

Edgar Filing: VERSAR INC - Form 10-Q

VERSAR INC  
Form 10-Q  
November 13, 2007

UNITED STATES SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D.C. 20549

FORM 10-Q

(Mark One)

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

For the Quarterly Period Ended September 28, 2007  
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Transition Report Pursuant to Section 13 or 15(d) of the Securities  
Exchange Act of 1934

For the transition period from \_\_\_\_\_ to \_\_\_\_\_  
Commission File Number 1-9309

VERSAR, INC.

-----  
(Exact name of registrant as specified in its charter)

DELAWARE

54-0852979

-----  
(State or other jurisdiction of  
incorporation or organization)

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

6850 Versar Center  
Springfield, Virginia

22151

-----  
(Address of principal executive  
offices)

(Zip Code)

Registrant's telephone number, including area code (703) 750-3000  
-----

Not Applicable

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

Indicate by check mark whether the registrant (1) has filed all reports  
required to be filed by 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 (as defined in  
Rule 12b-2 of the Exchange Act.) Check one:

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

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Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practical date.

Class of Common Stock	Outstanding at November 2, 2007
----- \$.01 par value	----- 8,933,013

## VERSAR, INC. AND SUBSIDIARIES

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VERSAR, INC. AND SUBSIDIARIES  
Consolidated Balance Sheets  
(In Thousands)

September 28,                      June 29,

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	2007	2007
	-----	-----
	(Unaudited)	
<b>ASSETS</b>		
Current assets		
Cash and cash equivalents	\$ 5,327	\$ 6,296
Accounts receivable, net	23,142	22,507
Prepaid expenses and other current assets	1,104	1,250
Deferred income taxes	1,679	2,107
	-----	-----
Total current assets	31,252	32,160
Property and equipment, net	2,332	2,306
Deferred income taxes	511	802
Goodwill	776	776
Other assets	792	773
	-----	-----
Total assets	\$ 35,663	\$ 36,817
	=====	=====
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>		
Current liabilities		
Accounts payable	\$ 9,082	\$ 10,454
Billings in excess of revenue	201	594
Accrued salaries and vacation	1,957	1,604
Accrued bonus	753	1,793
Other liabilities	1,098	1,539
	-----	-----
Total current liabilities	13,091	15,984
Other long-term liabilities	1,400	1,411
	-----	-----
Total liabilities	14,491	17,395
	-----	-----
Commitments and contingencies		
Stockholders' equity		
Common stock, \$.01 par value; 30,000,000 shares authorized; 8,866,835 shares and 8,705,733 shares issued; 8,812,844 and 8,651,742 shares outstanding at September 28, 2007 and June 29, 2007, respectively	89	87
Capital in excess of par value	25,410	24,679
Accumulated deficit	(3,928)	(4,945)
Treasury stock	(399)	(399)
	-----	-----
Total stockholders' equity	21,172	19,422
	-----	-----
Total liabilities and stockholders' equity	\$ 35,663	\$ 36,817
	=====	=====

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

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VERSAR, INC. AND SUBSIDIARIES  
 Consolidated Statements of Income  
 (Unaudited - in thousands, except per share amounts)

	For the Three-Month Periods Ended	
	September 28, 2007	September 29, 2006
GROSS REVENUE	\$ 28,882	\$ 22,285
Purchased services and materials, at cost	18,171	13,671
Direct costs of services and overhead	7,212	6,466
GROSS PROFIT	3,499	2,148
Selling, general and administrative expenses	1,776	1,497
OPERATING INCOME	1,723	651
OTHER EXPENSE		
Interest (income) expense, net	(64)	11
Income tax expense	770	34
NET INCOME	\$ 1,017	\$ 606
NET INCOME PER SHARE - BASIC	\$ 0.12	\$ 0.07
NET INCOME PER SHARE - DILUTED	\$ 0.11	\$ 0.07
WEIGHTED AVERAGE NUMBER OF SHARES OUTSTANDING - BASIC	8,809	8,148
WEIGHTED AVERAGE NUMBER OF SHARES OUTSTANDING - DILUTED	9,268	8,429

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

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	For the Three-Month Periods Ended	
	September 28, 2007	September 29, 2006
Cash flows from operating activities		
Net income	\$ 1,017	\$ 606
Adjustments to reconcile net income to net cash (used in)		
Provided by operating activities		
Depreciation and amortization	210	179
Provision for doubtful accounts receivable	---	25
Share based compensation	105	8
Decrease in deferred tax assets	720	---
Changes in assets and liabilities		
(Increase) decrease in accounts receivable	(635)	1,349
Decrease (increase) in prepaids and other assets	150	(135)
(Decrease) increase in accounts payable	(1,372)	716
Increase in accrued salaries and vacation	353	362
(Decrease) in other liabilities	(1,885)	(142)
Net cash (used in) provided by continuing operating activities	(1,337)	2,968
Changes in net liabilities of discontinued operations	---	(72)
Net cash (used in) provided by operating activities	(1,337)	2,896
Cash flows used in investing activities		
Purchase of property and equipment	(236)	(85)
Increase in life insurance policies cash surrender value	(24)	(26)
Net cash used in investing activities	(260)	(111)
Cash flows from financing activities		
Proceeds from issuance of common stock	628	10
Net cash provided by financing activities	628	10
Net (decrease) increase in cash and cash equivalents	(969)	2,795
Cash and cash equivalents at the beginning of the period	6,296	140

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Cash and cash equivalents at the end of the period	\$	5,327	\$	2,935
		=====		=====

Supplementary disclosure of cash flow information:

Cash paid during the period for				
Interest	\$	12	\$	9
Income taxes		50	\$	7

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

VERSAR, INC. AND SUBSIDIARIES  
Notes to Consolidated Financial Statements

(A) Basis of Presentation

The accompanying consolidated financial statements are presented in accordance with the requirements of Form 10-Q and consequently do not include all of the disclosures normally required by accounting principles generally accepted in the United States of America or those normally made in Versar, Inc.'s Annual Report on Form 10-K filed with the United States Securities and Exchange Commission. These financial statements should be read in conjunction with the Company's Annual Report filed on Form 10-K for the year ended June 29, 2007 for additional information.

