	<b>37,663</b>	<b>37,462</b>
<b>Other assets:</b>		
Goodwill	169,334	169,334
Identified intangibles, net	24,880	26,169
Deferred income taxes, noncurrent	4,901	3,462
Deferred compensation trust	8,088	7,768
<b>Total other assets</b>	<b>207,203</b>	<b>206,733</b>
<b>Total assets</b>	<b>\$ 750,122</b>	<b>\$ 721,974</b>

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

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**SRA INTERNATIONAL, INC. AND SUBSIDIARIES**  
**CONDENSED CONSOLIDATED BALANCE SHEETS (UNAUDITED)**

(in thousands, except share and per share amounts)

**Liabilities and Stockholders' Equity**

	September 30, 2006	June 30, 2006
<b>Current liabilities:</b>		
Accounts payable and accrued expenses	\$ 114,003	\$ 115,545
Accrued payroll and employee benefits	67,577	59,463
Billings in excess of revenue recognized	2,629	3,204
<b>Total current liabilities</b>	<b>184,209</b>	<b>178,212</b>
<b>Long-term liabilities:</b>		
Other long-term liabilities	11,636	10,465
<b>Total long-term liabilities</b>	<b>11,636</b>	<b>10,465</b>
<b>Total liabilities</b>	<b>195,845</b>	<b>188,677</b>
<b>Commitments and contingencies</b>		
<b>Stockholders' equity:</b>		
Preferred stock, par value \$0.20 per share; 5,000,000 shares authorized; none issued		
Class A common stock, par value \$0.004 per share; 180,000,000 shares authorized; 42,427,861 and 42,158,048 shares issued as of September 30, 2006 and June 30, 2006; 41,673,125 and 41,403,312 shares outstanding as of September 30, 2006 and June 30, 2006	170	169
Class B common stock, par value \$0.004 per share; 55,000,000 shares authorized; 14,459,828 shares issued and outstanding as of September 30, 2006 and June 30, 2006	58	58
Additional paid-in capital	283,375	275,440
Treasury stock, at cost	(6,302)	(6,302)
Deferred stock-based compensation	(2,965)	(888)
Retained earnings	279,941	264,820
<b>Total stockholders' equity</b>	<b>554,277</b>	<b>533,297</b>
<b>Total liabilities and stockholders' equity</b>	<b>\$ 750,122</b>	<b>\$ 721,974</b>

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

**Table of Contents****SRA INTERNATIONAL, INC. AND SUBSIDIARIES****CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS (UNAUDITED)**

(in thousands, except share and per share amounts)

	Three Months Ended September 30,	
	2006	2005
Revenue	\$ 304,034	\$ 280,695
Operating costs and expenses:		
Cost of services	228,059	210,240
Selling, general and administrative	48,404	43,657
Depreciation and amortization	4,740	4,010
Total operating costs and expenses	281,203	257,907
Operating income	22,831	22,788
Interest income, net	1,843	733
Income before taxes	24,674	23,521
Provision for income taxes	9,553	9,131
Net income	\$ 15,121	\$ 14,390
Earnings per share:		
Basic	\$ 0.27	\$ 0.27
Diluted	\$ 0.26	\$ 0.25
Weighted-average shares:		
Basic	55,981,631	54,263,817
Diluted	57,964,502	57,408,033

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

**Table of Contents****SRA INTERNATIONAL, INC. AND SUBSIDIARIES****CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (UNAUDITED)**

(in thousands)

	<b>Three Months Ended September 30,</b>	
	<b>2006</b>	<b>2005</b>
<b>Cash flows from operating activities:</b>		
Net income	\$ 15,121	\$ 14,390
<b>Adjustments to reconcile net income to net cash provided by operating activities:</b>		
Depreciation and amortization	4,740	4,010
Stock-based compensation	3,275	3,080
Deferred income taxes	(550)	(1,889)
<b>Changes in assets and liabilities, net of the effect of acquisitions:</b>		
Accounts receivable	13,389	(37,939)
Prepaid expenses and other	1,988	9,581
Accounts payable and accrued expenses	(1,542)	16,411
Accrued payroll and employee benefits	8,114	5,863
Billings in excess of revenue recognized	(575)	(1,023)
Other	761	(384)
<b>Net cash provided by operating activities</b>	<b>44,721</b>	<b>12,100</b>
<b>Cash flows from investing activities:</b>		
Capital expenditures	(3,652)	(2,775)
Sales and maturities of investments	4,922	2,636
Acquisition of Galaxy Scientific Corporation, net of cash acquired		(95,645)
<b>Net cash provided by (used in) investing activities</b>	<b>1,270</b>	<b>(95,784)</b>
<b>Cash flows from financing activities:</b>		
Issuance of common stock	1,689	4,727
Tax benefits of stock option exercises	895	4,438
<b>Net cash provided by financing activities</b>	<b>2,584</b>	<b>9,165</b>
<b>Net increase (decrease) in cash and cash equivalents</b>	<b>48,575</b>	<b>(74,519)</b>
<b>Cash and cash equivalents, beginning of period</b>	<b>173,564</b>	<b>162,973</b>
<b>Cash and cash equivalents, end of period</b>	<b>\$ 222,139</b>	<b>\$ 88,454</b>
<b>Supplemental disclosures of cash flow information:</b>		
<b>Cash paid during the period:</b>		
Income taxes	\$ 7,221	\$ 2,572
<b>Cash received during the period:</b>		
Interest	\$ 1,616	\$ 983
Income taxes	\$ 314	\$ 16

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





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**SRA INTERNATIONAL, INC. AND SUBSIDIARIES**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)**

**Three Months Ended September 30, 2006 and 2005**

**1. Basis of Presentation:**

The accompanying unaudited condensed consolidated financial statements include the accounts of SRA International, Inc. (a Delaware corporation) and its wholly-owned subsidiaries (SRA or the Company) and have been prepared pursuant to the rules and regulations of the Securities and Exchange Commission. Certain information and note disclosures normally included in the annual financial statements, prepared in accordance with generally accepted accounting principles, have been omitted pursuant to those rules and regulations, although the Company believes that the disclosures made are adequate to make the information presented not misleading.

In the opinion of management, the accompanying unaudited condensed consolidated financial statements reflect all necessary adjustments and reclassifications (all of which are of a normal, recurring nature) that are necessary for fair presentation of the periods presented. The results for the three months ended September 30, 2006 are not necessarily indicative of the results to be expected for the full fiscal year. These unaudited condensed consolidated financial statements should be read in conjunction with the audited consolidated financial statements and the notes thereto included in the Company's latest annual report to the Securities and Exchange Commission on Form 10-K for the year ended June 30, 2006.

*Recent Accounting Pronouncements*

In September 2006, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards No. 157 (SFAS 157), Fair Value Measurements. SFAS 157 provides a new single authoritative definition of fair value and enhanced guidance for measuring the fair value of assets and liabilities. It requires additional disclosures related to the extent to which companies measure assets and liabilities at fair value, the information used to measure fair value, and the effect of fair value measurements on earnings. SFAS 157 is effective for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. The Company is currently evaluating what effect, if any, the adoption of SFAS 157 will have on its financial position, results of operations, or cash flows.

In July 2006, the FASB issued Interpretation No. 48 (FIN 48), Accounting for Uncertainty in Income Taxes—an interpretation of FASB Statement No. 109, which clarifies the accounting for uncertainty in income taxes recognized in an enterprise's financial statements in accordance with FASB Statement No. 109, Accounting for Income Taxes, and prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. FIN 48 also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure, and transition. FIN 48 is effective for fiscal years beginning after December 15, 2006. The Company is currently evaluating what effect, if any, the adoption of FIN 48 will have on its financial position, results of operations, or cash flows.

**2. Nature of Business:**

SRA provides technology and strategic consulting services and solutions primarily to clients in national security, civil government, and health care and public health. Since SRA's founding in 1978, the Company has derived substantially all of its revenue from services provided to federal government clients. SRA expects that services provided to federal government clients will continue to account for substantially all of its revenue for the foreseeable future.

**Table of Contents****SRA INTERNATIONAL, INC. AND SUBSIDIARIES****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED) (Continued)****Three Months Ended September 30, 2006 and 2005**

Revenue from contracts with federal government agencies was 99 percent of total revenue for both the three months ended September 30, 2006 and 2005. The United States Agency for International Development

accounted for approximately 10 percent of revenue for the three months ended September 30, 2006. The National Guard, as a client group, accounted for approximately 11 percent of revenue for the three months ended September 30, 2005. No other client or client group accounted for more than 10 percent of revenue in the periods presented herein.

**3. Earnings Per Share:**

Basic earnings per share (EPS) is computed by dividing reported net income by the weighted-average number of common shares outstanding. Diluted EPS considers the potential dilution that could occur if securities or other contracts to issue common stock were exercised or converted into common stock. The difference between basic and diluted weighted-average common equivalent shares with respect to the Company's EPS calculation is due entirely to the assumed exercise of stock options. The dilutive effect of stock options for each period reported is summarized below:

	<b>Three Months Ended September 30,</b>	
	<b>2006</b>	<b>2005</b>
Basic weighted-average common shares outstanding	55,981,631	54,263,817
Effect of potential exercise of stock options	1,982,871	3,144,216
Diluted weighted-average common shares outstanding	57,964,502	57,408,033

Stock options that could potentially dilute basic EPS in the future that were not included in the computation of diluted EPS, because to do so would have been antidilutive, were 1,768,708 and 1,386,470 for the three months ended September 30, 2006 and 2005, respectively.

**4. Accounting for Stock-Based Compensation:*****Stock-Based Benefit Plans***

The Company maintained a key employee incentive plan that was approved by the Company's stockholders in November 1994. All options granted by the Company from November 1994 until January 2002 were granted under this 1994 plan. Following completion of the Company's initial public offering of stock, no additional options were granted under this plan. Under the terms of the plan, options to purchase class A common stock or class B common stock were granted by the board of directors to key employees. The option price per share was determined by the board of directors and generally was no less than the fair value of the stock on the date of grant of the option. Prior to becoming publicly traded, the Company retained an independent valuation firm to assist the board of directors in assessing the fair value of the stock. Each option is exercisable within periods and in increments determined by the board of directors.

In March 2002, the Company adopted the SRA International, Inc. 2002 Stock Incentive Plan. Upon adoption, up to 7,058,822 shares of class A common stock were reserved for issuance under the 2002 plan. Pursuant to the terms of the 2002 plan, the number of shares authorized for issuance automatically increases at the beginning of each fiscal year, beginning with the fiscal year ended June 30, 2004. An additional 6,353,463 shares of class A common stock were reserved for issuance pursuant to the automatic increase feature of the 2002 plan through July 1, 2006. The 2002 plan provides for the grant of incentive stock options, non-statutory stock



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**SRA INTERNATIONAL, INC. AND SUBSIDIARIES**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED) (Continued)**

**Three Months Ended September 30, 2006 and 2005**

options, restricted stock, and other stock-based awards. The 2002 plan is administered by the compensation committee of the board of directors, which determines the number of shares covered by options, and the exercise price, vesting period, and duration of option grants. The board of directors also has the authority under the 2002 plan to determine the number of shares of common stock subject to any restricted stock or other stock-based awards and the terms and conditions of such awards. The 2002 plan expires in March 2012.

***Adoption of SFAS No. 123R***

Effective July 1, 2005, the Company adopted SFAS No. 123 (revised 2004), Share-Based Payment, which requires that compensation costs related to share-based payment transactions be recognized in financial statements. The Company applied the modified prospective method under which compensation costs for all awards granted after the date of adoption and the unvested portion of previously granted awards outstanding at the date of adoption are measured at estimated fair value and included in operating expenses over the vesting period during which an employee provides service in exchange for the award.

