SI INTERNATIONAL INC
Form 10-Q
August 11, 2003

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

ý	**QUARTERLY REPORT PURSUANT TO SECTION 13 or 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934** **FOR THE QUARTER ENDED JUNE 28, 2003**
o	**TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

Commission File Number

000-50080

SI International, Inc.

(Exact name of registrant as specified in its charter)

Delaware	**52-2127278**
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
12012 Sunset Hills Road **Reston. Virginia**	**20190-5869**
(Address of principal executive offices)	(Zip Code)

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

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

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Exchange Act). o Yes ý No

As of August 4, 2003, there were 8,447,162 shares outstanding of the registrant s common stock.

SI INTERNATIONAL, INC.

FORM 10-Q

INDEX

PART I: FINANCIAL INFORMATION

Item 1. Financial Statements

SI International, Inc. and Subsidiaries

Consolidated Balance Sheets

(Amounts in thousands, except share and per share data)

	June 28, 2003	December 28, 2002
	(unaudited)	
Assets		
Current assets:		
Cash and cash equivalents	$ 16,646	$ 10,856
Accounts receivable, net	27,212	31,901
Other current assets	2,882	3,741
Total current assets	46,740	46,498
Property and equipment, net	4,162	4,542
Goodwill and assembled workforce, net	39,829	39,829
Other assets	1,260	1,446
Total assets	$ 91,991	$ 92,315
Liabilities and stockholders equity		
Current liabilities:		
Accounts payable and accrued expenses	$ 12,163	$ 12,712
Deferred revenue	67	1,074
Other current liabilities	437	2,775
Total current liabilities	12,667	16,561
Other long-term liabilities	2,178	1,777
Commitments and contingencies		
Stockholders equity:		
Common stock $0.01 par value per share; 50,000,000 shares authorized; 8,447,162 and 8,439,741 shares issued and outstanding as of June 28, 2003 and December 28, 2002, respectively	85	85
Additional paid-in capital	75,649	75,682
Deferred compensation	(406)	(509)
Retained Earnings (accumulated deficit)	1,818	(1,281)
Total stockholders equity	77,146	73,977
Total liabilities and stockholders equity	$ 91,991	$ 92,315

See accompanying notes

3

SI International, Inc. and Subsidiaries

Consolidated Statements of Operations

(Amounts in thousands, except per share data)

Unaudited

	Three Months Ended		Six Months Ended	
	June 28, 2003	**June 29, 2002**	**June 28, 2003**	**June 29, 2002**
Revenue	$ 40,724	$ 35,407	$ 82,048	$ 68,870
Costs and expenses:				
Direct costs	24,264	21,856	49,290	41,001
Indirect costs, including $32 and $35 of non-cash stock-based compensation in fiscal quarters ended June 28, 2003 and June 29, 2002, respectively and $67 and $69 in the six months ended June 28, 2003 and June 29, 2002, respectively	13,167	13,923	26,330	25,641
Depreciation and Amortization	486	515	998	996
Total operating expenses	37,917	36,294	76,618	67,638
Income (loss) from operations	2,807	(887)	5,430	1,232
Interest expense	(146)	(657)	(308)	(1,354)
Minority interests		(39)		(77)
Change in fair value of put warrants		(301)		(391)
Income (loss) before provision for (benefit from) income taxes	2,661	(1,884)	5,122	(590)
Provision for (benefit from) income taxes	1,052	(689)	2,024	(125)
Net income (loss)	1,609	(1,195)	3,098	(465)
Dividends on redeemable cumulative preferred stock		557		1,090
Net income (loss) attributable to common stockholders	$ 1,609	$ (1,752)	$ 3,098	$ (1,555)
Earnings (loss) per common share:				
Basic net income (loss) per common share	$ 0.19	$ (0.67)	$ 0.37	$ (0.59)
Diluted net income (loss) per common share	$ 0.19	$ (0.67)	$ 0.37	$ (0.59)
Basic weighted-average shares outstanding	8,447	2,632	8,445	2,632
Diluted weighted-average shares outstanding	8,447	2,632	8,445	2,632

See accompanying notes

SI International, Inc. and Subsidiaries

Consolidated Statements of Cash Flows

(Amounts in thousands)