The accompanying consolidated financial statements include the accounts of Versar, Inc. and its wholly-owned subsidiaries ("Versar" or the "Company"). All significant intercompany balances and transactions have been eliminated in consolidation. The financial information has been prepared in accordance with the Company's customary accounting practices. In the opinion of management, the information reflects all adjustments necessary for a fair presentation of the Company's consolidated financial position as of September 28, 2007, and the results of operations for the three-month periods ended September 28, 2007 and September 29, 2006. The results of operations for such periods, however, are not necessarily indicative of the results to be expected for a full fiscal year.

(B) Accounting Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results may differ from those estimates.

(C) Contract Accounting

Contracts in process are stated at the lower of actual cost incurred plus accrued profits or net estimated realizable value of incurred costs, reduced by progress billings. The Company records

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income from major fixed-price construction and engineering contracts, extending over more than one accounting period, using the percentage-of-completion method. During performance of such contracts, estimated final contract prices and costs are periodically reviewed and revisions are made as required. The effects of these revisions are included in the periods in which the revisions are made. On cost-plus-fee contracts, revenue is recognized to the extent of costs incurred plus a proportionate amount of fee earned, and on time-and-material contracts, revenue is recognized to the extent of billable rates times hours delivered plus material and other reimbursable costs incurred. Losses on contracts are recognized when they become known. Disputes arise in the normal course of the Company's business on projects where the Company is contesting with customers for collection of funds because of events such as delays, changes in contract specifications and questions of cost allowability or collectibility. Such disputes, whether claims or unapproved change orders in the process of negotiation, are recorded at the lesser of their estimated net realizable value or actual costs incurred and only when realization is probable and can be reliably estimated. Claims against the Company are recognized where loss is considered probable and reasonably determinable in amount. Management reviews outstanding receivables on a regular basis and assesses the need for reserves taking into consideration past collection history and other events that bear on the collectibility of such receivables.

### (D) Income Taxes

At September 28, 2007, the Company had approximately \$2.2 million in deferred tax assets which primarily relate to net operating loss and tax credit carry forwards. Given the Company's continued improved financial performance and funded backlog over the last three years, management believes the Company will be able to utilize the full benefit of the tax asset.

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## VERSAR, INC. AND SUBSIDIARIES Notes to Consolidated Financial Statements (continued)

### (E) Debt

The Company has a line of credit facility with United Bank (the Bank) that provides for advances up to \$7.5 million based upon qualifying receivables. Interest on borrowings is based upon the prime rate of interest minus 0.5% (7.25% as of September 28, 2007). In October 2006, the Company obtained a letter of credit of approximately \$1.6 million which serves as collateral for surety bond coverage provided by the Company's insurance carrier against project construction work. The letter of credit reduces the Company's availability on the line of credit. The line of credit capacity at September 28, 2007 was \$5.9 million. Obligations under the credit facility are guaranteed by the Company and each subsidiary individually and collectively are secured by accounts receivable, equipment and intangibles, plus all insurance policies on property constituting collateral. The line of credit matures in November 2009 and is subject to certain covenants related to the maintenance of financial ratios. These covenants require a minimum tangible net worth of \$15 million; a maximum total liabilities to tangible net

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worth ratio not to exceed 2.5 to 1; and a minimum current ratio of at least 1.25 to 1. The Company was in compliance with such covenants as of September 28, 2007.

The Company believes that with its current cash balance of over \$5.3 million along with the anticipated cash flows, cash provided by operating activities will be sufficient to meet the Company's liquidity needs within the current fiscal year. Expected capital requirements for fiscal year 2008 are approximately \$750,000 primarily to maintain the Company's existing information technology systems. Such capital requirements will be funded through existing working capital.

### (F) Goodwill and Other Intangible Assets

On January 30, 1998, Versar completed the acquisition of The Greenwood Partnership, P.C. subsequently renamed (Versar Global Solutions, Inc. or VGSI). The transaction was accounted for as a purchase. Goodwill resulting from this transaction was approximately \$1.1 million. In fiscal year 2003, the Company adopted SFAS No. 142, "Goodwill and Other Intangible Assets" which eliminated the amortization of goodwill, but requires the Company to test such goodwill for impairment annually. Currently, the carrying value of goodwill is approximately \$776,000 relating to the acquisition of VGSI, which is now part of the Company's Program Management business segment. The Company began reporting the Program Management business segment separately in fiscal year 2007, primarily due to the increase in business volume in Iraq and in United States construction related work. In performing its goodwill impairment analysis, management has utilized a market-based valuation approach to determine the estimated fair value of the Program Management business segment. Management engages outside professionals and valuation experts, as necessary, to assist in performing this analysis. An analysis was performed on public companies and company transactions to prepare a market-based valuation. Based upon the analysis, the estimated fair value of the Program Management business segment exceeds the carrying value of the net assets of \$6.5 million on an enterprise value basis by a substantial margin. Should the Program Management business segment's financial performance not meet estimates, then impairment of goodwill would have to be further assessed to determine whether a write down of goodwill value would be warranted. If such a write down were to occur, it would negatively impact the Company's financial position and results of operations. However, it would not impact the Company's cash flow or financial debt covenants.

