

SM&A
Form 10-Q
October 30, 2003

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SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

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

For the Quarter ended September 30, 2003

OR

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

Commission file number 0-23585

SM&A

(Exact name of registrant as specified in its charter)

California
(State or other jurisdiction of
incorporation or organization)

33-0080929
(I.R.S. Employer
Identification No.)

4695 MacArthur Court, 8th Floor, Newport Beach, California 92660
(Address of principal executive offices, including zip code)

(949) 975-1550
(Registrant's telephone number, including area code)

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 an accelerated filer as defined in Rule 12b-2 of the Securities Exchange Act of 1934. Yes No

The number of shares outstanding of the registrant's common stock as of October 28, 2003 was 20,224,382.

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CAUTIONARY STATEMENT RELATED TO FORWARD LOOKING STATEMENTS

This Quarterly Report on Form 10-Q includes certain forward-looking statements as defined within Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended, relating to revenue, revenue composition, demand trends, future expense levels, trends in average headcount and gross margins, and the level of expected capital expenditures. Such forward-looking statements are based on the beliefs of, estimates made by, and information currently available to SM&A (the Company) management and are subject to certain risks, uncertainties and assumptions. Any statements contained herein (including without limitation statements to the effect that the Company or management estimates, expects, anticipates, plans, believes, projects, continues, may, will, could, or will) concerning potential or opportunity or variations thereof or comparable terminology or the negative thereof) that are not statements of historical fact should be construed as forward-looking statements. The actual results of SM&A may vary materially from those expected or anticipated in these forward-looking statements. The realization of such forward-looking statements may be impacted by certain important unanticipated factors including those discussed in Risk Factors under Item 2, Management s Discussion and Analysis of Financial Condition and Results of Operations, at pages 11-16. Because of these and other factors that may effect SM&A s operating results, past performance should not be considered as an indicator of future performance and investors should not use historical results to anticipate results or trends in future periods. The Company undertakes no obligation to publicly release the results of any revisions to these forward-looking statements that may be made to reflect events or circumstances after the date hereof or to reflect the occurrence of unanticipated events. Readers should carefully review the risk factors described in this and other documents that SM&A files from time to time with the Securities and Exchange Commission (SEC), including subsequent Current Reports on Form 8-K, Quarterly Reports on Form 10-Q and Annual Reports on Form 10-K.

HOW TO OBTAIN SM&A SEC FILINGS

All reports filed by SM&A with the SEC are available free of charge via EDGAR through the SEC website at www.sec.gov. In addition, the public may read and copy materials filed by the Company with the SEC at the SEC s public reference room located at 450 Fifth St., N.W., Washington, D.C. 20549. SM&A also provides copies of its Forms 8-K, 10-K, 10-Q, Proxy and Annual Report at no charge to investors upon request and makes electronic copies of its most recently filed reports available through its website at www.smawins.com as soon as reasonably practicable after filing such material with the SEC.

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CONSOLIDATED BALANCE SHEETS

(in thousands)

	September 30 2003	December 31 2002
	(Unaudited)	
ASSETS		
Current assets:		
Cash and cash equivalents	\$ 12,021	\$ 5,956
Accounts receivable, net	13,914	9,961
Prepaid expenses and other current assets	489	425
Deferred income taxes	1,130	1,277
	<u> </u>	<u> </u>
Total current assets	27,554	17,619
Fixed assets, net	589	578
Other assets	288	111
	<u> </u>	<u> </u>
	\$ 28,431	\$ 18,308
	<u> </u>	<u> </u>
LIABILITIES AND SHAREHOLDERS EQUITY		
Current liabilities:		
Trade accounts payable	\$ 1,843	\$ 1,239
Accrued compensation and related benefits	3,256	2,832
Income taxes payable	1,856	2,989
Net liabilities of discontinued operations	1,586	2,453
	<u> </u>	<u> </u>
Total current liabilities	8,541	9,513
Deferred income taxes	73	73
Other liabilities	211	334
	<u> </u>	<u> </u>
Total liabilities	8,825	9,920
Commitments and contingencies		
Shareholders' equity:		
Preferred stock		
Common stock	51,115	49,438
Accumulated deficit	(31,509)	(41,050)
	<u> </u>	<u> </u>
Total shareholders' equity	19,606	8,388
	<u> </u>	<u> </u>
	\$ 28,431	\$ 18,308
	<u> </u>	<u> </u>