As a result of adopting SFAS 123R, the Company recorded \$3.2 million and \$3.0 million of stock-based compensation expense, or \$2.0 million and \$1.8 million after-tax, in its statement of operations for the three months ended September 30, 2006 and 2005, respectively. This stock-based compensation expense reduced both basic and diluted earnings per share by \$0.03 for the three months ended September 30, 2006 and 2005.

***Fair Value Determination***

The fair value concepts were not changed significantly in SFAS 123R; however, in adopting this Standard, companies were required to choose among alternative valuation models and amortization assumptions. The Company elected to continue to use both the Black-Scholes-Merton option pricing model and straight-line amortization of compensation expense over the requisite service period of the grant. The Company will reconsider use of the Black-Scholes-Merton model if additional information becomes available in the future that indicates another model would be more appropriate, or if grants issued in future periods have characteristics that cannot be reasonably estimated using this model.

The Company has 10-year and 15-year options. The following weighted-average assumptions were used for option grants during the three months ended September 30, 2006 and 2005:

*Expected Volatility.* The expected volatility of the Company's shares was estimated based upon the historical volatility of the Company's share price. The expected volatility factors used in valuing options granted were 31 percent and 32 percent during the three months ended September 30, 2006 and 2005, respectively.

*Expected Term.* The expected term was estimated based upon exercise experience of option grants made in the past to Company employees. Historical experience shows that employees typically exercise options prior to the end of the contractual term. The expected term used in valuing options granted was five years for the three months ended September 30, 2006 and 2005.

*Risk-free Interest Rate.* The Company bases the risk-free interest rate used in the Black-Scholes-Merton valuation method on the implied yield available on a U.S. Treasury note with a term equal to the expected term of the underlying grants. The risk-free interest rate used in valuing options granted was 4.9 percent and 4.1 percent during the three months ended September 30, 2006 and 2005, respectively.

**Table of Contents****SRA INTERNATIONAL, INC. AND SUBSIDIARIES****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED) (Continued)****Three Months Ended September 30, 2006 and 2005**

*Dividend Yield.* The Black-Scholes-Merton valuation model calls for a single expected dividend yield as an input. The Company has not paid dividends in the past nor does it expect to pay dividends in the future. As such, the Company used a dividend yield percentage of zero.

***Stock Compensation Expense***

The Company recorded \$3.1 million and \$3.0 million of stock-based compensation expense related to stock option grants for the three months ended September 30, 2006 and 2005, respectively. The Company also recorded \$0.2 million related to restricted stock grants for both the three months ended September 30, 2006 and 2005.

In accordance with SFAS 123R, the Company estimates forfeitures and is recognizing compensation expense only for those share-based awards that are expected to vest. As of September 30, 2006, there was \$28.3 million of total unrecognized compensation cost related to nonvested share-based compensation arrangements. This cost is expected to be fully amortized in four years, with half of the total amortization cost being recognized within the next 15 months.

***Stock Option Activity***

The Company granted stock options to purchase 370,992 and 1,398,470 shares of class A common stock at a weighted-average exercise price of \$25.11 and \$35.38 per share based on the fair value of class A common stock on the date of grant during the three months ended September 30, 2006 and 2005, respectively. The Black-Scholes-Merton weighted-average per share value of options granted for the three months ended September 30, 2006 and 2005 was \$9.19 and \$12.56, respectively. Using the Black-Scholes-Merton model, the total expected value of the options granted for the three months ended September 30, 2006 and 2005 was \$3.1 million and \$16.0 million, respectively. The options vest at the rate of 25 percent per year over four years, beginning on the date of grant and expire ten years from the grant date.

During the three months ended September 30, 2006 and 2005, the Company also granted 94,395 and 4,250 shares of restricted stock at a weighted-average price of \$25.11 and \$33.56 per share, respectively. These shares vest at the rate of 25 percent per year over four years.

The following table summarizes stock option activity for the three months ended September 30, 2006:

	<b>Number of Shares</b>	<b>Weighted-Average Exercise Price</b>	<b>Aggregate Intrinsic Value (in thousands)</b>
Shares under option, July 1, 2006	7,666,784	\$ 18.00	\$ 80,365
Options granted	370,992	25.11	
Options exercised	(166,189)	10.16	2,930
Options cancelled and expired	(223,305)	28.84	572
Shares under option, September 30, 2006	7,648,282	\$ 18.20	\$ 102,594
Options exercisable at September 30, 2006	4,886,288	\$ 13.22	\$ 84,293
Shares reserved for equity awards at September 30, 2006	6,396,865		

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Information with respect to stock options outstanding and stock options exercisable at September 30, 2006 was as follows:

Range of Exercise Price	Options Outstanding	Weighted-Average Remaining Contractual Life	Weighted-Average Exercise Price
\$ 0.20 \$ 0.30	268,744	0.6 years	\$ 0.29
\$ 2.58 \$ 5.07	1,568,187	6.9	4.07
\$10.85 \$16.80	2,067,671	8.8	14.27
\$19.39 \$35.40	3,743,680	8.3	27.58
	7,648,282		

Range of Exercise Price	Options Exercisable	Weighted-Average Remaining Contractual Life	Weighted-Average Exercise Price
\$ 0.20 \$ 0.30	268,744	0.6 years	\$ 0.29
\$ 2.58 \$ 5.07	1,568,187	6.9	4.07
\$10.85 \$16.80	1,766,447	9.0	13.97
\$19.39 \$35.40	1,282,910	7.7	26.09
	4,886,288		

**Employee Stock Purchase Plan**

The Company maintains the SRA International, Inc. 2004 Employee Stock Purchase Plan (ESPP) and has reserved 500,000 shares for issuance thereunder. The ESPP was available to all eligible employees beginning on January 1, 2005. The ESPP permits eligible employees to purchase class A common stock, through payroll deductions of up to 15% of the employee's compensation, at a price equal to 100% of the average of the high and low price of the common stock on the last day of each offering period. Employees purchased 12,815 shares for the three months ended September 30, 2006 under the ESPP.

**5. Accounts Receivable:**

Accounts receivable, net as of September 30, 2006 and June 30, 2006 consisted of the following (in thousands):

	September 30, 2006	June 30, 2006
Billed and billable, net of allowance of \$1,622 as of September 30, 2006 and \$1,614 as of June 30, 2006	\$ 226,561	\$ 242,259
Unbilled:		
Retainages	4,851	5,347
Revenue recorded in excess of milestone billings on fixed-price contracts	10,930	7,210
	12,158	13,079

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Revenue recorded in excess of contractual authorization, billable upon receipt of contractual amendments/documents		
Allowance for unbillable amounts	(1,639)	(1,735)
Total unbilled	26,300	23,901
Total accounts receivable	\$ 252,861	\$ 266,160

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**SRA INTERNATIONAL, INC. AND SUBSIDIARIES**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED) (Continued)**

**Three Months Ended September 30, 2006 and 2005**

The billable receivables included in the billed and billable line item above represent primarily revenue earned in the final month of the reporting period that were billable as of the balance sheet date. These billable receivables are typically billed and collected within 90 days of the balance sheet date.

Consistent with industry practice, certain receivables related to long-term contracts and programs are classified as current, although a portion of these amounts is not expected to be billed and collected within one year. Unbilled accounts receivable at September 30, 2006 are expected to be billed and collected within one year except for approximately \$1.9 million related to a portion of retainages.

The Company may proceed with work based on client direction prior to the receipt of formal contract funding documents. Revenue associated with such work is recognized only when it can be reliably estimated and realization is probable. Two contracts account for approximately \$5.7 million of the unbilled receivables balance related to revenue recorded in excess of contractual authorization as of September 30, 2006. The Company believes, based on communications regarding funding status and past experiences with these clients, it is probable the funding will be received.

**6. Commitments and Contingencies:**

*Government Contracting*

Payments to the Company on cost-plus-fee contracts are provisional and are subject to adjustment upon audit by the Defense Contract Audit Agency. Audits through June 30, 2004 have been completed. In the opinion of management, audit adjustments that may result from audits for periods after June 30, 2004 are not expected to have a material effect on the Company's financial position, results of operations, or cash flows.

Additionally, federal government contracts, by their terms, generally can be terminated at any time by the federal government, without cause, for the convenience of the federal government. If a federal government contract is so terminated, the Company would be entitled to receive compensation for the services provided and costs incurred through the time of termination, plus a negotiated amount of profit. Federal government contractors who fail to comply with applicable government procurement-related statutes and regulations may be subject to potential contract termination, suspension and debarment from contracting with the government, or other remedies. Management believes the Company has complied with all applicable procurement-related statutes and regulations.

*Litigation*

The Company is involved in various legal proceedings concerning matters arising in the ordinary course of business. The Company currently believes that any ultimate liability arising out of these proceedings will not have a material adverse effect on the Company's financial position, results of operations, or cash flows.

**7. Subsequent Event:**

*Gain on Sale of Mantas*

On October 2, 2006, i-flex solutions completed its acquisition of Mantas, Inc. The Company's portion of the net sale proceeds is approximately \$4.4 million, including a portion to be held in escrow. The Company will recognize a total pre-tax gain of approximately \$3.7 million, or \$2.2 million after-tax, in the quarter ended December 31, 2006. The contingent gain attributable to the amount held in escrow will be recognized upon the release of funds pursuant to the terms of the escrow agreement.



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**SRA INTERNATIONAL, INC. AND SUBSIDIARIES**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED) (Continued)**

**Three Months Ended September 30, 2006 and 2005**

*Acquisition of RABA Technologies*

On October 25, 2006, the Company completed its acquisition of all of the outstanding stock of RABA Technologies, LLC (RABA) for approximately \$93.8 million in cash. Approximately \$14.0 million of the purchase price was deposited in escrow to secure indemnification obligations. RABA is a provider of high-end technical services to the national security and intelligence communities.

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**Table of Contents**

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

**FORWARD-LOOKING STATEMENTS**

The matters discussed in this Management's Discussion and Analysis of Financial Condition and Results of Operations, and elsewhere in this Form 10-Q, constitute forward-looking statements within the meaning of The Private Securities Litigation Reform Act of 1995. These statements involve known and unknown risks, uncertainties, and other factors that may cause our actual results, levels 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 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 or control accurately. The factors listed in the section captioned RISK FACTORS, as well as any cautionary language in this Form 10-Q, provide examples of risks, uncertainties, and events that may cause our actual results to differ materially from the expectations we describe in our forward-looking statements.

Although we believe that the expectations reflected in the forward-looking statements are reasonable, we cannot guarantee future results, levels of activity, performance or achievements. You should not place undue reliance on these forward-looking statements, which apply only as of the date of this Form 10-Q. Subsequent events and developments may cause our views to change. However, while we may elect to update these forward-looking statements at some point in the future, we specifically disclaim any obligation to do so.

**OVERVIEW**

We are a leading provider of technology and strategic consulting services and solutions to the federal government. We offer a broad range of services that spans the information technology life-cycle: strategic consulting; systems design, development, and integration; and outsourcing and managed services. In addition, to address recurring client needs, we develop business solutions for contingency and disaster response planning, information assurance, business intelligence, privacy protection, enterprise architecture, infrastructure management, and wireless integration. We provide services in three target markets: national security, civil government, and health care and public health. Our largest market, national security, includes the Department of Defense, the National Guard, the Department of Homeland Security, the intelligence agencies, and other federal organizations with homeland security missions.

Since our founding in 1978 we have derived substantially all of our revenue from services provided to federal government clients. Although the federal information technology market is currently facing challenges as a result of a shift in expenditures to pay for the war against terrorism and other international conflicts, we believe that the federal government's spending on information technology will continue to increase over the next several years. According to the *Federal IT Market Forecast, FY 2006 - FY 2011* report published by INPUT, an independent federal government market research firm, the contracted portion of federal government spending on information technology is forecasted to grow at an annual rate of 5.0% from \$63.3 billion in federal fiscal year 2006 to \$80.5 billion in federal fiscal year 2011.