On April 15, 2005, the Company acquired the Cultural Resources Group from Parsons Infrastructure & Technology Group, Inc., a subsidiary of Parsons Corporation's for a purchase price of approximately \$260,000 in cash. The Cultural Resources Group, based in Fairfax County, Virginia provides archaeological, cultural and historical services to federal, state and municipal clients across the country. The acquisition expanded the Company's existing and future capabilities in cultural resources work enhancing and complementing Versar's environmental core business. The Cultural Resources Group was incorporated into the Company's Compliance and Environmental Programs business segment. As part of the acquisition, the Company executed a two year marketing agreement with Parsons which gave Versar the first right of refusal to certain Parsons cultural resources work from existing Parsons' clients. Substantially all of the purchase price was

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allocated to contract rights and was amortized over a three-year period. In fiscal year 2007, the Company recorded approximately \$78,000 amortization expense for Culture Resources intangible assets. At June 29, 2007, the remaining balance of the intangible asset was written off due to the completion of Parson's agreement, which was not renewed.

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VERSAR, INC. AND SUBSIDIARIES  
Notes to Consolidated Financial Statements (continued)

(G) Net Income Per Share

Basic net income per common share is computed by dividing net income by the weighted average number of common shares outstanding during the period. Diluted net income per common share also includes common stock equivalents outstanding during the period if dilutive. The Company's common stock equivalents consist of stock options and restricted stock units.

	For the Three-Month Periods Ended	
	September 28, 2007	September 29, 2006
	-----	-----
Weighted average common shares outstanding - basic	8,809,255	8,147,879
Assumed exercise of options and vesting of restricted stock units (treasury stock method)	459,126	281,251
	-----	-----
Weighted average common shares outstanding - basic/diluted	9,268,381	8,429,130
	=====	=====

(H) Common Stock

The Company issued approximately 161,000 shares of common stock upon the exercise of stock options during the three months ended September 28, 2007. Total proceeds from the exercise of such stock options were approximately \$628,000. The Company also awarded 93,000 shares of restricted stock to its executive officers and employees for their performance and contribution to the Company.

Effective January 1, 2005, the Company implemented an Employee Stock Purchase Plan (ESPP) to allow eligible employees of Versar the opportunity to acquire an ownership interest in the Company's common stock. As amended, the Plan permits employees to purchase shares of Versar common stock from the open market at 95% of its fair market value. The Plan qualifies as an "employee stock purchase plan" under Section 423 of the Internal Revenue Code.

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### (I) Stock-Based Compensation

Effective July 1, 2005, the Company adopted the Financial Accounting Standards Board (FASB) SFAS No. 123 (Revised 2004), "Accounting for Stock-Based Compensation" (SFAS 123(R)). This Statement revises SFAS No. 123 by eliminating the option to account for employee stock options under APB No. 25 and generally requires companies to recognize the cost of employee services received in exchange for awards of equity instruments based on the grant-date fair value of those awards (the "fair-value-based" method). In the first three months of fiscal year 2008, the Company has awarded 93,000 shares of restricted stock to employees. Stock-based compensation expense relating to restricted stock and options was \$105,000 and \$8,000 for the first three months of fiscal year 2008 and 2007, respectively, was included in the Consolidated Statements of Operations.

In November 2005, the stockholders approved the Versar, Inc. 2005 Stock Incentive Plan (the 2005 Plan). The 2005 Plan provides for grants of incentive awards, including stock options, SARS, restricted stock, restricted stock units and performance based awards, to directors, officers and employees of the Company and its affiliates as approved from time to time by the Company's Compensation Committee. Only employees may receive stock options classified as "incentive stock options", also known as "ISO's". The per share exercise price for options and SARS granted under the 2005 Plan shall not be less than the fair market value of the common stock on the date of grant. A maximum of 400,000 shares of Common Stock may be awarded under the 2005 Plan. No single director, officer, or employee may receive awards of more than 100,000 shares of Common Stock during the term of the 2005 Plan. The ability to make awards under the 2005 Plan will terminate in November 2015. Approximately 229,700 shares are available for future grant at September 28, 2007.

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### VERSAR, INC. AND SUBSIDIARIES

#### Notes to Consolidated Financial Statements (continued)

In November 2002, the stockholders approved the Versar, Inc. 2002 Stock Incentive Plan (the 2002 Plan). The 2002 Plan provides for the grant of options, restricted stock and other types of stock-based awards to any employee, service provider or director to whom a grant is approved from time to time by the Company's Compensation Committee. A "service provider" is defined for purposes of the 2002 Plan as an individual who is neither an employee nor a director of the Company or any of its affiliates but who provides the Company or one of its affiliates substantial and important services. The aggregate number of shares of the Company's Common Stock that may be issued upon exercise of options or granted as restricted stock or other stock-based awards under the 2002 Plan is 700,000. Grants of restricted stock, performance equity awards, options and stock appreciation rights in any one fiscal year to any one participant may not exceed 250,000 shares. The maximum amount of compensation that may be received by any one employee with respect to performance unit grants in any one fiscal year may not exceed \$250,000.

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In November 1996, the stockholders approved the Versar 1996 Stock Option Plan (the 1996 Plan) to provide employees and directors of the Company and certain other persons an incentive to remain as employees of the Company and to encourage superior performance. The Company also maintains the Versar 1992 Stock Option Plan (the "1992 Plan"). Options covering all shares reserved under these plans have been granted.