See accompanying notes to consolidated financial statements

Table of Contents**SM&A****CONSOLIDATED STATEMENTS OF OPERATIONS**

(in thousands, except per share data)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2003	2002	2003	2002
	(Unaudited)	(Unaudited)	(Unaudited)	(Unaudited)
Revenue	\$ 18,704	\$ 14,315	\$ 56,231	\$ 40,521
Cost of revenue	10,135	8,361	31,316	23,933
Gross margin	8,569	5,954	24,915	16,588
Selling, general and administrative expenses	3,733	2,985	10,478	8,878
Operating income	4,836	2,969	14,437	7,710
Other income (expense):				
Interest income (expense), net	32	(150)	42	(890)
Unrealized gain (loss) on interest rate swap		(86)		5
Other income (expense), net	32	(236)	42	(885)
Income from operations before income taxes	4,868	2,733	14,479	6,825
Income tax expense	1,996	1,122	4,938	2,637
Income from operations	2,872	1,611	9,541	4,188
Extraordinary loss from early extinguishment of debt, net of income taxes				(2,499)
Net income	\$ 2,872	\$ 1,611	\$ 9,541	\$ 1,689
Income per share from continuing operations:				
Basic	\$ 0.14	\$ 0.08	\$ 0.48	\$ 0.22
Diluted	\$ 0.13	\$ 0.08	\$ 0.45	\$ 0.21
Loss per share from early extinguishment of debt:				
Basic	\$	\$	\$	\$ (0.13)
Diluted	\$	\$	\$	\$ (0.12)
Net income per share:				
Basic	\$ 0.14	\$ 0.08	\$ 0.48	\$ 0.09
Diluted	\$ 0.13	\$ 0.08	\$ 0.45	\$ 0.08
Shares used in calculating net income per share:				
Basic	20,113	19,602	19,907	19,483
Diluted	21,610	20,510	21,309	20,447

See accompanying notes to consolidated financial statements.

Table of Contents**SM&A****CONSOLIDATED STATEMENTS OF CASH FLOWS**

(in thousands)

	Nine months Ended September 30,	
	2003	2002
	(unaudited)	(unaudited)
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income	\$ 9,541	\$ 1,689
Adjustments to reconcile net income to net cash provided by operating activities:		
Change in fair value of interest rate swap		(5)
Depreciation and amortization	208	190
Gain on disposal of fixed assets	(35)	
Deferred income taxes	147	692
Amortization of debt issuance costs		4,165
Changes in operating assets and liabilities:		
(Increase) in accounts receivable	(3,953)	
Decrease in prepaid income taxes		1,860
(Increase) in prepaid expense and other assets	(241)	(155)
Increase (Decrease) in trade accounts payable	674	(961)
Increase (Decrease) in accrued compensation and related benefits	424	(1,345)
Increase (Decrease) in income taxes payable	(1,133)	248
Increase (Decrease) in other liabilities	(28)	5
Net cash provided by operating activities	<u>5,604</u>	<u>6,383</u>
CASH FLOWS FROM INVESTING ACTIVITIES:		
Purchase of fixed assets	(349)	(638)
Decrease in restricted cash		3,265
Net cash (used in) provided by investing activities	<u>(349)</u>	<u>2,627</u>
CASH FLOWS FROM FINANCING ACTIVITIES:		
Repayment of subordinated notes		(25,000)
Payment of early payment penalty on subordinated notes		(1,250)
Payments on termination of interest rate swap agreement		(1,781)
Proceeds from issuance of common stock	1,677	571
Net cash provided by (used in) financing activities	<u>1,677</u>	<u>(27,460)</u>
Net increase (decrease) in cash from continuing operations	6,932	(18,450)
Net cash used in discontinued operations	(867)	(4,383)
Net increase (decrease) increase in cash	6,065	(22,833)
Cash at beginning of period	5,956	26,270
Cash at end of period	<u>\$ 12,021</u>	<u>\$ 3,437</u>

See accompanying notes to consolidated financial statements.

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**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
For the Three and Nine months ended September 30, 2003 and 2002
(unaudited)**

NOTE 1. BASIS OF PRESENTATION AND SIGNIFICANT ACCOUNTING POLICIES

The consolidated financial statements included herein are unaudited; however, they contain all normal recurring accruals and adjustments that, in the opinion of management, are necessary to present fairly the consolidated financial position of SM&A at September 30, 2003, the consolidated results of our operations for the three and nine months ended September 30, 2003 and 2002, and our cash flows for the nine months ended September 30, 2003 and 2002.

It should be understood that accounting measurements at interim dates inherently involve greater reliance on estimates than at year-end. The results of operations for the three and nine months ended September 30, 2003 are not necessarily indicative of the results to be expected for the full fiscal year.