We work with the federal government under three primary contract types: cost-plus-fee, time-and-materials, and fixed-price contracts. Cost-plus-fee contracts are typically lower risk arrangements and thus yield lower profit margins than time-and-materials and fixed-price arrangements. Time-and-materials and fixed-price contracts typically generate higher profit margins reflecting their generally higher risk. Where customer requirements are clear, we prefer to enter into time-and-materials and fixed-price arrangements rather than cost-plus-fee arrangements. Typically under fixed-price contracts, as compared with cost-plus-contracts, the customer can save money and we can earn better margins, given the more specific delivery requirements of these structures.

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Most of our revenue is generated based on services provided either by our employees or subcontractors. To a lesser degree, the revenue we earn includes reimbursable travel and other items to support the contractual effort, and may include third-party hardware and software that we purchase and integrate for customers as part of the solutions that we provide. Thus, once we win new business, the key to delivering the revenue is through hiring new employees to meet customer requirements, retaining our employees, and ensuring that we deploy them on direct-billable jobs. Therefore, we closely monitor hiring success, attrition trends, and direct labor utilization. It has become increasingly difficult to hire and retain qualified individuals with appropriate security clearances. Since we earn higher profits from the labor services that our employees provide compared with subcontracted efforts and other reimbursable items such as hardware and software purchases for customers, we seek to optimize our labor content on the contracts we win. The level of hardware and software purchases we make for customers may vary from period to period depending on specific contract and customer requirements.

Cost of services includes labor, or the salaries and wages of our employees, plus fringe benefits; the costs of subcontracted labor and outside consultants; third-party materials, such as hardware and software that we purchase for customer solutions; and other direct costs such as travel incurred to support contract efforts. Since we earn higher profits on our own labor services, we expect the ratio of cost of services to revenue to decline when our labor services mix increases relative to subcontracted labor or third-party material. Conversely, as subcontracted labor or third-party material purchases for customers increase relative to our own labor services, we expect the ratio of cost of services to revenue to increase. As we continue to bid and win larger contracts, our own labor services component could decrease. This is because the larger contracts typically are broader in scope and require more diverse capabilities resulting in more subcontracted labor with the potential for more third-party hardware and software purchases. In addition, we can face hiring challenges in staffing larger contracts. While these factors could lead to a higher ratio of cost of services to revenue, the economics of these larger jobs are nonetheless generally favorable because they increase income, broaden our revenue base, and have a favorable return on invested capital.

We have been able to build and effectively use what we refer to as a central services model. This central services model employs the use of central services for marketing, business development, human resources, recruiting, finance and accounting, infrastructure and other core administrative services. This central services model allows us to reduce selling, general and administrative expenses as a percentage of revenue as revenue grows organically and through selective acquisitions, thereby contributing to growth in operating income.

Depreciation and amortization expenses are affected by the level of our annual capital expenditures and the amount of identified intangibles related to acquisitions. We do not presently foresee significant changes in our capital expenditure requirements, which have been approximately 2.0% or less of revenue over the last three fiscal years. As we continue to make selected strategic acquisitions, the amortization of identified intangible assets may increase as a percentage of our revenue.

Our operating income, or revenue minus cost of services, selling, general and administrative expenses, and depreciation and amortization, and thus our operating margin, or the ratio of operating income to revenue, is driven by the mix and execution on our contracts, how we manage our costs, and the amortization charges resulting from acquisitions.

Our cash position is driven primarily by the level of net income, working capital in accounts receivable, capital expenditures and acquisition activities.

### *Challenges for fiscal 2007*

As described in our risk factors, we face several challenges in the current business environment that could make our substantial growth objectives for fiscal 2007 more difficult to achieve. First, the Department of Defense continues to divert funding away from certain information technology initiatives to support the war against terrorism and the reconstruction of Iraq. The resulting budget tightness is likely to slow short-term industry growth. We considered this factor when planning fiscal 2007. To achieve our growth goals, it is critical that we

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capture market share in the second and third quarters of fiscal 2007. Additionally, we must add significant numbers of highly qualified individuals who have advanced information technology and technical services skills and who work well with our clients in a government environment. These individuals are in great demand and are likely to remain a limited resource for the foreseeable future. It is becoming more difficult to hire and retain these employees, especially those with security clearances. In the first quarter of 2007, we were not able to increase our workforce to the extent we had planned. As this is critical for our growth, we are investing more in recruiting and employee development to increase hiring and improve retention.

**SELECTED KEY METRICS EVALUATED BY MANAGEMENT**

We manage and assess the performance of our business by evaluating a variety of metrics. Selected key metrics are discussed below.

**Revenue Growth**

Our revenue growth is primarily organic, but has been augmented by selective strategic acquisitions. Our total year-over-year revenue growth rate was 8.3% for the three months ended September 30, 2006. Our organic revenue growth rate was 6.5% for the three months ended September 30, 2006, driven by building-out existing accounts, broadening our client base, and leveraging our research and development into high value services.

A part of our growth strategy includes pursuing acquisitions. Through fiscal year 2006 we completed the following acquisitions:

Acquisition	Strategic Value	Closing Date	Purchase Price (in millions)
The Marasco Newton Group, Ltd.	Environment	January 4, 2002	\$ 16.2
Adroit Systems, Inc.	Command and Control, Communications, Computers, Intelligence, Surveillance and Reconnaissance (C4ISR)	January 31, 2003	38.3
ORION Scientific Systems	Counterterrorism	January 30, 2004	34.7
Touchstone Consulting Group, Inc.	Strategic Consulting	April 21, 2005	37.0
Galaxy Scientific Corporation	Command and Control, Communications, Computers, Intelligence (C4I)	July 1, 2005	98.7
Spectrum Solutions Group, Inc.	Enterprise Resource Planning	November 2, 2005	9.7
Mercomms Unlimited, Inc.	Maritime and Defense Communications	April 10, 2006	0.6

In October 2006, we acquired RABA, a provider of high-end technical services to the national security and intelligence communities.

**Contract Backlog**

Future growth is dependent upon the strength of our target markets, our ability to identify opportunities, and our ability to successfully bid and win new contracts. Our success can be measured in part based upon the growth of our backlog. The following table summarizes our contract backlog:

	September 30, 2006	June 30, 2006
	(in millions)	
Backlog:		
Funded	\$ 654.9	\$ 512.8
Unfunded	2,991.2	2,748.8
Total backlog	\$ 3,646.1	\$ 3,261.6



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Our total backlog of \$3.6 billion as of September 30, 2006 represented an 11.8% increase over the June 30, 2006 backlog. We currently expect to recognize revenue during the remaining three quarters of fiscal 2007 from approximately 19% of our total backlog as of September 30, 2006.

Our backlog includes orders under contracts that in some cases extend for several years, with the latest expiring during calendar year 2016.

Congress often appropriates funds for our clients on a yearly basis, even though their contract with us may call for performance that is expected to take a number of years. As a result, contracts typically are only partially funded at any point during their term, and all or some of the work to be performed under the contracts may remain unfunded unless and until Congress makes subsequent appropriations and the procuring agency allocates funding to the contract. Our estimate of the portion of the backlog as of September 30, 2006 from which we expect to recognize revenue in the last three quarters of fiscal 2007 is likely to be inaccurate because the receipt and timing of any revenue is subject to various contingencies, many of which are beyond our control. In addition, we may never realize revenue from some of the engagements that are included in our backlog, and there is a higher degree of risk in this regard with respect to unfunded backlog. Finally, the amount of revenue we expect to realize under a particular engagement included in backlog may change because a program schedule could change or the program could be cancelled, or a contract could be reduced, modified, or terminated early.

**Contract Mix**

Contract profit margins are generally affected by the type of contract. We can typically earn higher profits on fixed-price and time-and-materials contracts than cost-plus-fee contracts. Thus, an important part of growing our operating income is to increase the amount of services delivered under fixed-price and time-and-materials contracts. The following table summarizes our historical contract mix, measured as a percentage of total revenue, for the periods indicated:

	<b>Three Months Ended</b>	
	<b>September 30,</b>	
	<b>2006</b>	<b>2005</b>
Cost-plus-fee	46%	44%
Time-and-materials	40	40
Fixed-price	14	16

While our government clients typically determine what type of contract will be awarded to us, where we have the opportunity to influence the type of contract awarded, we try to pursue time-and-materials and fixed-price contracts for the reasons discussed above.

**Operating Margin**

Operating margin, or the ratio of operating income to revenue, is affected by the mix of our contracts and how we manage our costs. Our operating margins were 7.5% and 8.1% for the three months ended September 30, 2006 and 2005, respectively. The decrease in operating margin for the three months ended September 30, 2006 is primarily due to one-time costs incurred to consolidate several of our offices into a new centrally-located facility in Virginia. Operating margin was also lower given the increase in third-party material purchases, which typically generate lower profit.

**Table of Contents*****Headcount and Labor Utilization***

Because most of our revenue derives from services delivered by our employees, our ability to hire new employees and deploy them on direct-billable jobs is critical to our success. The market for highly qualified personnel with security clearances remains very tight. Therefore, we closely monitor hiring success, attrition trends, and direct labor utilization. The following table represents our headcount and our direct labor utilization:

	<b>Three Months Ended September 30, 2006</b>	<b>Year Ended June 30, 2006</b>
Headcount	4,989	4,975
Direct labor utilization	78.5%	78.5%

***Days Sales Outstanding***

Days sales outstanding, or DSO, is a measure of how efficiently we manage the billing and collection of our accounts receivable, our most significant working capital requirement. Accounts receivable represents the most significant asset we report on our balance sheet. For the three months ended September 30, 2006, we reported DSO of 76 days, a decrease from 81 days for the three months ended June 30, 2006. The decrease in DSO was due primarily to internal process initiatives implemented to improve our invoicing and collection of accounts receivable.

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The following tables detail our condensed consolidated statements of operations, the period-over-period rate of change in each of the line items and express these items as a percentage of revenue, for the periods indicated.

	<b>Three Months Ended September 30,</b>		<b>% Change</b>
	<b>2006 (unaudited, in thousands)</b>	<b>2005</b>	
Revenue	\$ 304,034	\$ 280,695	8.3%
Operating costs and expenses:			
Cost of services	228,059	210,240	8.5
Selling, general and administrative	48,404	43,657	10.9
Depreciation and amortization	4,740	4,010	18.2
Total operating costs and expenses	281,203	257,907	9.0
Operating income	22,831	22,788	0.2
Interest income, net	1,843	733	151.4
Income before taxes	24,674	23,521	4.9
Provision for income taxes	9,553	9,131	4.6
Net income	\$ 15,121	\$ 14,390	5.1

	<b>(unaudited, as a percentage of revenue)</b>	
	<b>2006</b>	<b>2005</b>
Revenue	100.0%	100.0%
Operating costs and expenses:		
Cost of services	75.0	74.9
Selling, general and administrative	15.9	15.6
Depreciation and amortization	1.6	1.4
Total operating costs and expenses	92.5	91.9
Operating income	7.5	8.1
Interest income, net	0.6	0.3
Income before taxes	8.1	8.4
Provision for income taxes	3.1	3.3
Net income	5.0%	5.1%

**THREE MONTHS ENDED SEPTEMBER 30, 2006 COMPARED TO THREE MONTHS ENDED SEPTEMBER 30, 2005****Revenue**

For the three months ended September 30, 2006, our revenue increased 8.3% to \$304.0 million, from \$280.7 million for the three months ended September 30, 2005. Organic revenue growth was 6.5% for the period and has been driven in part by several large contracts. Our Federal Deposit Insurance Corporation, or FDIC, contract and our United States Agency for International Development, or USAID, contract were significant drivers of our revenue growth, generating approximately \$9.2 million in additional revenue during the three months ended September 30, 2006 compared to the three months ended September 30, 2005.