Unaudited

	Six Months Ended	
	June 28, 2003	**June 29, 2002**
Cash flows from operating activities:		
Net income (loss)	$ 3,098	$ (465)
Adjustments to reconcile net income (loss) to net cash provided by operating activities:		
Depreciation and amortization	998	996
Loss on disposal of fixed assets	168	
Stock-based compensation	67	69
Amortization of deferred financing costs and debt discount	188	148
Change in fair value of put warrants		391
Minority interests		77
Changes in operating assets and liabilities:		
Accounts receivable	4,689	3,454
Other current assets	859	(2,422)
Other assets	(2)	26
Accounts payable and accrued expenses	(549)	270
Deferred revenue	(1,007)	1,006
Other long term liabilities	447	249
Net cash provided by operating activities	8,956	3,799
Cash flows from investing activities:		
Purchase of property and equipment	(786)	(839)
Net cash used in investing activities	(786)	(839)
Cash flows from financing activities:		
Proceeds from issuance of common stock	4	
Repayments (proceeds) from bank overdrafts	(2,201)	1,102
Borrowings under line of credit		40,080
Repayments of line of credit		(41,302)
Repayments of notes payable	(137)	(900)
Repayments of long-term debt and borrowings from stockholders		(1,125)
Payments of capital leases	(46)	(86)
Net cash used in financing activities	(2,380)	(2,231)
Net increase in cash and cash equivalents	5,790	729
Cash and cash equivalents, beginning of period	10,856	470
Cash and cash equivalents, end of period	$ 16,646	$ 1,199
Supplemental disclosures of cash flow information:		
Cash payments for interest	$ 142	$ 963
Cash payments for income taxes	$ 2,181	$ 1,640

See accompanying notes

SI International, Inc. and Subsidiaries

Notes to consolidated financial statements

(Unaudited)

1. Basis of Presentation

The accompanying unaudited consolidated financial statements of SI International, Inc. and its subsidiaries (the Company) have been prepared in accordance with accounting principles generally accepted in the United States for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by accounting principles generally accepted in the United States for complete financial statements. In the opinion of management, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation have been included. Operating results for the quarter and six months ended June 28, 2003 are not necessarily indicative of the results that may be expected for the year ending December 27, 2003. For further information, refer to the financial statements and footnotes included in SI International s Annual Report on Form 10-K/A for the year ended December 28, 2002.

2. Summary of significant accounting policies:

Principles of consolidation

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

Use of estimates

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

Reporting periods

The Company s fiscal year ends on the Saturday nearest to December 31 of that year. All fiscal years presented include 52 weeks. The Company s quarters end on the Saturday nearest to the applicable quarterly month-end. All quarters presented include 13 weeks.

Cash and cash equivalents

The Company considers all investments with maturities of three months or less at the date of purchase to be cash equivalents.

The balance of checks the Company has written, but have not yet been presented to the bank for payment is $0 and $2.2 million at June 28, 2003 and December 28, 2002, respectively. These balances have been classified in other current liabilities in the accompanying consolidated balance sheets.

Revenue Recognition

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

Under cost reimbursable contracts, the Company is reimbursed for allowable costs, and paid a fee. Revenues on cost reimbursable contracts are recognized as costs are incurred plus an estimate of applicable fees earned. The Company considers fixed fees under cost reimbursable contracts to be earned in proportion of the allowable costs incurred in performance of the contract. For cost reimbursable contracts that include performance based fee incentives, the Company recognizes the relevant portion of the expected fee to be awarded by the customer at the time such fee can be reasonably estimated, based on factors such as the Company s prior award experience and communications from the customer regarding performance.

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

Fixed price contracts may include either a product delivery or specific service performance throughout a period. Revenue on fixed price contracts that provide for the Company to render services throughout a period is recognized as earned according to contract terms as the service is provided on a proportionate performance basis. For fixed price contracts that provide for the delivery of a specific product with related customer acceptance provisions, revenues and associated contract costs are recognized upon product delivery and customer acceptance.

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

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

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

Significant customers

Revenue generated from contracts with the federal government or prime contractors doing business with the federal government accounted for a significant percent of revenues in the fiscal quarters and six months ended June 28, 2003 and June 29, 2002.

	Percent of revenues			
	Three Months Ended		Six Months Ended	
	June 28, 2003	June 29, 2002	June 28, 2003	June 29, 2002
Department of Defense	52.8%	50.7%	52.6%	47.2%
Federal civilian agencies	40.3	43.7	40.8	45.5
Commercial entities	6.9	5.6	6.6	7.3
Total revenue	100.0%	100.0%	100.0%	100.0%

For the second quarter of 2003 as well as the second quarter of 2002, we had two contracts that generated more than 10% of our revenue. Our C4I2SR contract with the U.S. Air Force Space Command represented approximately 21.1% and 24.9% of total revenue for the quarters ended June 28, 2003 and June 29, 2002, respectively. Our National Visa Center contract with the Department of State represented approximately 14.8% and 10.8% of total revenue for the quarters ended June 28, 2003 and June 29, 2002, respectively. For the first six months of 2003 as well as the first six months of 2002, these two contracts also represented the contracts which generated more than 10% of total revenue. Our C4I2SR contract represented approximately 21.2% and 22.1% of total revenue for the six months ended June 28, 2003 and June 29, 2002, respectively. Our National Visa Center contract represented approximately 14.6% and 11.1% of total revenue for the six months ended June 28, 2003 and June 29, 2002, respectively.