Under the 1996 Plan, through September 2006, options were granted to key employees, directors and service providers at the fair market value on the date of grant. The vesting of each option was determined by the Administrator of the Plan. Each option expires on the earlier of the last day of the tenth year after the date of grant or after expiration of a period designated in the option agreement. The 1996 Plan has expired and no additional options may be granted under this plan. The Company will continue to maintain the plan until all previously granted options have been exercised, forfeited or expire.

Under the 1992 Plan, through November 2002, options were generally granted to key employees at the fair market value on the date of grant and became exercisable during the five-year period from the date of the grant at 20% per year. Options were granted with a ten year term and expire if not exercised by the tenth anniversary of the grant date. The 1992 plan has expired and no additional options may be granted under this plan. The Company will continue to maintain the plan until all previously granted options have been exercised, forfeited or expire.

A summary of activity under the Company's stock option plans as of September 28, 2007, and changes during the first three months of fiscal year 2008 are presented below:

Options	Shares (in thousands)	Weighted- Average Exercise Price	Weighted- Average Remaining Contractual Term	Aggregate Intrinsic Value (\$000)
Outstanding at June 30, 2007	838	\$ 3.25		
Exercised	(156)	\$ 3.89		
Outstanding at September 28, 2007	682	\$ 3.10	5.18	\$ 1,197
Exercisable at September 28, 2007	646	\$ 3.12	5.14	\$ 1,136

As of September 28, 2007, there were unvested options to purchase approximately 36,000 shares outstanding under the plans. Estimated compensation costs of \$4,000 are expected to be recognized over a weighted-average period of one year. The total fair value of these unvested options is approximately \$60,000 as of September 28, 2007.

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VERSAR, INC. AND SUBSIDIARIES  
Notes to Consolidated Financial Statements (continued)

(J) Business Segments

The Company evaluates and measures the performance of its business segments based on gross revenue, gross profit and operating income. As such, selling, general and administrative expenses, interest and income taxes have not been allocated to the Company's business segments.

Management re-evaluated its segment reporting in fiscal year 2007 due to significant growth in its business and changes in the internal reporting of business segment financial information. The Company's business is now operated through four business segments as follows: Program Management, Compliance and Environmental Programs, Professional Services, and National Security. The Chief Operating Decision Maker (CODM) reviews financial performance based upon these operating segments.

These segments were segregated based on the nature of the work, business processes, customer base and the business environment in which each of the segments operates. Segment information in previous periods has been revised to conform to the current structure.

The Program Management business segment manages larger more complex projects whose business processes and management are unique to the rest of the Company. The Compliance and Environmental Programs business segment provides consulting support to several federal government and municipal agencies. The Professional Services business segment provides outsourced personnel to various government agencies providing our clients with cost-effective resources. The National Security business segment provides unique solutions to the federal government including testing and evaluation and personal protective solutions to meet our clients' needs.

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VERSAR, INC. AND SUBSIDIARIES  
Notes to Consolidated Financial Statements (continued)

Summary of financial information for each of the Company's segments follows:

	For the Three-Months Ended	
	September 28, 2007	September 29, 2006
	(In thousands)	
GROSS REVENUE		
-----		
Program Management	\$ 17,263	\$ 12,325
Compliance and Environmental Programs	8,226	6,477
Professional Services	1,455	1,736
National Security	1,938	1,747
-----		

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	\$ 28,882	\$ 22,285
	=====	=====
GROSS PROFIT (A)		
-----		
Program Management	\$ 2,282	\$ 974
Compliance and Environmental Programs	680	772
Professional Services	248	378
National Security	289	24
	-----	-----
	\$ 3,499	\$ 2,148
Selling, general and administrative Expenses	(1,776)	(1,497)
	-----	-----
OPERATING INCOME	\$ 1,723	\$ 651
	=====	=====

(A) Gross Profit is defined as gross revenue less purchased services and materials and direct costs of services and overhead.

	Years Ended	
	September 28,	June 29,
	2007	2007
	-----	-----
	(In thousands)	
IDENTIFIABLE ASSETS		
-----		
Program Management	\$ 12,981	\$ 11,497
Compliance and Environmental Programs	9,415	10,042
Professional Services	1,382	1,651
National Security	2,294	1,985
Corporate and Other	9,591	11,642
	-----	-----
Total Assets	\$ 35,663	\$ 36,817
	=====	=====

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

This report contains certain forward-looking statements which are based on current expectations. Actual results may differ materially. The forward-looking statements include without limitation, those regarding the continued award of future work or task orders from government and private clients, cost controls and reductions, the expected resolution of delays in billing of certain projects, and the possible impact of current and future claims against the Company based upon negligence and other theories of liability. Forward-looking statements involve numerous risks and uncertainties that could cause actual results to differ materially, including, but not limited to, the possibilities that the demand for the Company's services may decline as a result of possible changes in general and industry

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specific economic conditions and the effects of competitive services and pricing; the possibility that the Company will not be able to perform work within budget or contractual limitations; one or more current or future claims made against the Company may result in substantial liabilities; the possibility that the Company will not be able to attract and retain key professional employees; changes to or failure of the Federal government to fund certain programs in which the Company participates; delays in project funding; and such other risks and uncertainties, described in our Form 10-K for fiscal year ended June 29, 2007 and in other reports and other documents filed by the Company from time to time with the Securities and Exchange Commission.

### Financial Trends

-----

Operating results for the Company were relatively flat through fiscal year 2006, but began to improve in fiscal year 2007. Prior to fiscal year 2007, the Company's gross revenues and gross profits were relatively stagnant. In fiscal year 2006, the Company's operating results were further impacted by decreases in federal funding. During 2006, the Company took a number of steps to eliminate non-performing operations as well as significantly reduce fixed facility costs.