The accompanying unaudited consolidated financial statements do not include footnotes and certain financial presentations normally required under generally accepted accounting principles. Therefore, these financial statements should be read in conjunction with our audited consolidated financial statements and notes thereto for the year ended December 31, 2002, included in our Annual Report on Form 10-K filed with the Securities and Exchange Commission on March 11, 2003.

Recent Accounting Pronouncements

In June 2002, the FASB issued Statement of Financial Accounting Standards No. 146, *Accounting for Costs Associated with Exit or Disposal Activities* (Statement No. 146). Statement No. 146 addresses financial accounting and reporting for costs associated with exit or disposal activities and nullifies Emerging Issues Task Force (EITF) Issue No. 94-3, *Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity (including Certain Costs Incurred in a Restructuring)*. The provisions of this Statement are effective for exit or disposal activities that are initiated after December 31, 2002, with early application encouraged. We adopted Statement No. 146 in the first quarter of 2003 and it did not have a material effect on our results of operations, financial position or cash flows.

Significant Accounting Policies

Cash and Cash Equivalents. The Company considers all highly liquid investments with an original maturity of three months or less to be cash equivalents.

Revenue Recognition. The Company recognizes revenue from services rendered when the following four revenue recognition criteria are met: persuasive evidence of an arrangement exists, delivery has occurred or services have been rendered, the selling price is fixed or determinable, and collectibility is reasonably assured. The Company's services are generally provided under time and expenses billing arrangements, and revenue is recognized on the basis of hours utilized, plus other reimbursable contract costs incurred during the period. Revenue is directly related to the total number of hours billed to clients and the associated hourly billing rates.

Reclassifications. Certain items in the 2002 financial statements have been reclassified to conform to the current period presentation.

Table of Contents**NOTE 2. NET INCOME PER SHARE**

The following table illustrates the number of shares used in the computation of basic and diluted net income per share (in thousands):

	Three Months Ended September 30, (in thousands, except per share data)		Nine months Ended September 30,	
	2003	2002	2003	2002
Denominator for basic income per share: weighted average shares outstanding during the period	20,113	19,602	19,907	19,483
Incremental shares attributable to dilutive outstanding stock options	1,497	908	1,402	964
Denominator for diluted income per share:	21,610	20,510	21,309	20,447

NOTE 3. STOCK-BASED COMPENSATION

The Company has accounted for its stock-based compensation plans in accordance with the intrinsic value provisions of Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees. Accordingly, the Company did not record any compensation expense in the consolidated financial statements for its stock-based compensation plans. The following table illustrates the effect on net income and net income per share had compensation expense been recognized consistent with the fair value provisions of Statement of Financial Accounting Standards (SFAS) No. 123, Accounting for Stock-Based Compensation .

	Three Months Ended September 30,		Nine months Ended September 30,	
	2003	2002	2003	2002
Net income as reported	\$2,872	\$1,611	\$9,541	\$1,689
Less: stock compensation expense net of tax	(150)	(17)	(271)	(240)
Net income (loss) SFAS No. 123 pro forma	\$2,722	\$1,594	\$9,270	\$1,449
Basic income per share as reported	\$ 0.14	\$ 0.08	\$ 0.48	\$ 0.09
Basic income (loss) per share SFAS No. 123 pro forma	\$ 0.14	\$ 0.08	\$ 0.47	\$ 0.07
Diluted income per share as reported	\$ 0.13	\$ 0.08	\$ 0.45	\$ 0.08
Diluted income (loss) per share SFAS No 123 pro forma	\$ 0.13	\$ 0.08	\$ 0.44	\$ 0.07

NOTE 4. REVOLVING LINE OF CREDIT AND INTEREST RATE SWAP

In April 2003, the Company renewed its previous revolving credit agreement. The renewed agreement allows for borrowings up to \$10.0 million at the prime rate minus one half of one percent (-0.50%) per annum or LIBOR plus two and one quarter percent (2.25%) per annum. The new revolving credit agreement expires in April 2004. Borrowings under the revolving credit agreement are secured by a lien on substantially all of the Company's assets. The agreement requires the Company to comply with certain financial covenants pertaining to its tangible net worth, ratio of total liabilities to tangible net worth, and ratio of current assets to current liabilities (as defined in the agreement). The agreement also contains certain negative covenants which, among other things, restricts the Company's ability to incur additional indebtedness of more than \$1.0 million in excess of the \$10.0 million limit set forth in the credit agreement and make capital expenditures in excess of \$2.0 million without the prior written approval of the lender.