Deferred financing costs

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

	June 28, 2003	December 28, 2002
Deferred loan costs	$ 1,093	$ 1,093
Accumulated amortization	(226)	(42)
	$ 867	$ 1,051

At the end of the quarter ended June 28, 2003 and the fiscal year ended December 28, 2002, we received advance payments of approximately $0 and $1,074,000, respectively, from a customer to purchase equipment to be used in a contract. This advance was reflected as deferred revenue as of December 28, 2002 in the accompanying consolidated balance sheet.

During the quarter ended June 28, 2003, we received an advanced payment of $67,000 from a customer for future work. This advance was recorded as deferred revenue as of June 28, 2003 in the accompanying consolidated balance sheet.

Fair value of financial instruments

The Company s financial instruments consist primarily of cash and cash equivalents, accounts receivable, accounts payable, credit facilities, and long-term debt. In management s opinion, the carrying amounts of these financial instruments approximate their fair values at June 28, 2003 and December 28, 2002.

Stock-based compensation

In December 2002, the FASB issued SFAS No. 148, Accounting for Stock-Based Compensation Transition and Disclosure an amendment of SFAS 123. This statement amends SFAS No. 123, Accounting for Stock-Based Compensation, to provide alternative methods of transition for a voluntary change to the fair value based method of accounting for stock-based employee compensation. In addition, this statement amends the disclosure requirements of SFAS

No. 123 to require prominent disclosures in both annual and interim financial statements about the method of accounting for stock-based employee compensation and the effect of the method used on reported results. The Company has chosen to continue to account for stock-based compensation using the intrinsic value method prescribed in APB Opinion No. 25 and related interpretations. Accordingly, compensation expense for stock options is measured as the excess, if any, of the fair market value of the Company s stock at the date of the grant over the exercise price of the related option. The Company has adopted the annual disclosure provisions of SFAS No. 148 in its financial reports for the year ended December 28, 2002 and has adopted the interim disclosure provisions for its financial reports for the quarter and six months ended June 28, 2003.

	Three Months Ended				Six Months Ended			
		June 28, 2003		June 29, 2002		June 28, 2003		June 29, 2002
Net income (loss) - as reported	$	1,609	$	(1,195)	$	3,098	$	(465)
Add: total stock-based employee compensation expense as reported under intrinsic value method (APB No. 25) for all awards		32		35		67		69
Deduct: Total stock-based compensation expense determined under fair value based method (SFAS No. 123) for all awards		(48)		(35)		(420)		(290)
Net income (loss) - Pro forma		1,593		(1,195)		2,745		(686)
Dividends on redeemable cumulative preferred stock				557				1,090
Net income attributable to common stockholders - Pro forma	$	1,593	$	(1,752)	$	2,745	$	(1,776)
Basic earnings per common share - as reported	$	0.19	$	(0.67)	$	0.37	$	(0.59)
Diluted earnings per common share - as reported		0.19		(0.67)		0.37		(0.59)
Basic earnings per common share - Pro forma		0.19		(0.67)		0.33		(0.67)
Diluted earnings per common share - Pro forma		0.19		(0.67)		0.33		(0.67)

Earnings (loss) per share

The Company has applied SFAS No. 128, Earnings Per Share, for all fiscal years presented in these consolidated financial statements. SFAS No. 128 requires disclosure of basic and diluted earnings per share (EPS). Basic EPS is computed by dividing reported earnings available to common stockholders by the weighted average number of shares outstanding without consideration of common stock equivalents or other potentially dilutive securities. Diluted EPS gives effect to common stock equivalents and other potentially dilutive securities outstanding during the period. Redeemable cumulative preferred stock is excluded from diluted earnings per share as it is not convertible into common stock.