*Cost of Services*

For the three months ended September 30, 2006, cost of services increased 8.5% to \$228.1 million, from \$210.2 million for the three months ended September 30, 2005. This increase in cost of services was due

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primarily to the increased volume of services provided under the FDIC and USAID contracts. As a percentage of revenue, cost of services increased slightly to 75.0% in the three months ended September 30, 2006, from 74.9% in the three months ended September 30, 2005.

### ***Selling, General and Administrative Expenses***

For the three months ended September 30, 2006, selling, general and administrative expenses increased 10.9% to \$48.4 million, from \$43.7 million for the three months ended September 30, 2005. As a percentage of revenue, selling, general and administrative expenses increased to 15.9% for the three months ended September 30, 2006, from 15.6% for the three months ended September 30, 2005. This increase as a percentage of revenue resulted primarily from one-time costs incurred to consolidate several of our offices into a new centrally-located facility in Virginia.

### ***Depreciation and Amortization***

For the three months ended September 30, 2006, depreciation and amortization increased 18.2% to \$4.7 million, from \$4.0 million for the three months ended September 30, 2005. The increase in depreciation expense reflects the capital expenditures made associated with our new facility in Virginia. As a percentage of revenue, depreciation and amortization increased to 1.6% for the three months ended September 30, 2006, from 1.4% for the three months ended September 30, 2005.

### ***Interest Income***

For the three months ended September 30, 2006, interest income increased to \$1.8 million, from \$0.7 million for the three months ended September 30, 2005. This increase was due to a general rise in interest rates and higher average cash and cash equivalents and investment balances.

### ***Income Taxes***

For the three months ended September 30, 2006, our effective income tax rate decreased to 38.7%, from 38.8% for the three months ended September 30, 2005. This decrease was due primarily to an increased proportion of interest income earned from tax-advantaged municipal bond investments during the quarter. The estimated effective tax rate is based on current tax law and current income and expense projections. The effective tax rate may be affected by future acquisitions, by changes in interest income from tax-advantaged municipal bond investments, or by the receipt of certain tax credits or refunds.

## **SEASONALITY**

We generally experience a decline in operating margin during the quarter ending September 30 due to lower staff utilization rates. These lower utilization rates are attributable both to summer vacations and to increased proposal activity in connection with the end of the federal fiscal year. We typically transition a number of professional staff temporarily off of billable engagements to support this increased proposal activity.

## **LIQUIDITY AND CAPITAL RESOURCES**

Our primary liquidity needs are to finance the costs of operations pending the billing and collection of accounts receivable, to acquire capital assets, to invest in research and development, and to make selective strategic acquisitions.

### ***Cash Flow***

Accounts receivable represent our largest working capital requirement. We bill most of our clients monthly after services are rendered. Our operating cash flow is primarily affected by the overall profitability of our

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contracts, our ability to invoice and collect from our clients in a timely manner, and our ability to manage our vendor payments. We continue to improve our invoicing and collection procedures to ensure that cash flows from operations remain a top priority.

Net cash provided by operating activities was \$44.7 million for the three months ended September 30, 2006 compared to \$12.1 million for the three months ended September 30, 2005, or 3.0 and 0.8 times net income for the same periods. The higher cash provided by operating activities was driven primarily by the decrease in accounts receivable. The decrease in accounts receivable was primarily the result of internal process initiatives implemented to improve our invoicing and collection of accounts receivable.

Net cash provided by investing activities was \$1.3 million in the three months ended September 30, 2006, compared to net cash used of \$95.8 million in the three months ended September 30, 2005. The cash used for investing activities in the three months ended September 30, 2005 was primarily the result of our acquisition of Galaxy in July 2005.

Net cash provided by financing activities was \$2.6 million in the three months ended September 30, 2006, compared to \$9.2 million in the three months ended September 30, 2005. The decrease was due to lower stock option exercises. On a periodic basis, our employees exercise stock options resulting in the issuance of common stock.

**Credit Facility and Borrowing Capacity**

Since our May 2002 initial public offering, we have been able to meet all of our liquidity requirements, including the completion of seven acquisitions, with cash generated from our operations. We do not maintain a commercial credit facility as we expect our cash and cash equivalents and investments, together with cash flow generated from operations, to meet our normal operating liquidity and capital expenditure requirements for at least the next twelve months. Based on our profitability and the cash flow generated from our operating activities, we believe we have significant borrowing capacity. We maintain relationships with a number of banks who have communicated a willingness to extend credit to us on reasonable terms if the need for credit arises. In particular, it is likely that we would be required to borrow in the event of a large acquisition or a series of smaller acquisitions in a relatively short period of time.

**OFF-BALANCE SHEET ARRANGEMENTS**

We do not have any off-balance sheet arrangements.

**CONTRACTUAL OBLIGATIONS**

The following table summarizes our contractual obligations as of September 30, 2006 that require us to make future cash payments. For contractual obligations, we included payments that we have an unconditional obligation to make. We did not include amounts already recorded on our balance sheet as liabilities at September 30, 2006.

Contractual obligations:	Total	Payments due by period			
		Less than 1 Year	Years 2 and 3	Years 4 and 5	After 5 Years
Operating lease obligations, net	\$ 182,239	\$ 27,727	\$ 48,170	\$ 37,634	\$ 68,708
Total contractual obligations	\$ 182,239	\$ 27,727	\$ 48,170	\$ 37,634	\$ 68,708

In the normal course of our business, we enter into agreements with subcontractors and vendors to provide products and services that we consume in our operations or that are delivered to our customers. These products and services are not considered unconditional obligations until the products and services are actually delivered, at which time we record a liability for our obligation.

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### **DESCRIPTION OF CRITICAL ACCOUNTING POLICIES**

The preparation of our financial statements in accordance with accounting principles generally accepted in the United States of America requires that we make estimates and judgments that affect the reported amounts of assets, liabilities, revenue and expenses, as well as the disclosure of contingent assets and liabilities. On an ongoing basis, we evaluate our estimates including those related to revenue recognition, doubtful accounts receivable, goodwill and other intangible assets, and other contingent liabilities. We base our estimates on our historical experience and various other factors that we believe are reasonable at the time the estimates are made. Actual results may differ significantly from our estimates under different assumptions or conditions. We believe the critical accounting policies requiring us to make significant estimates and judgments are revenue recognition, contract cost accounting, and accounting for acquisitions, including the identification of intangible assets and the ongoing impairment assessments of the intangible assets. If any of these estimates or judgments proves to be incorrect, our reported results could be materially affected.

#### ***Revenue Recognition***

We recognize revenue when persuasive evidence of an arrangement exists, services have been rendered or goods delivered, the contract price is fixed or determinable, and collectibility is reasonably assured. We have a standard management process that we use to determine whether all required criteria for revenue recognition have been met. This standard management process includes a regular review of our contract performance. This review covers, among other matters, outstanding action items, progress against schedule, effort and staffing, requirements stability, quality, risks and issues, subcontract management, cost, commitments, and client satisfaction. During this review we determine whether the overall progress on a contract is consistent with the effort expended.

Absent evidence to the contrary, we recognize revenue as follows. Revenue on cost-plus-fee contracts is recognized to the extent of costs actually incurred plus a proportionate amount of the fee earned. We consider fixed fees under cost-plus-fee contracts to be earned in proportion to the allowable costs actually incurred in performance of the contract. Revenue on time-and-materials contracts is recognized based on the hours actually incurred at the negotiated contract billing rates, plus the cost of any allowable material costs and out-of-pocket expenses. Revenue on fixed-price contracts is generally recognized using the percentage-of-completion method of contract accounting. Unless it is determined as part of our regular contract performance review that overall progress on a contract is not consistent with costs expended to date, we determine the percentage completed based on the percentage of costs incurred to date in relation to total estimated costs expected upon completion of the contract. Revenue on fixed-price contracts pursuant to which a client pays us a specified amount to provide only a particular service for a stated time period, a so-called fee-for-service arrangement, is generally recognized ratably over the contract period, assuming all other criteria for revenue recognition are met. We consider performance-based fees, including award fees, under any contract type to be earned when we can demonstrate satisfaction of performance goals, based upon historical experience, or we receive contractual notification from a client that the fee has been earned. Billings for hardware or software purchased by customers under one of our contracts where we act as an agent to the transaction are excluded from our revenue and cost of services, except to the extent of any fee or profit earned.

Contract revenue recognition inherently involves estimation. Examples of estimates include the contemplated level of effort to accomplish the tasks under contract, the cost of the effort, and an ongoing assessment of our progress toward completing the contract. From time to time, as part of our standard management processes, facts develop that require us to revise our estimated total costs or revenue. To the extent that a revised estimate affects contract profit or revenue previously recognized, we record the cumulative effect of the revision in the period in which the facts requiring the revision become known. The full amount of an anticipated loss on any type of contract is recognized in the period in which it becomes probable and can be reasonably estimated.

We may proceed with work based on client direction prior to the completion and signing of formal contract documents. We have a formal review process for approving any such work. Revenue associated with such work

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is recognized only when it can be reliably estimated and realization is probable. We base our estimates on previous experiences with the client, communications with the client regarding funding status, and our knowledge of available funding for the contract or program.

We maintain reserves for doubtful accounts receivable that may arise in the normal course of business. Historically, we have not had significant write-offs of doubtful accounts receivable related to work we perform for the federal government. However, we do perform work on contracts and task orders where, on occasion, issues arise that lead to accounts receivable not being collected.

### ***Contract Cost Accounting***

As a contractor providing services primarily to the federal government, we must categorize our costs as either direct or indirect and allowable or unallowable. Direct costs are those costs that are identified with specific contracts. These costs include labor, subcontractor and consultant services, third party materials we purchase under a contract, and other non-labor costs incurred in support of a contract. Indirect costs are those costs not identified with specific contracts. Rather, indirect costs are allocated to contracts in accordance with federal government rules and regulations. These costs typically include our selling, general and administrative expenses, fringe benefit expenses, and depreciation and amortization costs. Direct and indirect costs that are not allowable under the Federal Acquisition Regulation or specific contract provisions cannot be considered for reimbursement under our federal government contracts. We must specifically identify these costs to ensure we comply with these requirements. Our unallowable costs include a portion of our executive compensation, certain employee morale activities, certain types of legal and consulting costs, and the amortization of identified intangible assets, among others. As we acquire and integrate new companies, we try to manage our indirect costs by realizing opportunities for cost synergies and integrating the indirect support function of acquired companies into our own.

### ***Accounting for Acquisitions and Asset Impairment***

The purchase price that we pay to acquire the stock or assets of an entity must be assigned to the net assets acquired based on the estimated fair market value of those net assets. The purchase price in excess of the estimated fair market value of the tangible net assets and separately identified intangible assets acquired represents goodwill. The purchase price allocation related to acquisitions involves significant estimates and management judgments that may be adjusted during the purchase price allocation period, but generally not beyond one year from the acquisition date.

We must evaluate goodwill for impairment on an annual basis, or during any interim period if we have an indication that goodwill may be impaired. We assess the potential impairment of goodwill by comparing the carrying value of the assets and liabilities of our reporting unit to which goodwill is assigned to the estimated fair value of the reporting unit using a discounted cash flow approach. We performed our annual goodwill impairment analysis as of January 1, 2006. There was no indication of goodwill impairment as a result of our impairment analysis. If we are required to record an impairment charge in the future, it could materially affect our results of operations.