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NOTE 4. REVOLVING LINE OF CREDIT AND INTEREST RATE SWAP (cont d)

On May 12, 2000, the Company entered into an interest rate swap agreement to manage its interest rate risk exposure related to the Company's previous credit agreement. The agreement required that the Company pay a fixed rate of 7.5225% on \$20.0 million and in turn receive a variable rate of interest based on one-month LIBOR. During the three and nine months ended September 30, 2002, the Company recognized a loss of \$(86,000) and a gain of \$5,000 related to the change in the fair value of the interest rate swap, respectively. On July 5, 2002, the Company paid in full the then fair value of the interest rate swap and, as a result, the interest rate swap agreement was terminated.

NOTE 5. INCOME TAXES

In March 2003, the Internal Revenue Service completed their examination of our income and payroll taxes for the calendar years 1998 through 2001. Based on the conclusion of the examination, we adjusted our tax accounts leading to a one-time income tax adjustment of \$1.0 million or \$0.05 per diluted share in the first quarter of 2003. During the second quarter of fiscal 2002, we received an income tax refund of \$145,000, which decreased our income tax expense. The excess refund was due primarily to a recent change in tax law relating to alternative minimum taxes.

NOTE 6. LONG-TERM DEBT

We entered into a Note and Stock Purchase Agreement (the Subordinated Debt Agreement) dated December 29, 2000 with various investors (the Purchasers). In consideration of a \$25.0 million investment, we issued to the Purchasers (i) 13% unsecured, Senior Subordinated Notes due in 2005 in the aggregate principal amount of \$25.0 million (the Notes), and (ii) 2,250,000 shares of our common stock with a fair value of \$1,968,750. The Subordinated Debt Agreement required payment of a premium if the Notes were prepaid within three years of the closing.

The value of the common stock issued and related financing costs of \$3.5 million were reflected as a discount on the Notes and were being amortized over the term of the Notes. On January 11, 2002, the Notes were repaid in full. In connection with the repayment, we incurred a prepayment penalty of \$1.25 million, and wrote off the remaining original issue discount and debt issuance costs. This retirement of the Notes resulted in a loss of \$2.5 million, net of tax, and is reflected as an extraordinary item in the accompanying consolidated statements of operations.

NOTE 7. RELATED PARTIES

In April 2003, we entered into a contract with the Precept Group, for which one of our members of our Board of Directors serves as the President and CEO. We agreed to retain the Precept Group to assist us in the development and implementation of a competency based human resources evaluation system. The contract value was determined through a review of prevailing market rates for such services. Under this contract, we paid none and \$15,000 during the three and nine months ended September 30, 2003.

In April 2002, we entered into a contract with ProView, a subsidiary of the Precept Group, for which one of our members of our Board of Directors serves as the President and CEO. We agreed to outsource our employee benefits administration, which requires us to pay a monthly fee based on the number of participating employees. ProView provides enrollment activity administration, benefit and billing administration, COBRA processing, flexible spending account administration and a human resources intranet website. The contract value was determined through a review of prevailing market rates for such services. Under this contract, we paid \$6,000 and \$18,000 during the three and nine months ended September 30, 2003.

Table of Contents**NOTE 7. RELATED PARTIES (cont d)**

During June 2002, we entered into a right of offset and barter agreement with SummitJets, Inc. (SummitJets), which is owned by our CEO. The agreement provides for the offset of the existing accounts receivable and accounts payable balances between the companies. After giving effect to the offset, SM&A was owed \$114,000, which amounts SummitJets agreed to pay in the form of credits to use SummitJets aircraft. The \$114,000 owed represents expenses incurred related to a former location sharing agreement for rent and related utilities. In June 2002, SummitJets moved into their own facilities and cancelled the existing location sharing agreement. During the three and nine months ended September 30, 2003, total credits used were none and \$48,000 and are included in Selling, General and Administrative Expenses. In March 2003, SummitJets paid the Company the remaining credits owed of \$17,000 and the contract was terminated.

NOTE 8. DISCONTINUED OPERATIONS

On November 30, 2001, we completed the sale of our interest in the common stock of Emergent-East (also known as the Government Services Group or GSG), a provider of system engineering, scientific research, program management and technical support services.

Liabilities related to the sale of GSG totaled \$1.6 million at September 30, 2003 and consisted of reserves for lease termination costs and contingent liabilities related to the sale. Under the terms of the sale agreement, we indemnified the purchaser for certain contingent liabilities, arising before November 30, 2001, for the two-year period ending November 30, 2003. The Company has not been requested to make any payments under these indemnification obligations as of September 30, 2003.