In fiscal year 2006, the Company's gross revenues declined primarily due to the continuation of federal government delays in funding, which in certain instances, spanned as much as nine months and the continued diversion of funding to the war in Iraq. The Company adapted to the funding shifts by expanding its services in Iraq under existing contracts and seeking new contract work in Iraq. By the end of fiscal year 2006, the project funding began to return to normal levels and as a result, the Company's funded backlog increased by 55% to \$48 million. By the end of fiscal year 2007, as a result of continued efforts to grow the business and success in securing new contracts, increased funded backlog by an additional 19% to \$57 million.

In the first quarter of fiscal year 2008, the Company's funded backlog further increased to \$91 million, a 60% increase over that reported at the end of fiscal year 2007. The increase is primarily due to additional funding by the Air Force in support of the Company's continuing Title II efforts to support the reconstruction work in Iraq.

Approximately 40% of the Company's business volume related to the war in Iraq in fiscal year 2007. However, the Company is taking steps to further diversify the business in anticipation that those efforts in Iraq will eventually be reduced or eliminated. The Company's current primary business development focus is on BRAC efforts and requirements which have been delayed as a result of the war in Iraq.

The Company re-evaluated its segment reporting in fiscal year 2007 due to the business growth and changes in its business mix during the year. The Company's business is now operated through four segments as follows: Program Management, Compliance and Environmental Programs, Professional Services, and National Security. These segments were segregated based on the nature of the work, business processes, customer base and the business environment in which each of the segments operates. Information in previous periods has been allocated among these segments as

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discussed below for comparative purposes.

There are a number of risk factors or uncertainties that could significantly impact our future financial performance including the following:

- \* General economic or political conditions;
- \* Threatened or pending litigation;
- \* The timing of expenses incurred for corporate initiatives;
- \* Employee hiring, utilization, and turnover rates;

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### ITEM 2 Management's Discussion and Analysis of Financial Condition and Results of Operations (continued)

- \* The seasonality of spending in the federal government and for commercial clients;
- \* Delays in project contracted engagements;
- \* Unanticipated contract changes impacting profitability;
- \* Reductions in prices by our competitors;
- \* The ability to obtain follow-on project work;
- \* Failure to properly manage projects resulting in additional costs;
- \* The cost of compliance for the Company's laboratories;
- \* The results of a negative government audit potentially impacting our costs, reputation and ability to work with the federal government;
- \* Loss of key personnel;
- \* The ability to compete in a highly competitive environment; and
- \* Federal funding delays due to war in Iraq.

#### Results of Operations

#### First Quarter Comparison of Fiscal Year 2008 and 2007

	For the Three-Months Ended	
	September 28, 2007	September 29, 2006
	(In thousands)	
GROSS REVENUE		
Program Management	\$ 17,263	\$ 12,325
Compliance and Environmental Programs	8,226	6,477
Professional Services	1,455	1,736
National Security	1,938	1,747
	\$ 28,882	\$ 22,285

Gross revenue for the first quarter of fiscal year 2008 was \$28,882,000, an increase of \$6,597,000 (30%) over that reported in the first quarter of fiscal year 2007. Gross revenue increased during the

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first quarter of fiscal year 2008 in each of our segments other than the Professional Services business segment. Gross revenue for the Program Management business segment was \$17,263,000, an increase of \$4,938,000 (40%) over that reported in the first quarter of fiscal year 2007. The increase is attributable to our efforts on behalf of the Air Force and the Army in Iraq as part of their reconstruction support efforts. Gross revenue for the Compliance and Environmental Programs business segment was \$8,226,000, an increase of \$1,749,000 (27%) over that reported in the first quarter of fiscal year 2007. The increase is attributable to increased work for municipal aquatic facilities. Gross revenue for the National Security business segment was \$1,938,000, an increase of \$191,000 (11%) over that reported in the first quarter of fiscal year 2007. The increase is attributable to revenue from increased laboratory testing during the quarter. Gross revenue for the Professional Services business segment was \$1,455,000, a decrease of \$281,000 (16%) over that reported in the first quarter of fiscal year 2007. The decrease was attributable to funding delays and the completion of task orders during the quarter.

Purchased services and materials increased by \$4,500,000 (33%) in the first quarter of fiscal year 2008 compared to that reported in the first quarter of fiscal year 2007. The increase was attributable to increases in subcontracted work in the Program Management business segment and Compliance and Environmental Programs business segments.

Direct costs of services and overhead include the cost to Versar of direct and overhead staff, including recoverable and unallowable costs that are directly attributable to contracts. Direct costs of services and overhead increased by \$746,000 (12%) in the first quarter of fiscal year 2008 compared to that reported in the first quarter of fiscal year 2007. The increase is due to increased marketing and sales costs, and staffing and recruiting costs in support of the Company's business growth during the first quarter of fiscal year 2008.

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### ITEM 2 Management's Discussion and Analysis of Financial Condition and Results of Operations (continued)

Gross profit for the first quarter of fiscal year 2008 was \$3,499,000, a \$1,351,000 (63%) increase over that reported in the first quarter of fiscal year 2007. The increase is attributable to the increased gross revenues as mentioned above, while the Company continued to control costs.

	For the Three-Months Ended	
	September 28, 2007	September 29, 2006
	(In thousands)	
GROSS PROFIT		
Program Management	\$ 2,282	\$ 974
Compliance and Environmental Programs	680	772
Professional Services	248	378

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National Security	289	24
	-----	-----
	\$ 3,499	\$ 2,148
	=====	=====

Selling, general and administrative expenses increased by \$279,000 during the first quarter of fiscal year 2008 compared to that reported in the first quarter of fiscal year 2007. The increase is primarily due to costs of increased business development activity to continue the business growth of the Company.