The estimated fair market value of identified intangible assets is amortized over the estimated useful life of the related intangible asset. We have a process pursuant to which we typically retain third-party valuation experts to assist us in determining the fair market values and useful lives of identified intangible assets. We evaluate these assets for impairment when events occur that suggest a possible impairment. Such events could include, but are not limited to, the loss of a significant client or contract, decreases in federal government appropriations or funding for specific programs or contracts, or other similar events. None of these events have occurred for the periods presented. We determine impairment by comparing the net book value of the asset to its future undiscounted net cash flows. If an impairment occurs, we will record an impairment expense equal to the difference between the net book value of the asset and its estimated discounted cash flows using a discount rate based on our cost of capital and the related risks of recoverability.

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### **DESCRIPTION OF STATEMENT OF OPERATIONS ITEMS**

The following is a description of certain line items of our statements of operations.

#### ***Revenue***

Most of our revenue is generated on the basis of services provided to the federal government, either by our employees or by our subcontractors. To a lesser degree, the revenue we earn may include third-party hardware and software that we purchase and integrate when requested by the client as a part of the solutions that we provide to our clients.

*Contract Types.* When contracting with our government clients, we enter into one of three basic types of contracts: cost-plus-fee, time-and-materials, and fixed-price.

*Cost-plus-fee contracts.* Cost-plus-fee contracts provide for reimbursement of allowable costs and the payment of a fee, which is our profit. Cost-plus-fixed-fee contracts specify the contract fee in dollars. Cost-plus-award-fee contracts may provide for a base fee amount, plus an award fee that varies, within specified limits, based upon the client's assessment of our performance as compared to contractual targets for factors such as cost, quality, schedule, and performance.

*Time-and-materials contracts.* Under a time-and-materials contract, we are paid a fixed hourly rate for each direct labor hour expended and we are reimbursed for allowable material costs and out-of-pocket expenses. To the extent our actual direct labor and associated costs vary in relation to the fixed hourly billing rates provided in the contract, we will generate more or less profit, or could incur a loss.

*Fixed-price contracts.* Under a fixed-price contract, we agree to perform the specified work for a pre-determined price. To the extent our actual costs vary from the estimates upon which the price was negotiated, we will generate more or less than the anticipated amount of profit or could incur a loss. Some fixed-price contracts have a performance-based component, pursuant to which we can earn incentive payments or incur financial penalties based on our performance.

#### ***Cost of Services***

Cost of services includes the direct costs to provide our services and business solutions to clients. The most significant of these costs are the salaries and wages, plus associated fringe benefits, of our employees directly serving clients. Cost of services also includes the costs of subcontractors and outside consultants, third-party materials, such as hardware or software that we purchase and provide to the client as part of an integrated solution, and any other direct costs, such as travel expenses incurred to support contract efforts.

#### ***Selling, General and Administrative Expenses***

Selling, general and administrative expenses include the salaries and wages, plus associated fringe benefits, of our employees not performing work directly for clients. Among the functions covered by these costs are asset and facilities management, business development, research and development, contracts and legal, finance and accounting, executive and senior management, human resources, and information system support. Facilities-related costs are also included in selling, general and administrative expenses.

#### ***Depreciation and Amortization***

Depreciation and amortization includes depreciation of computers and other equipment, the amortization of software we use internally, the amortization of leasehold improvements, and the amortization of identified intangible assets.

**Table of Contents****DEFINITION OF CERTAIN TERMS USED IN THIS MANAGEMENT'S DISCUSSION AND ANALYSIS**

The following is our definition of certain terms we have used in our discussion and analysis.

***Backlog***

We define backlog to include funded and unfunded orders for services under existing signed contracts, assuming the exercise of all options relating to those contracts, less the amount of revenue we have previously recognized under those contracts. Backlog includes all contract options that have been priced but not yet funded. Backlog also includes the contract value under single award indefinite delivery, indefinite quantity, or ID/IQ, contracts against which we expect future task orders to be issued without competition. Backlog does not take contract ceiling value into consideration under multiple award contracts, nor does it include any estimate of future potential delivery orders that might be awarded under multiple award ID/IQ vehicles, government-wide acquisition contracts, or GWACs, or General Services Administration, or GSA, schedule contracts. We define funded backlog to be the portion of backlog for which funding currently is appropriated and obligated to us under a contract or other authorization for payment signed by an authorized purchasing authority.

We cannot guarantee that we will recognize any revenue from our backlog. The federal government has the prerogative to cancel any contract or delivery order at any time. Most of our contracts and delivery orders have cancellation terms that would permit us to recover all or a portion of our incurred costs and potential fees in such cases. Backlog varies considerably from time to time as current contracts or delivery orders are executed and new contracts or delivery orders under existing contracts are won.

***Days Sales Outstanding***

We calculate days sales outstanding, or DSO, by dividing the average accounts receivable at the beginning and end of the period, net of average billings in excess of revenue, by revenue per day in the period. Revenue per day for a quarter is determined by dividing total revenue by 90 days. Revenue per day for a year is determined by dividing total revenue by 360 days.

***Direct Labor Utilization***

We define direct labor utilization as the ratio of labor dollars worked on customer engagements to total labor dollars worked. We include every working employee of the company in the computation. We exclude leave taken, such as vacation time or sick leave, so that we can understand how we are applying worked labor. Leave actually taken by our employees is largely beyond the control of management in the near term.

***Organic Growth***

We calculate organic growth by comparing our actual reported revenue in the current period, including revenue attributable to acquired companies, with adjusted revenue from the prior-year period. In arriving at prior-year revenue, we include the revenue of acquired companies for the prior-year periods comparable to the current-year periods for which the acquired companies are included in our actual reported revenue. The resulting growth rate is intended to represent our organic, or non-acquisitive, growth year-over-year, including comparable period growth attributable to acquired companies. For illustrative purposes, we compute our quarterly organic growth rate of 6.5% as follows:

	<b>Quarter Ended September 30,</b>		
	<b>2006</b>	<b>2005</b>	<b>% Increase</b>
Revenue, as reported	\$ 304,034	\$ 280,695	8.3%
Plus: Revenue from acquired companies for the comparable prior year period		4,713	
Organic Revenue	\$ 304,034	\$ 285,408	6.5%

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***Recent Accounting Pronouncements***

In September 2006, the FASB issued Statement of Financial Accounting Standards No. 157 (SFAS 157), Fair Value Measurements. SFAS 157 provides a new single authoritative definition of fair value and enhanced guidance for measuring the fair value of assets and liabilities. It requires additional disclosures related to the extent to which companies measure assets and liabilities at fair value, the information used to measure fair value, and the effect of fair value measurements on earnings. SFAS 157 is effective for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. We are currently evaluating what effect, if any, the adoption of SFAS 157 will have on our financial position, results of operations, or cash flows.

In July 2006, the FASB issued Interpretation No. 48 (FIN 48), Accounting for Uncertainty in Income Taxes an interpretation of FASB Statement No. 109, which clarifies the accounting for uncertainty in income taxes recognized in an enterprise's financial statements in accordance with FASB Statement No. 109, Accounting for Income Taxes, and prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. FIN 48 also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure, and transition. FIN 48 is effective for fiscal years beginning after December 15, 2006. We are currently evaluating what effect, if any, the adoption of FIN 48 will have on our financial position, results of operations, or cash flows.

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

Financial instruments that potentially subject us to credit risk consist primarily of cash equivalents, short- and long-term investments, and accounts receivable.

We believe that concentrations of credit risk with respect to cash equivalents and investments are limited due to the high credit quality of these investments. Our investment policy requires that investments be in direct obligations of the U.S. government, certain U.S. government sponsored entities, investments that are secured by direct or sponsored U.S. government obligations, or certain corporate or municipal debt obligations rated at least single-A or A-1/P-1, as applicable, by both Moody's Investor Service and Standard and Poor's. Our policy does not allow investment in any equity securities or the obligations of any entity under review for possible downgrade by a major rating service to a debt rating below single-A.

Investments in both fixed and floating rate interest earning instruments carry a degree of interest rate risk. Fixed securities may have their fair market value adversely affected because of a rise in interest rates, while floating rate securities may produce less income than expected if interest rates fall. Due in part to these factors, our future investment income may fall short of expectations because of changes in interest rates or we may suffer losses in principal if forced to sell securities which have seen a decline in market value because of changes in interest rates. Investments are made in accordance with an investment policy approved by our board of directors. Under this policy, no investment securities may have maturities exceeding two years and the average duration of the portfolio cannot exceed nine months.

We believe that concentrations of credit risk with respect to accounts receivable are limited as they are primarily federal government receivables.

As of September 30, 2006 and June 30, 2006, the carrying value of financial instruments approximated fair value. These investments consist of corporate and municipal bonds with maturities of 4 months or less that are classified as held-to-maturity.

**Item 4. Controls and Procedures**

Our management, with the participation of our chief executive officer and chief financial officer, evaluated the effectiveness of our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under



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the Exchange Act) as of September 30, 2006. Based on this evaluation, our chief executive officer and chief financial officer concluded that, as of September 30, 2006, our disclosure controls and procedures were (1) designed to ensure that material information relating to us, including our consolidated subsidiaries, is made known to our chief executive officer and chief financial officer by others within those entities, particularly during the period in which this report was being prepared and (2) effective, in that they provide reasonable assurance that information required to be disclosed by us in the reports that we file or submit under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms.

No change in our internal control over financial reporting occurred during the fiscal quarter ended September 30, 2006 that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

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**Part II. OTHER INFORMATION**

**Item 1. Legal Proceedings**

From time to time, we are involved in various legal matters and proceedings concerning matters arising in the ordinary course of business. We currently believe that any ultimate liability arising out of these matters and proceedings will not have a material adverse effect on our financial position, results of operations or cash flows.

**Item 1A. Risk Factors**

**Risks Related To Our Business**

*We depend on contracts with U.S. federal government agencies for substantially all of our revenue, and if our relationships with these agencies were harmed, our business would be threatened.*

Revenue from contracts with U.S. federal government agencies accounted for 99% of our revenue for all periods presented herein. Revenue from contracts with clients in the Department of Defense and the National Guard accounted for 48%, 49%, and 53%, of our revenue for the three months ended September 30, 2006, fiscal 2006, and fiscal 2005, respectively. We believe that federal government contracts will continue to be the source of substantially all of our revenue for the foreseeable future. For this reason, any issue that compromises our relationship with agencies of the federal government in general, or within the Department of Defense and the National Guard in particular would cause serious harm to our business.

Among the key factors in maintaining our relationships with federal government agencies and departments are our performance on individual contracts and delivery orders, the strength of our professional reputation, and the relationships of our senior management with client personnel. The loss of any member of our senior management could impair our ability to identify and secure new contracts and to maintain good client relations. Additionally, to the extent that our performance does not meet client expectations, or our reputation with one or more key clients is impaired, our revenue and operating results could be materially harmed.

*We face intense competition from many competitors that have greater resources than we do, which could result in price reductions, reduced profitability, and loss of market share.*

We operate in highly competitive markets and generally encounter intense competition to win contracts. If we are unable to successfully compete for new business or win recompetitions of existing business, our revenue growth and operating margins may decline. Many of our competitors are larger and have greater financial, technical, marketing, and public relations resources, larger client bases, and greater brand or name recognition than we do. Larger competitors include federal systems integrators such as Computer Sciences Corporation and Science Applications International Corporation, divisions of large defense contractors such as General Dynamics Corporation, Lockheed Martin Corporation, and Northrop Grumman Corporation, and consulting firms such as Accenture Ltd. and BearingPoint, Inc. Our larger competitors may be able to compete more effectively for very large-scale government contracts. Our larger competitors also may be able to provide clients with different or greater capabilities or benefits than we can provide in areas such as technical qualifications, past performance on large-scale contracts, geographic presence, the ability to provide a broader range of services without creating conflicts of interest or intra-organizational conflicts of interest, price, and the availability of key professional personnel. Our competitors also have established or may establish relationships among themselves or with third parties, including through mergers and acquisitions, to increase their ability to address client needs. Accordingly, it is possible that new competitors or alliances among competitors may emerge.