The following details the computation of net income (loss) per common share:

	Three Months Ended		Six Months Ended	
	June 28, 2003	June 29, 2002	June 28, 2003	June 29, 2002
Net income (loss)	$ 1,609	$ (1,195)	$ 3,098	$ (465)
Dividends on redeemable cumulative preferred stock		557		1,090
Net income (loss) attributable to common stockholders basic & diluted	$ 1,609	$ (1,752)	$ 3,098	$ (1,555)
Weighted average share calculation:				
Basic & diluted weighted average shares outstanding	8,447	2,632	8,445	2,632

Reclassifications

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

New accounting pronouncements

In November 2002, the Financial Accounting Standards Board issued Interpretation No. 45, Guarantor s Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others (FIN 45). FIN 45 elaborates on the disclosure to be made by a guarantor in its interim and annual financial statements about its obligations under certain guarantees that it has issued. It also clarifies that a guarantor is required to recognize, at the inception of a guarantee, a liability for the fair value of the obligation undertaken in issuing the guarantee. The initial recognition and initial measurement provisions of FIN 45 are applicable on a prospective basis to guarantees issued or modified after December 31, 2002. The disclosure requirements of FIN 45 are effective for financial statements of interim or annual periods ending after December 31, 2002. The Company does not expect adoption of FIN 45 to have a material effect on its financial condition, results of operations of liquidity**.**

In January 2003, the Financial Accounting Standards Board issued Interpretation No. 46, Consolidation of Variable Interest Entities (FIN 46). FIN 46 clarifies the application of Accounting Research Bulletin No. 51, Consolidated Financial Statements , to certain entities in which equity investors do not have the characteristics of a controlling financial interest or do not have sufficient equity at risk for the entity to finance its activities without additional subordinated financial support from other parties. FIN 46 applies immediately to variable interest entities created after January 31, 2003. Management believes that the Company s business practice does not require the application of FIN 46.

3. Acquisitions:

On March 9, 2000, the Company purchased all of the outstanding common stock of System Technology Associates, Inc. for consideration of approximately \$33.0 million in cash and \$4.8 million in subordinated notes in a transaction accounted for as a purchase. The subordinated notes bear interest at the prime rate plus 2 percent with \$3.8 million due in March 2001, subject to collection of certain accounts receivable, and \$1.0 million due in March 2002. Approximately \$4.3 million of the notes were repaid at maturity in March 2001 and 2002 and payments of approximately \$343,000 of these notes had been withheld by the Company as of June 28, 2003 since certain accounts receivable have not been fully collected.

4. Accounts receivable:

Accounts receivable consists of the following (in thousands):

	June 28, 2003	December 28, 2002
Billed accounts receivable	$ 13,234	$ 18,377
Unbilled accounts receivable:		
Currently billable	11,711	11,926
Unbilled retainages and milestones payments expected to be billed within the next 12 months	3,093	2,054
Indirect costs incurred and charged to cost-plus contracts in excess of provisional billing rates	629	640
Total unbilled accounts receivable	15,433	14,620
Allowance for doubtful accounts	(1,455)	(1,096)
Accounts receivable, net	$ 27,212	$ 31,901

The currently billable amounts included as unbilled accounts receivable as of June 28, 2003 represent amounts, which are billed during the following quarter of the current year. They are billings for services rendered prior to quarter-end, which are billed once necessary billing data has been collected and an invoice produced.

Long-term unbilled accounts receivable of approximately $400,000 as of June 28, 2003 and December 28, 2002 are included in other assets in the accompanying consolidated balance sheets.

5. Property and equipment:

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

	June 28, 2003	December 28, 2002
Computers and equipment	$ 5,947	$ 5,620
Software	1,852	1,810
Furniture and fixtures	1,285	1,216
Leasehold improvements	638	692
	9,722	9,338
Less Accumulated depreciation and amortization	(5,560)	(4,796)
	$ 4,162	$ 4,542

Property and equipment includes assets financed under capital lease obligations of approximately $116,000 and $272,000, net of accumulated depreciation, as of June 28, 2003 and December 28, 2002, respectively.

Depreciation expense of approximately $0.5 million and $1.0 million and was recorded in the quarter and six months ended June 28, 2003, respectively compared to $0.5 million and $1.0 million in the quarter and six months ended June 29, 2002, respectively.

6. Accounts payable and accrued expenses:

Accounts payable and accrued expenses consists of the following (in thousands):

	June 28, 2003	December 28, 2002

Accounts payable	$ 3,686	$ 6,660
Accrued compensation and benefits	5,438	5,216
Accrued interest	90	45
Other accrued liabilities	2,949	791
Accounts payable and accrued expenses	$ 12,163	$ 12,712

7. Debt:

Debt consists of the following and is included in other current liabilities on the accompanying consolidated balance sheets (in thousands):

	June 28, 2003	December 28, 2002
Notes payable:		
Indemnification note payable	$ 343	$ 480
Total debt	$ 343	