Operating income for the first quarter of fiscal year 2008 was \$1,723,000, a \$1,072,000 (165%) increase over that reported in the first quarter of fiscal year 2007. The increase is primarily due to increased gross profit for the Program Management business segment of \$2,282,000, an increase of \$1,308,000 (134%) over that reported in the first quarter of fiscal year 2007. The increase is due to the increased gross revenues and improved operating margins as a result of the increased business volume. Operating income for the Compliance and Environmental Programs business segment for the first quarter of fiscal year 2008 was \$680,000, a decrease of \$92,000 (12%) over that reported in the first quarter of fiscal year 2007. The decrease is due to increased business development costs during the quarter. Operating income for the Professional Services business segment was \$248,000, a decrease of \$130,000 (34%) over that reported in the first quarter of fiscal year 2007. The decrease is due to completed delivery orders during the quarter, and funding delays due to the war effort in Iraq. Operating income for the National Security business segment for the first quarter of fiscal year 2008 was \$289,000, an increase of \$265,000 over that reported in the first quarter of fiscal year 2007. The increase is due to increased laboratory work and improved operating margins during the quarter.

Interest income, net for the first quarter of fiscal year 2008 was \$64,000, an increase of \$75,000 compared to interest expense, net of \$11,000 reported in the first quarter of fiscal year 2007. The increase was due to the interest earned on short-term investment of cash balances maintained with the Company's bank.

Income tax expense for the first quarter of fiscal year 2008 was \$770,000 an increase of \$736,000 over that reported in the first quarter of fiscal year 2007. During fiscal year 2007, the Company was carrying a valuation allowance against its tax assets. In the third quarter of fiscal year 2007, the Company re-evaluated the need for the valuation allowance. Because of the Company's continued improved financial performance and funded contract backlog over the past three years, management believes that the Company will be able to utilize the full benefit of the tax asset. At the end of the first quarter of fiscal year 2008, the Company has approximately \$2.2 million of tax assets available.

Versar's net income for the first quarter of fiscal year 2008 was \$1,017,000 compared to \$606,000 in the first quarter of fiscal year 2007. The increase was due to the increased gross revenues and operating margins, in part offset by the tax expense discussed above.

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### ITEM 2 Management's Discussion and Analysis of Financial Condition and Results of Operations (continued)

#### Liquidity and Capital Resources

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The Company's working capital as of September 28, 2007 approximated \$18,161,000, an increase of \$1,985,000 (12%) from June 29, 2007. In addition, at September 28, 2007, the Company's current ratio was 2.39, an improvement over the 2.01 current ratio reported on June 29, 2007. The increase was due to the reduction of current liabilities during the quarter.

The Company has a line of credit facility with United Bank (the Bank) that provides for advances up to \$7.5 million based upon qualifying receivables. Interest on borrowings is based on the prime rate of interest minus 0.5% (7.25% as of September 28, 2007). In October 2006, the Company obtained a letter of credit of approximately \$1.6 million which serves as collateral for surety bond coverage provided by the Company's insurance carrier. The letter of credit reduces the Company's borrowing base on the line of credit. As of September 28, 2007, there were no borrowings under the line of credit. The line of credit capacity at September 28, 2007 was \$5.9 million. Obligations under the credit facility are guaranteed by the Company and each subsidiary individually and collectively secured by accounts receivable, equipment and intangibles, plus all insurance policies on property constituting collateral. The line of credit matures in November 2009 and is subject to certain covenants related to the maintenance of financial ratios. These covenants require a minimum tangible net worth of \$15 million; a maximum total liabilities to tangible net worth ratio not to exceed 2.5 to 1; and a minimum current ratio of at least 1.25 to 1. Failure to meet the covenant requirements gives the Bank the right to demand outstanding amounts due under the line of credit, which may impact the Company's ability to finance its working capital requirements. At September 28, 2007, the Company was in compliance with the financial covenants.

The Company believes that the current cash balance of over \$5.3 million along with anticipated cash flows from operations will be sufficient to meet its liquidity needs within the next year. Expected capital requirements for the remainder of fiscal year 2008 are approximately \$750,000 primarily to maintain our existing information technology systems. Such capital requirements will be funded through existing working capital.

#### Critical Accounting Policies and Related Estimates That Have a Material Effect on Versar's Consolidated Financial Statements

Below is a discussion of the accounting policies and related estimates that we believe are the most critical to understanding the Company's consolidated, financial position, and results of operations which require management judgments and estimates, or involve uncertainties. Information regarding our other accounting policies is included in the notes to our consolidated financial statements included elsewhere in this report on Form 10-Q and in our annual report on Form 10-K filed for our 2007 fiscal year.

Revenue recognition: Contracts in process are stated at the lower of actual costs incurred plus accrued profits or net estimated realizable value of costs, reduced by progress billings. On cost-plus

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fee contracts, revenue is recognized to the extent of costs incurred plus a proportionate amount of fee earned, and on time-and-material contracts, revenue is recognized to the extent of billable rates times hours delivered plus material and other reimbursable costs incurred. The Company records income from major fixed-price contracts, extending over more than one accounting period, using the percentage-of-completion method. During the performance of such contracts, estimated final contract prices and costs are periodically reviewed and revisions are made as required. Fixed price contracts can be significantly impacted by changes in contract performance, contract delays, liquidated damages and penalty provisions, and contract change orders, which may affect the revenue recognition on a project. Losses on contracts are recognized in the period when they become known.