*We derive significant revenue from contracts awarded through a competitive bidding process, which can impose substantial costs upon us, and we will lose revenue if we fail to compete effectively.*

We derive significant revenue from federal government contracts that are awarded through a competitive bidding process. We expect that most of the government business we seek in the foreseeable future will be

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awarded through competitive bidding. Competitive bidding imposes substantial costs and presents a number of risks, including:

the need to bid on engagements in advance of knowing the complete design or full requirements, which may result in unforeseen difficulties in executing the engagement and cost overruns;

the substantial cost and managerial time and effort that we spend to prepare bids and proposals for contracts that may not be awarded to us;

the need to accurately estimate the resources and costs that will be required to service any contract we are awarded;

the possibility that difficult market conditions will cause our competitors to strive for growth by reducing their bid pricing and compel us to choose between bidding at unprofitable levels or losing contracts and foregoing revenue;

the expense and delay that may arise if our competitors protest or challenge contract awards made to us pursuant to competitive bidding, and the risk that any such protest or challenge could result in the resubmission of bids on modified specifications, or in termination, reduction, or modification of the awarded contract; and

the opportunity cost of not bidding on and winning other contracts we might otherwise pursue.

To the extent we engage in competitive bidding and are unable to win particular contracts, we not only incur substantial costs in the bidding process that would negatively affect our operating results, but we may be precluded from operating in the market for services that are provided under those contracts for a number of years. Even if we win a particular contract through competitive bidding, our profit margins may be depressed as a result of the costs incurred through the bidding process.

***Loss of our General Services Administration, or GSA, schedule contracts or our position as a prime contractor on one or more of our government-wide acquisition contracts, or GWACs, or our other multiple-award contracts would impair our ability to win new business.***

We believe that one of the key elements of our success is our position as the holder of five GSA schedule contracts and as a prime contractor under three GWACs and more than 35 agency-specific indefinite delivery/indefinite quantity, or ID/IQ, contracts. For the three months ended September 30, 2006, fiscal 2006, and fiscal 2005, revenue from GSA schedule contracts, GWACs, and other ID/IQ contracts accounted for approximately 78%, 76%, and 77%, respectively, of our revenue from federal government clients. If we were to lose our position on one or more of these contracts, we could lose revenue and our operating results could suffer.

The GSA intends to combine two of its large GWACs, Millennia and ANSWER, and other specialized contracts under a new Alliant contract to be competitively awarded. We expect the GSA to award the new Alliant contract in 2007. If we do not win a position as a prime contractor on the new Alliant contract, we could lose revenue and our operating results could suffer.

The Department of Defense has issued guidance providing that procurements of services that are not performance-based or that are to be procured using a contract vehicle outside of the Department of Defense must be approved in advance. This could result in the Department of Defense limiting its future use of GWACs and GSA schedule contracts. Initiatives taken by the Department of Defense or other government agencies and departments, or the impact of the ongoing reorganization by the GSA, could cause services we provide on existing contracts to migrate to contract vehicles on which we are not a prime contractor. Should this occur, our ability to compete for business from these organizations in the future may be harmed.

Orders under GSA schedule contracts, GWACs, and other ID/IQ contracts typically have a one- or two-year initial term with multiple options that may be exercised by our government clients to extend the contract for successive periods of one or more years. We can provide no assurance that our clients will exercise these options.



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***If subcontractors on our prime contracts are able to secure positions as prime contractors, we may lose revenue.***

For each of the past several years we have received substantial revenue from government clients relating to work performed by other information technology providers acting as subcontractors to us. In some cases, companies that have not held GSA schedule contracts or secured positions as prime contractors on GWACs have approached us in our capacity as a prime contractor, seeking to perform services as our subcontractor for a government client. Some of these providers that are currently acting as subcontractors to us may in the future secure positions as prime contractors. If one or more of our current subcontractors are awarded prime contractor status in the future, it could reduce or eliminate our revenue for the work they were performing as subcontractors to us. Revenue derived from work performed by our subcontractors represented approximately 30%, 30%, and 32% of our revenue for the three months ended September 30, 2006, fiscal 2006, and fiscal 2005, respectively.

***If our subcontractors fail to perform their contractual obligations, our performance and reputation as a prime contractor and our ability to obtain future business could suffer.***

As a prime contractor, we often rely significantly upon other companies as subcontractors to perform work we are obligated to deliver to our clients. Revenue derived from work performed by our subcontractors represented approximately 30%, 30%, and 32% of our revenue for the three months ended September 30, 2006, fiscal 2006, and fiscal 2005, respectively. A failure by one or more of our subcontractors to satisfactorily perform the agreed-upon services on a timely basis may compromise our ability to perform our obligations as a prime contractor. In some cases, we have limited involvement in the work performed by the subcontractor and may have exposure as a result of problems caused by the subcontractor. In extreme cases, performance deficiencies on the part of our subcontractors could result in a government client terminating our contract for default. A default termination could expose us to liability for the agency's costs of re-procurement, damage our reputation, and hurt our ability to compete for future contracts. Additionally, we may have disputes with our subcontractors that could impair our ability to execute our contracts as required.

***Our quarterly operating results may fluctuate significantly as a result of factors outside of our control, which could cause the market price of our class A common stock to decline.***

Our revenue and operating results could vary significantly from quarter to quarter. In addition, we cannot predict with certainty our future revenue or results of operations. As a consequence, our operating results may fall below the expectations of securities analysts and investors, which could cause the price of our class A common stock to decline. Factors that may affect our operating results include:

fluctuations in revenue earned on contracts;

commencement, completion, or termination of contracts during any particular quarter;

variable purchasing patterns under GSA schedule contracts, GWACs, and agency-specific indefinite delivery/indefinite quantity contracts;

providing services under a share-in-savings or performance-based contract;

additions and departures of key personnel;

strategic decisions by us or our competitors, such as acquisitions, divestitures, spin-offs, joint ventures, strategic investments, or changes in business strategy;

timing of significant bid and proposal costs;

contract mix, the extent of use of subcontractors, and the level of third-party hardware and software purchases for customers;

changes in presidential administrations and senior federal government officials or their priorities that affect the timing of technology procurement;

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changes in policy or budgetary measures that adversely affect government contracts in general;

interruption by events beyond our control such as earthquakes, power losses, telecommunications failures, hurricanes, and incidents of terrorism; and

the seasonality of our business.

Reductions in revenue in a particular quarter could lead to lower profitability in that quarter because a relatively large amount of our expenses are fixed in the short-term. We may incur significant operating expenses during the start-up and early stages of large contracts and may not receive corresponding payments or revenue in that same quarter. We may also incur significant or unanticipated expenses when contracts expire, when they are terminated, or when they are not renewed. In addition, payments due to us from government agencies may be delayed due to billing cycles or as a result of failures of governmental budgets to gain Congressional and administration approval in a timely manner.

***If we fail to attract and retain skilled employees, we might not be able to staff recently awarded engagements and sustain our profit margins and revenue growth.***

We must continue to hire significant numbers of highly qualified individuals who have advanced information technology and technical services skills and who work well with our clients in a government environment. In some cases, they are required to have security clearances issued by the Department of Defense or other government agencies. These employees are in great demand and are likely to remain a limited resource for the foreseeable future. If we are unable to recruit and retain a sufficient number of these employees, our ability to staff recently awarded engagements and to maintain and grow our business could be limited. We are operating in a tight labor market and, if it continues to tighten, we could be required to engage larger numbers of subcontractor personnel, which could cause our profit margins to suffer. In addition, some of our contracts contain provisions requiring us to commit to staff an engagement with personnel the client considers key to our successful performance under the contract. In the event we are unable to provide these key personnel or acceptable substitutions, the client may terminate the contract, and we may not be able to recover our costs.

***We may lose revenue and our cash flow and profitability could be negatively affected if expenditures are incurred prior to final receipt of a contract or contract funding modification.***

We provide professional services and sometimes procure materials on behalf of our government clients under various contract arrangements. In order to ensure that we satisfy our clients' delivery requirements and schedules, we may elect to initiate procurements or provide services in advance of receiving formal contractual authorization from the government client or a prime contractor. If our government or prime contractor requirements should change or the government directs the anticipated procurement to a contractor other than us, or if the materials become obsolete or require modification before we are under contract for the procurement, our investment might be at risk. If we do not receive the required funding, our cost of services incurred in excess of contractual funding may not be recoverable. This could reduce anticipated revenue or result in a loss, negatively affecting our cash flow and profitability.

***We may lose money on some contracts if we underestimate the resources we need to perform under the contract.***

We provide services to the federal government under three types of contracts: cost-plus-fee, time-and-materials, and fixed-price. For the three months ended September 30, 2006, we derived 46%, 40%, and 14% of our revenue from cost-plus-fee, time-and-materials, and fixed-price contracts, respectively. Each of these types of contracts, to differing degrees, involves the risk that we could underestimate our cost of fulfilling the contract, which may reduce the profit we earn or lead to a financial loss on the contract.

Under cost-plus-fee contracts, which are subject to a ceiling amount, we are reimbursed for allowable costs and paid a fee, which may be fixed or performance-based. However, if our costs exceed the ceiling

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or are not allowable under the terms of the contract or applicable regulations, we may not be able to recover those costs.

Under time-and-materials contracts, we are reimbursed for labor at negotiated hourly billing rates along with the cost of certain expenses, and we assume the risk that our costs of performance may exceed the negotiated hourly rates.

Under fixed-price contracts, we perform specific tasks for a fixed price. Compared to cost-plus-fee contracts and time-and-materials contracts, fixed-price contracts involve greater financial risk due to the potential for cost overruns. To the extent our actual costs exceed the estimates upon which the price was negotiated, we will generate less than the anticipated amount of profit or could incur a loss.

For all three contract types, we bear varying degrees of risk associated with the assumptions we use to formulate our pricing for the work. To the extent our working assumptions prove inaccurate, we may lose money on the contract, which would adversely affect our operating results.

### ***We may lose money or incur financial penalties if we agree to provide services under a performance-based contract arrangement.***

Under certain performance-based contract arrangements, we are paid only to the extent our customer actually realizes savings or achieves some other performance-based improvements that result from our services. In addition, we may also incur certain penalties. Performance-based contracts could impose substantial costs and risks, including:

the need to accurately understand and estimate in advance the improved performance that might result from our services;

the lack of experience both we and our primary customers have in using this type of contract arrangement; and

the requirement that we incur significant expenses with no guarantee of recovering these expenses or realizing a profit in the future. Even if we successfully execute a performance-based contract, our interim operating results and cash flows may be negatively affected by the fact that we may be required to incur significant up-front expenses prior to realizing any related revenue.

### ***Contracts with state and local governments, other governments, international entities, or other organizations with special standing, could impose substantial additional liability and costs upon us.***

As organizations seek to enhance their security, particularly state and local governments, other governments, international entities, and other organizations with special standing, such as the World Bank, we have the opportunity to expand our services beyond our core federal government client base. Contracting with such entities involves additional risks that may result in additional costs to us, including:

the additional costs associated with evaluating, qualifying, and negotiating such opportunities;

a requirement to understand and comply with the specific procurement laws and/or regulations of each individual state, locality, other government, international entity, or other party with special standing;

the contractual acceptance of liability provisions that impose, for example, liquidated damages or other monetary damages in excess of the amount of services we provide, and in some cases are unlimited;

the unavailability of certain protections that would typically be available under federal or common law; and



an increased risk of additional costs associated with dispute resolution.