From time to time we may proceed with work based on customer direction pending finalizing and signing of contract funding documents. We have an internal process for approving any such work. The Company recognizes revenue based on actual costs incurred to the extent that the funding is assessed as probable. In evaluating the probability of the receipt of funding, we consider our previous experiences with the customer, communications with the customer regarding funding status, and our knowledge of available funding for the contract or program. If funding is not assessed as probable, costs are expensed as they are incurred.

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### ITEM 2 Management's Discussion and Analysis of Financial Condition and Results of Operations (continued)

There is the possibility that there will be future and currently unforeseeable significant adjustments to our estimated contract revenues, costs and margins for fixed price contracts, particularly in the later stages of these contracts. It is likely that such adjustments could occur with our larger fixed priced projects. Such adjustments are common in the construction industry given the nature of the contracts. These adjustments could either positively or negatively impact our estimates due to the circumstances surrounding the negotiations of change orders, the impact of schedule slippage, subcontractor claims and contract disputes which are normally resolved at the end of the contract. Adjustments to the financial statements are made when they are known.

Allowance for doubtful accounts: Disputes arise in the normal course of the Company's business on projects where the Company is contesting with customers for collection of funds because of events such as delays, changes in contract specifications and questions of cost allowability and collectibility. Such disputes, whether claims or unapproved change orders in process of negotiation, are recorded at the lesser of their estimated net realizable value or actual costs incurred and only when realization is probable and can be reliably estimated. Claims against the Company are recognized where loss is considered probable and reasonably determinable in amount. Management reviews outstanding receivables on a regular basis and assesses the need for reserves, taking into consideration past collection history and other events that bear on the collectibility of such receivables.

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Deferred tax valuation assets: The Company has approximately \$2.2 million in deferred tax, net assets as of September 28, 2007. In the third quarter of fiscal year 2007, the Company released the entire \$2.95 million tax valuation allowance that was previously established against such assets due to improved earnings and the likelihood of using such assets in future periods.

Asset retirement obligation: In fiscal year 2007, the Company recorded an asset retirement obligation associated with the estimated clean-up costs for its chemical laboratory in its National Security business segment. In accordance with SFAS 143, the Company estimated the costs to clean up the laboratory and return it to its original state at a present value of approximately \$497,000. The Company currently estimates the amortization and accretion expense to be between \$180,000 to \$190,000 per year over the next 3 1/2 years. The Company is currently rigorously pursuing reimbursement for such costs and other costs from the U.S. Army as a significant portion of the chemical agent that was used in the chemical laboratory was government owned. If the Company determines that the estimated clean up cost is larger than expected or the likelihood of recovery from the U.S. Army is remote, such adjustments will be reflected when they become known and adjusted in accordance with SFAS 143. During the first quarter of fiscal year 2008, the Company recorded accretion and depreciation expenses of approximately \$10,000 and \$47,000, respectively, for this obligation.

Goodwill and other intangible assets: On January 30, 1998, Versar completed the acquisition of The Greenwood Partnership, P.C. subsequently renamed (Versar Global Solutions, Inc. or VGSI). The transaction was accounted for as a purchase. Goodwill resulting from this transaction was approximately \$1.1 million. In fiscal year 2003, the Company adopted SFAS No. 142, "Goodwill and Other Intangible Assets" which eliminated the amortization of goodwill, but requires the Company to test such goodwill for impairment annually. Currently, the carrying value of goodwill is approximately \$776,000 relating to the acquisition of VGSI, which is now part of the Program Management business segment. The Company began reporting the Program Management business segment separately in fiscal year 2007, primarily due to the increase in business volume in Iraq and in United States construction related work. In performing its goodwill impairment analysis, management has utilized a market-based valuation approach to determine the estimated fair value of the Program Management business segment. Management engages outside professionals and valuation experts, as necessary, to assist in performing this analysis. An analysis was performed on public companies and company transactions to prepare a market-based valuation. Based upon the analysis, the estimated fair value of the Program Management business segment exceeds the carrying value of the net assets of \$6.5 million on an enterprise value basis by a substantial margin. Should the Program Management business segment's financial performance not meet estimates, then impairment of goodwill would have to be further assessed to determine whether a write down of goodwill value would be warranted. If such a write down were to occur, it would negatively impact the Company's financial position and results of operations. However, it would not impact the Company's cash flow or financial debt covenants.

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### ITEM 2 Management's Discussion and Analysis of Financial Condition and Results of Operations (continued)

On April 15, 2005, the Company acquired the Cultural Resources Group from Parsons Infrastructure & Technology Group, Inc., a subsidiary of Parsons Corporation's for a purchase price of approximately \$260,000 in cash. The Cultural Resources Group, based in Fairfax County, Virginia provides archaeological, cultural and historical services to federal, state and municipal clients across the country. The acquisition expanded the Company's existing and future capabilities in cultural resources work enhancing and complimenting Versar's environmental core business. The Cultural Resources Group was incorporated into the Company's Compliance and Environmental Programs business segment. As part of the acquisition, the Company executed a two year marketing agreement with Parsons which gave Versar the first right of refusal to certain Parsons cultural resources work from existing Parsons' clients. Substantially all of the purchase price was allocated to contract rights and was amortized over a three-year period. In fiscal year 2007, the Company recorded approximately \$78,000 amortization expense for Culture Resources intangible assets. At June 29, 2007, the remaining balance of the intangible asset was written off due to the completion of Parson's agreement, which was not renewed.