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*We may not be successful in identifying acquisition candidates and, if we undertake acquisitions, they could be expensive, increase our costs or liabilities, or disrupt our business. Additionally, if we are unable to successfully integrate companies we acquire, our revenue and operating results may be impaired.*

One of our strategies is to augment our organic growth through acquisitions. We have completed eight acquisitions of complementary companies that provide services in one of our three target markets. We may not be able to identify suitable acquisition candidates at prices that we consider appropriate or to finance acquisitions on terms that are satisfactory to us. Acquisitions of businesses or other material operations may require additional debt or equity financing, resulting in leverage or dilution of ownership. Additionally, negotiations of potential acquisitions and the integration of acquired business operations could disrupt our business by diverting management attention away from day-to-day operations and we may not be able to successfully integrate the companies we acquire. We also may not realize cost efficiencies or synergies that we anticipated when selecting our acquisition candidates. Acquired companies may have liabilities or adverse operating issues that we fail to discover through due diligence. Any costs, liabilities, or disruptions associated with future acquisitions could harm our operating results. In addition, following the integration of acquired companies, we may experience increased attrition, including but not limited to key employees of acquired companies, which could reduce our future revenue.

*Unfavorable government audit results could force us to adjust previously reported operating results and could subject us to a variety of penalties and sanctions.*

The federal government audits and reviews our performance on contracts, pricing practices, cost structure, and compliance with applicable laws, regulations, and standards. Like most large government contractors, our contracts are audited and reviewed on a continual basis by federal agencies, including the Defense Contract Management Agency, or DCMA and the Defense Contract Audit Agency, or DCAA. An audit of our work, including an audit of work performed by companies we have acquired or may acquire or subcontractors we have hired or may hire, could result in a substantial adjustment to our previously reported operating results.

The DCAA issued audit guidance suggesting that a Federal Acquisition Regulation billing clause prohibits billing subcontractor or third-party consultant hours using the prime contract hourly rates under time-and-material contracts, stating that these hours must be billed at cost. This is contrary to previously issued instructions from many customers, and contrary to industry practice. If the DCAA were to prevail with this new interpretation, cash we have already collected may need to be refunded, which could materially reduce profits and revenue on time-and-material orders.

Audits for costs incurred on work performed after fiscal year 2004 have not yet been completed. In addition, non-audit reviews by the government may still be conducted on all our government contracts. If a government audit uncovers improper or illegal activities, we may be subject to civil and criminal penalties and administrative sanctions, including termination of contracts, forfeiture of profits, suspension of payments, fines, and suspension or debarment from doing business with U.S. federal government agencies. In addition, we could suffer serious harm to our reputation if allegations of impropriety were made against us, whether or not true.

If we were suspended or debarred from contracting with the federal government generally, or any specific agency, if our reputation or relationship with government agencies were impaired, or if the government otherwise ceased doing business with us or significantly decreased the amount of business it does with us, our revenue and operating results would be materially harmed.

*If we experience systems, service, or product failure, our reputation could be harmed and our clients could assert claims against us for damages or refunds.*

We create, implement, and maintain information technology solutions, as well as sell products, that are often critical to our clients' operations, including operations in war-zones and other hazardous environments. We have experienced and may in the future experience some systems and service failures, schedule or delivery

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delays, and other problems in connection with our work. If our solutions, services, products, including third party products we may resell to our clients, or other applications have significant defects or errors, are subject to delivery delays, or fail to meet our clients' expectations, we may:

lose revenue due to adverse client reaction;

be required to provide additional services to a client at no charge;

receive negative publicity, which could damage our reputation and adversely affect our ability to attract or retain clients; or

suffer claims for substantial damages against us.

In addition to any costs resulting from product or service warranties, contract performance, or required corrective action, these failures may result in increased costs or loss of revenue if clients postpone subsequently scheduled work or cancel or fail to renew contracts.

While many of our contracts limit our liability for consequential damages that may arise from negligence in rendering services to our clients, these contractual provisions may not be legally sufficient to protect us if we are sued. In addition, our errors and omissions and product liability insurance coverage may not continue to be available on reasonable terms or in sufficient amounts to cover one or more large claims, or the insurer may disclaim coverage as to some types of future claims. As we continue to grow and expand our business into new areas, our insurance coverage may not be adequate. The successful assertion of any large claim against us could seriously harm our business. Even if not successful, these claims could result in significant legal and other costs, may be a distraction to our management, and may harm our reputation.

***Our business commitments require our employees to travel to potentially dangerous places, which may result in injury to our employees.***

Our business involves providing services that require our employees to operate in various countries around the world, including Iraq. These countries may be experiencing political upheaval or unrest, and in some cases war or terrorism. Senior level employees or executives may, on occasion, be part of the teams deployed to provide services in these countries. As a result, it is possible that certain of our employees or executives will suffer injury or bodily harm in the course of these deployments. It is also possible that we will encounter unexpected costs in connection with additional risks inherent with sending our employees to dangerous locations, such as increased insurance costs, as well as the repatriation of our employees or executives for reasons beyond our control.

***Our employees may engage in misconduct or other improper activities, which could harm our business.***

We are exposed to the risk that employee fraud or other misconduct could occur. Misconduct by employees could include intentional failures to comply with federal government procurement regulations, engaging in unauthorized activities, seeking reimbursement for improper expenses or falsifying time records. Employee misconduct could also involve the improper use of our clients' sensitive or classified information, which could result in regulatory sanctions against us and serious harm to our reputation. It is not always possible to deter employee misconduct, and the precautions we take to prevent and detect this activity may not be effective in controlling unknown or unmanaged risks or losses, which could harm our business.

***Our failure to obtain and maintain necessary security clearances may limit our ability to perform classified work for government clients, which could cause us to lose business.***

Some government contracts require us to maintain facility security clearances and require some of our employees to maintain individual security clearances. We have seen a recent increase in the number of clients requiring special security clearances and the types of clearances required. If our employees lose or are unable to

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timely obtain security clearances, or we lose a facility clearance, the government client can terminate the contract or decide not to renew it upon its expiration. As a result, to the extent we cannot obtain the required security clearances for our employees working on a particular contract, or we fail to obtain them on a timely basis, we may not derive the revenue anticipated from the contract, which could harm our operating results.

### ***Security breaches in sensitive government systems could result in loss of clients and negative publicity.***

Many of the systems we develop, install, and maintain involve managing and protecting information used in intelligence, national security, and other sensitive or classified government functions. A security breach in one of these systems could cause serious harm to our business, damage our reputation, and prevent us from being eligible for further work on sensitive or classified systems for federal government clients. We could incur losses from such a security breach that could exceed the policy limits under our insurance. Damage to our reputation or limitations on our eligibility for additional work resulting from a security breach in one of our systems could materially reduce our revenue.

### ***We depend on our intellectual property and our failure to protect it could enable competitors to market products and services with similar features that may reduce demand for our products.***

Our success depends in part upon the internally developed technology, proprietary processes, and other intellectual property that we utilize to provide our services and incorporate in our products. If we are unable to protect our intellectual property, our competitors could market services or products similar to our services and products, which could reduce demand for our offerings. Federal government clients typically retain a perpetual, world-wide, royalty-free right to use the intellectual property we develop for them in any manner they deem appropriate, including providing it to our competitors in connection with their performance of other federal government contracts. We typically seek governmental authorization to re-use intellectual property developed for the federal government or to secure export authorization. Federal government clients typically grant contractors the right to commercialize software developed with federal funding. However, if we were to improperly use intellectual property even partially funded by the federal government, the federal government could seek damages or royalties from us, sanction us, or prevent us from working on future government contracts.

We may be unable to prevent unauthorized parties from attempting to copy or otherwise obtain and use our technology. Policing unauthorized use of our technology is difficult, and we may not be able to prevent misappropriation of our technology, particularly in foreign countries where the laws may not protect our intellectual property as fully as those in the United States. Others, including our employees, may compromise the trade secrets and other intellectual property that we own. Although we require our employees to execute non-disclosure and intellectual property assignment agreements and comply with related policies and procedures, these agreements may not be legally or practically sufficient to protect our rights. Litigation may be necessary to enforce our intellectual property rights, to protect our trade secrets, and to determine the validity and scope of the proprietary rights of others. Any litigation could result in substantial costs and diversion of resources, with no assurance of success.

### ***We may be harmed by intellectual property infringement claims.***

We may become subject to claims from our employees or third parties who assert that software and other forms of intellectual property that we use in delivering services and business solutions to our clients infringe upon intellectual property rights of such employees or third parties. Our employees develop much of the software and other forms of intellectual property that we use to provide our services and business solutions to our clients, but we also license technology from other vendors. If our vendors, our employees, or third parties assert claims that we or our clients are infringing on their intellectual property, we could incur substantial costs to defend those claims. In addition, if any of these infringement claims are ultimately successful, we could be required to:

cease selling or using products or services that incorporate the challenged software or technology;

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obtain a license or additional licenses from our vendors or other third parties; or

redesign our products and services that rely on the challenged software or technology.

***Activation of military and National Guard reserves could significantly reduce our revenue and profits.***

Activation of military reserves, in connection with international conflicts or otherwise, could result in some clients and client contracting staff being activated into the military services. This could delay contract awards that might be in the evaluation or award process, which could in turn reduce our revenue until such time as our clients are able to complete the evaluation and award process, or could even result in the loss of the potential contract award.

As of September 30, 2006 we had approximately 200 employees who serve as reserves for a branch of the military or the National Guard. In the event of a significant call-up we will pay these employees the differential between their military pay and their salary for up to six months. Our standard practice in the absence of a significant call-up is to provide for up to two weeks of differential pay for military leave. To the extent those called for military duty are directly billable on our contracts, our revenue could be reduced. Additionally, our fringe benefit expenses would be increased by any differential payments, which could reduce our profits.

**Risks Related To Our Industry**

***A reduction in the U.S. defense budget or the diversion of funding from IT services and solutions to support the war against terrorism or the reconstruction of Iraq could result in a substantial decrease in our revenue.***

Revenue from contracts with clients in the Department of Defense and the National Guard accounted for 48%, 49%, and 53% of our revenue for the three months ended September 30, 2006, fiscal 2006, and fiscal 2005, respectively. A decline in overall U.S. military expenditures, or in the portion of those expenditures allocated to information technology services and solutions, could cause a decrease in our revenue and profitability. The reduction in the U.S. defense budget during the early 1990s caused some defense-related government contractors to experience decreased sales, reduced operating margins and, in some cases, net losses. Defense spending levels may not continue at present levels, and future levels of expenditures and authorizations for existing programs may decline, remain constant, or shift to agencies or programs in areas where we do not currently have contracts. A significant decline in defense expenditures, or a shift in expenditures away from agencies or programs that we support, could cause a material decline in our revenue.

***A reduction in U.S. civil government agency budgets, including a reduction caused by the diversion of funding to support the war against terrorism, the reconstruction of Iraq, or natural disaster recovery could result in a substantial decrease in our revenue.***

Revenue from contracts with civil agency clients accounted for 51%, 50%, and 46% of our revenue for the three months ended September 30, 2006, fiscal 2006, and fiscal 2005, respectively. We expect civil agency clients will continue to represent a substantial portion of our future revenue. A decline in expenditures by civil agencies, or in the portion of those expenditures allocated to information technology services and solutions, could cause a material decrease in our revenue and profitability. In particular, a shift of funds away from civil agencies to pay for programs within other agencies, for example the Department of Defense, to reduce federal budget deficits, or to fund tax reductions, could cause a material decline in our revenue. In particular, it is possible that funding for civil agencies may be diverted to support the ongoing war against terrorism, the reconstruction of Iraq, natural disaster recovery, or other international conflicts.