Share-based compensation: Effective July 1, 2005, the Company adopted the Financial Accounting Standards Board (FASB) SFAS No. 123 (Revised 2004), "Share-Based Payment" (FAS 123(R)). This Statement revised SFAS No. 123 by eliminating the option to account for employee stock options under APB No. 25 and related interpretations and generally requires companies to recognize the cost of employee services received in exchange for awards of equity instruments based on the grant-date fair value of those awards (the "fair-value-based" method).

New accounting pronouncements: On July 13, 2006, the Financial Accounting Standards Board (FASB) issued FIN No. 48, Accounting for Uncertainty of Income Taxes, which is an interpretation of FAS 109, Accounting for Income Taxes. The regulation requires that the Company cannot record tax benefits of a transaction unless it is more likely than not to be entitled to the benefits from a tax position in the financial statements. FIN No. 48 became effective as of July 1, 2007. As a result of the implementation of FIN 48, the Company made a comprehensive review of its portfolio of uncertain tax positions in accordance with recognition standards established by FIN 48. As a result of this review, the Company concluded that at this time there are no unrecognized tax benefits. As a result of applying the provisions of FIN 48, there was no cumulative effect on retained earnings. The Company conducts business in the US and the Philippines and is subject to tax in those jurisdictions. For income tax returns filed by the Company, the Company is no longer subject to examination by the tax authorities for year prior to June 30, 2003, although carryforward tax attributes that were generated prior to FY 2003 may still be adjusted by the tax authorities if either they have been or will be utilized. The Company has not received any communications by taxing authorities that cause it to believe it is currently under examination by the tax authorities in any of the jurisdictions in which it operates. The Company recognizes interest and penalties accrued related to unrecognized tax benefits as a component of income tax provision. For the three months ended September 30, 2007, there have been no interest and penalties recorded as a component of income tax provision.

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In September 2006, the FASB issued SFAS No. 157, "Fair Value Measurements," which is effective January 1, 2008. SFAS No. 157 defines fair value, establishes a market-based framework or hierarchy for measuring fair value and expands disclosures about fair value measurements. The new standard is applicable whenever another accounting pronouncement requires or permits assets and liabilities to be measured at fair value, with limited exceptions. Management is currently evaluating the effect that adoption of this statement may have on the Company's consolidated financial position and results of operations when it becomes effective in 2008.

In February 2007, the FASB issued Statement of Financial Accounting Standards (SFAS) No. 159, "The Fair Value Option for Financial Assets and Financial Liabilities - Including an amendment of FASB Statement No. 115." SFAS No. 159 permits entities to choose to measure eligible items at fair value at specified election dates and report unrealized gains and losses on items for which the fair value option has been elected in earnings at each subsequent reporting date. SFAS No. 159 is effective for fiscal years beginning after November 15, 2007. Management is currently evaluating the effect that adoption of this statement may have on the Company's consolidated financial position and results of operations when it becomes effective in 2008.

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### ITEM 2 Management's Discussion and Analysis of Financial Condition and Results of Operations (continued)

#### Impact of Inflation

Versar seeks to protect itself from the effects of inflation. The majority of contracts the Company performs are for a period of a year or less or are cost-plus-fixed-fee type contracts and, accordingly, are less susceptible to the effects of inflation. Multi-year contracts provide for projected increases in labor and other costs.

#### Contingencies

Versar and its subsidiaries are parties to various legal actions arising in the normal course of business. The Company believes that the ultimate resolution of these legal actions will not have a material adverse effect on its consolidated financial position and results of operations. (See Part II, Item 1 - Legal Proceedings).

#### Business Segments

Versar currently has four business segments: Program Management, Compliance and Environmental Programs, Professional Services, and National Security. Details regarding these segments may be found in Note J of the Notes to the Consolidated Financial Statements.

### Item 3 - Quantitative and Qualitative Disclosures About Market Risk

The Company has not entered into any transactions using derivative financial instruments or derivative commodity instruments and believes that its exposure to interest rate risk and other relevant market risk is not material.

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### Item 4 - Procedures and Controls

As of the last day of the period covered by this report, the Company carried out an evaluation, under the supervision of the Company's Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of the Company's disclosure controls and procedures pursuant to Exchange Act Rule 13a-15. Based upon that evaluation, the Chief Executive Officer and Chief Financial Officer concluded that the Company's disclosure controls and procedures are effective, as of such date, to ensure that required information will be disclosed on a timely basis in its reports under the Exchange Act.

Further, our Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures have been designed to ensure that information required to be disclosed in reports filed by us under the Exchange Act is accumulated and communicated to our management, including the Chief Executive Officer and Chief Financial Officer, in a manner to allow timely decisions regarding the required disclosure.

There were no changes in the Company's internal control over financial reporting during the last quarter that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

### PART II - OTHER INFORMATION

#### Item 1 - Legal Proceedings

Versar and its subsidiaries are parties from time to time to various legal actions arising in the normal course of business. The Company believes that any ultimate unfavorable resolution of these legal actions will not have a material adverse effect on its consolidated financial condition and results of operations.

#### Item 6 - Exhibits

##### (a) Exhibits

- 31.1 and 31.2 - Certification pursuant to Securities Exchange Act Section 13a-14.
- 32.1 and 32.2 - Certification under 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.

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VERSAR, INC.

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(Registrant)

By: /S/ Theodore M. Prociv

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Theodore M. Prociv  
Chief Executive Officer,  
President, and Director

By: /S/ Lawrence W. Sinnott

\_\_\_\_\_  
Lawrence W. Sinnott  
Executive Vice President,  
Chief Operating Officer,  
Chief Financial Officer,  
Treasurer, and Principal  
Accounting Officer

Date: November 12, 2007