***Changes in the spending policies or budget priorities of the federal government could cause us to lose revenue.***

We derived 99% of our revenue for all periods presented herein, from contracts with federal government agencies. We believe that contracts with federal government agencies and departments will continue to be the

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primary source of our revenue for the foreseeable future. Accordingly, changes in federal government fiscal or spending policies could directly affect our financial performance. Among the factors that could harm our federal government contracting business are:

the curtailment of the federal government's use of technology services firms;

a significant decline in spending by the federal government in general, or by specific departments or agencies in particular;

a reduction in spending or shift of expenditures from existing programs to pay for an international conflict or related reconstruction efforts;

a failure of Congress to pass adequate supplemental appropriations to pay for an international conflict, or to pay for the cost of related reconstruction efforts;

reductions in federal government programs or requirements;

the adoption of new laws or regulations that affect companies that provide services to the federal government;

delays in the payment of our invoices by government payment offices;

new legislation, procurement regulations, or union pressure that cause federal agencies to adopt restrictive procurement practices regarding the use of outside information technology providers;

changes in policy and goals by the government providing set aside funds to small businesses, disadvantaged businesses, and other socio-economic requirements in the allocation of contracts; and

general economic and political conditions.

These or other factors could cause federal government agencies and departments to reduce their purchases under contracts, to exercise their right to terminate contracts, or not to exercise options to renew contracts, any of which could cause us to lose revenue. We have substantial contracts in place with many federal departments and agencies, and our continued performance under these contracts, or award of additional contracts from these agencies, could be materially harmed by federal government spending reductions or budget cutbacks at these departments or agencies.

***The failure by Congress to approve budgets on a timely basis for the federal agencies we support could delay or reduce spending and cause us to lose revenue.***

On an annual basis, Congress must approve budgets that govern spending by each of the federal agencies we support. When Congress is unable to agree on budget priorities and is unable to pass the annual budget on a timely basis, Congress typically enacts a continuing resolution. A continuing resolution allows government agencies to operate at spending levels approved in the previous budget cycle. When government agencies must operate under a continuing resolution, it may delay funding we expect to receive from clients on work we are already performing and will likely result in any new initiatives being delayed, and potentially cancelled.

*The Office of Management and Budget process for ensuring government agencies properly support capital planning initiatives, including information technology investments, could reduce or delay federal information technology spending and cause us to lose revenue.*

The Office of Management and Budget, or OMB, supervises spending by federal agencies, including enforcement of the Government Performance Results Act. This Act requires, among other things, that federal agencies make an adequate business justification to support capital planning initiatives, including all information technology investments. The factors considered by the OMB include, among others, whether the proposed information technology investment is expected to achieve an appropriate return on investment, whether related processes are contemporaneously reviewed, whether inter-operability with existing systems and the capacity for

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these systems to share data across government has been considered, and whether existing off-the-shelf products are being utilized to the extent possible. If our clients do not adequately justify proposed information technology investments to the OMB, the OMB may refuse funding for their new or continuing information technology investments, and we may lose revenue as a result.

***Federal government contracts contain provisions giving government clients a variety of rights that are unfavorable to us, including the ability to terminate a contract at any time for convenience.***

Federal government contracts contain provisions and are subject to laws and regulations that provide government clients with rights and remedies not typically found in commercial contracts. These rights and remedies allow government clients, among other things, to:

terminate existing contracts, with short notice, for convenience, as well as for default;

reduce or modify contracts or subcontracts;

terminate our facility security clearances and thereby prevent us from receiving classified contracts;

cancel multi-year contracts and related orders if funds for contract performance for any subsequent year become unavailable;

decline to exercise an option to renew a multi-year contract;

claim rights in products, systems, and technology produced by us;

prohibit future procurement awards with a particular agency due to a finding of organizational conflict of interest based upon prior related work performed for the agency that would give a contractor an unfair advantage over competing contractors;

subject the award of GSA schedule contracts, GWACs, and other ID/IQ contracts to protest by competitors, which may require the contracting federal agency or department to suspend our performance pending the outcome of the protest and may also result in a requirement to resubmit bids for the contract or in the termination, reduction, or modification of the awarded contract; and

suspend or debar us from doing business with the federal government or with a particular governmental agency.

If a government client terminates one of our contracts for convenience, we may recover only our incurred or committed costs, settlement expenses, and profit on work completed prior to the termination. If a federal government client were to unexpectedly terminate, cancel, or decline to exercise an option to renew with respect to one or more of our significant contracts or suspend or debar us from doing business with government agencies, our revenue and operating results would be materially harmed.

Some government procurement offices have recently issued requests for proposals, or RFPs, stating that fees will not be permitted on subcontractors that are used on time-and-material orders issued under those contracts. If this prohibition is included in these future contract awards, and we subcontract a significant component of time and material orders issued under these contracts, this could reduce our profitability on future work.

***Our failure to comply with complex procurement laws and regulations could cause us to lose business and subject us to a variety of penalties.***



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We must comply with laws and regulations relating to the formation, administration, and performance of federal government contracts, which affect how we do business with our government clients and may impose added costs on our business. Among the most significant regulations are:

the Federal Acquisition Regulation, and agency regulations analogous or supplemental to the Federal Acquisition Regulation, which comprehensively regulate the formation, administration, and

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performance of government contracts, including provisions relating to the avoidance of conflicts of interest and intra-organizational conflicts of interest;

the Truth in Negotiations Act, which requires certification and disclosure of all cost and pricing data in connection with some contract negotiations;

the Procurement Integrity Act, which requires evaluation of ethical conflicts surrounding procurement activity and establishing certain employment restrictions for individuals who participate in the procurement process;

the Cost Accounting Standards, which impose accounting requirements that govern our right to reimbursement under some cost-based government contracts;

laws, regulations, and executive orders restricting the use and dissemination of information classified for national security purposes and the exportation of specified products, technologies, and technical data;

laws surrounding lobbying activities a corporation may engage in and operation of a Political Action Committee established to support corporate interests; and

compliance with antitrust laws.

If a government review or investigation uncovers improper or illegal activities, we may be subject to civil and criminal penalties and administrative sanctions, including termination of contracts, forfeiture of profits, harm to our reputation, suspension of payments, fines, and suspension or debarment from doing business with federal government agencies. The government may in the future reform its procurement practices or adopt new contracting rules and regulations, including cost accounting standards, that could be costly to satisfy or that could impair our ability to obtain new contracts. Any failure to comply with applicable laws and regulations could result in contract termination, price or fee reductions, or suspension or debarment from contracting with the federal government, each of which could lead to a material reduction in our revenue.

### **Other Risks Related To Our Stock**

*A public market for our class A common stock has existed only for a limited period of time, and our stock price is volatile and could decline.*

Prior to May 24, 2002, there was no public market for any class of our common stock. An active trading market for our class A common stock may not be sustained, which could affect your ability to sell your shares and could depress the market price of your shares.

The stock market in general, and the market for technology-related stocks in particular, has been highly volatile. As a result, the market price of our class A common stock is likely to be similarly volatile, and holders of our class A common stock may experience a decrease in the value of their stock, including decreases unrelated to our operating performance or prospects. The price of our class A common stock could be subject to wide fluctuations in response to a number of factors, including those listed in this Risk Factors section and others such as:

our operating performance and the performance of other similar companies or companies deemed to be similar;

actual or anticipated differences in our quarterly operating results;

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changes in our revenue or earnings estimates or recommendations by securities analysts;

publication of research reports about us or our industry by securities analysts;

additions and departures of key personnel;

contract mix and the extent of use of subcontractors;

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strategic decisions by us or our competitors, such as acquisitions, consolidations, divestments, spin-offs, joint ventures, strategic investments, or changes in business strategy;

federal government spending levels, both generally and by our particular government clients;

the passage of legislation or other regulatory developments that adversely affect us or our industry;

the failure by Congress to approve budgets on a timely basis;

speculation in the press or investment community;

changes in the government information technology services industry;

changes in accounting principles;

terrorist acts;

general market conditions, including economic factors unrelated to our performance; and

military action related to international conflicts, wars, or otherwise.

In the past, securities class action litigation has often been instituted against companies following periods of volatility in their stock price. This type of litigation could result in substantial costs and divert our management's attention and resources.

***Our chairman, whose interests may not be aligned with yours, controls our company, which could result in actions of which you or other stockholders do not approve.***

As of October 27, 2006, Ernst Volgenau, our chairman, beneficially owned 274,316 shares of class A common stock and 12,050,736 shares of class B common stock, which represented approximately 65.0% of the combined voting power of our outstanding common stock. As of October 27, 2006, our executive officers and directors as a group beneficially owned an aggregate of 2,279,674 shares of class A common stock and 14,399,828 shares of class B common stock, which represented approximately 78.1% of the combined voting power of our outstanding common stock. As a result, these individuals acting together, or Dr. Volgenau acting alone, will be able to control the outcome of all matters that our stockholders vote upon, including the election of directors, amendments to our certificate of incorporation, and mergers or other business combinations. In addition, upon the death of Dr. Volgenau and the conversion of his class B common stock into class A common stock, William K. Brehm, a current director and the former chairman of our board of directors, if he survives Dr. Volgenau, would beneficially own all of the outstanding class B common stock and could exercise significant influence over corporate matters requiring stockholder approval. This concentration of ownership and voting power may also have the effect of delaying or preventing a change in control of our company and could prevent stockholders from receiving a premium over the market price if a change in control is proposed.

***Provisions of our charter documents and Delaware law may inhibit potential acquisition bids that you and other stockholders may consider favorable, and the market price of our class A common stock may be lower as a result.***

There are provisions in our certificate of incorporation and by-laws that make it more difficult for a third party to acquire, or attempt to acquire, control of our company, even if a change in control was considered favorable by you and other stockholders. For example, our board of directors has the authority to issue up to 5,000,000 shares of preferred stock. The board of directors can fix the price, rights, preferences, privileges, and restrictions of the preferred stock without any further vote or action by our stockholders. The issuance of shares of preferred stock may delay or

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prevent a change in control transaction. As a result, the market price of our class A common stock and the voting and other rights of our stockholders may be adversely affected. This issuance of shares of preferred stock may result in the loss of voting control to other stockholders.

Our charter documents contain other provisions that could have an anti-takeover effect, including:

the high-vote nature of our class B common stock;

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only one of the three classes of directors is elected each year;

stockholders have limited ability to remove directors without cause;

stockholders cannot take actions by written consent;

stockholders cannot call a special meeting of stockholders; and

stockholders must give advance notice to nominate directors or submit proposals for consideration at stockholder meetings.

In addition, we are subject to the anti-takeover provisions of Section 203 of the Delaware General Corporation Law, which regulates corporate acquisitions. These provisions could discourage potential acquisition proposals and could delay or prevent a change in control transaction. They could also have the effect of discouraging others from making tender offers for our class A common stock. These provisions may also prevent changes in our management.

**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**

None

**Item 5. Other Information**

None

**Item 6. Exhibits**

<b>Exhibit Number</b>	<b>Description</b>
31.1	Certification of the Chief Executive Officer pursuant to Rule 13a-14(a) of the Securities Exchange Act of 1934, as amended
31.2	Certification of the Chief Financial Officer pursuant to Rule 13a-14(a) of the Securities Exchange Act of 1934, as amended
32.1	Certification of the Chief Executive Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
32.2	Certification of the 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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**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, in the county of Fairfax, Virginia on the 1st day of November, 2006.

**SRA INTERNATIONAL, INC.**

By: /s/ RENATO A. DIPENTIMA  
**Renato A. DiPentima,**

**President and Chief Executive Officer**

**(Principal Executive Officer)**

**SRA INTERNATIONAL, INC.**

By: /s/ STEPHEN C. HUGHES  
**Stephen C. Hughes,**

**Executive Vice President, Chief Financial Officer and**

**Chief of Finance and Administration**

**(Principal Financial and Accounting Officer)**