	Beginning Balance at December 31, 2002	Amounts Added	Amounts Paid	Ending Balance at September 30, 2003
2003 Discontinued Operations	\$2,453	\$	\$(867)	\$1,586

Table of Contents**ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**

SM&A is the world's leading provider of business capture services, and a leading provider of high-value program support services. Our more than 300 employees and consultants provide program management, systems engineering, and expert support to major industrial customers in the defense, homeland security, aerospace, information technology, and architect and engineering sectors. Since 1982, we have managed more than 725 proposals worth more than \$260 billion for our clients and have achieved an 85% win rate on awarded contracts. We also provide systems engineering, program planning and other high-value technical support services to such high priority national programs as the Joint Strike Fighter program and America's missile defense efforts.

RESULTS OF CONTINUING OPERATIONS

The following table sets forth certain historical operating results as a percentage of revenue:

	Three Months Ended September 30,		Nine months Ended September 30,	
	2003	2002	2003	2002
Revenue	100.0%	100.0%	100.0%	100.0%
Cost of revenue	54.2	58.4	55.7	59.1
Gross margin	45.8	41.6	44.3	40.9
Selling, general and administrative expenses	20.0	20.9	18.6	21.9
Operating income	25.8	20.7	25.7	19.0
Income from operations	15.4%	11.3%	17.0%	10.3%

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**ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS
(cont d)**

Three Months Ended September 30, 2003 Compared to Three Months Ended September 30, 2002

Revenue. We derive our revenue from the various consulting services that we provide: proposal management; program support services; management consulting; and competitive strategy services. Revenue increased \$4.4 million, or 30.7%, to \$18.7 million for the three months ended September 30, 2003 compared to \$14.3 million for the three months ended September 30, 2002. The increase in revenue is a result of the Company's larger account executive team spending increased time with clients, combined with two key structural changes in the industry: higher defense and homeland security spending and an increased rate of retirement by crucial personnel among SM&A's clients which led to an increased need for SM&A's services. We have increased the average number of people working on projects to 187 from 164 for the three months ended September 30, 2003 and 2002, respectively.

Gross Margin. Gross margin increased \$2.6 million, or 43.9%, to \$8.6 million, for the three months ended September 30, 2003 as compared to \$6.0 million for the three months ended September 30, 2002. As a percentage of revenue, gross margin increased to 45.8% compared to 41.6% for the three months ended September 30, 2003. The increase is attributable to our continued focus on gross margin targets and cost controls relating to travel expenses incurred while providing our services.

Selling, General and Administrative Expenses. Selling, general and administrative expenses consist principally of salary and benefit costs for executive and administrative personnel, professional services and other general corporate activities. Selling, general and administrative expenses increased \$748,000, or 25.1%, to \$3.7 million for the three months ended September 30, 2003, as compared to \$3.0 million for the three months ended September 30, 2002. As a percentage of revenue, selling, general and administrative expenses decreased to 20.0% for the three months ended September 30, 2003, as compared to 20.9% for the same period of the prior year. The increase in expenses is attributed to an increase in the number of account executives, increases in our director and officer liability and healthcare insurance premiums, and increases in our professional services fees.

Operating Income. Operating income was \$4.8 million for the three months ended September 30, 2003 compared to \$3.0 million for the three months ended September 30, 2002, an increase of \$1.8 million. As a percentage of revenue, operating income increased to 25.8% for the three months ended September 30, 2003, from 20.7% in the same period of the prior year. Operating income increased due to the increased revenue and gross margin, partially offset by an increase in selling, general and administrative expenses, as discussed above.

Interest Income (Expense), net. Interest income (expense), net was \$32,000 for the three months ended September 30, 2003 as compared to \$(150,000) for the three months ended September 30, 2002. Included in interest for the three months ended September 30, 2002 is interest on borrowings on our line of credit under which we had no borrowings in 2003.

Unrealized Loss on Interest Rate Swap. For the three months ended September 30, 2002, we recognized a loss of \$(86,000) resulting from changes in the fair value of our interest rate swap agreement. The swap agreement was terminated in July 2002.

Income Tax Expense. Our effective income tax rate for the three months ended September 30, 2003 and 2002 was 41.0%.

Table of Contents**ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS
(cont'd)****Nine months Ended September 30, 2003 Compared to Nine months Ended September 30, 2002**

Revenue. We derive our revenue from the various consulting services that we provide: proposal management; program support services; management consulting; and competitive strategy services. Revenue increased \$15.7 million, or 38.8%, to \$56.2 million for the nine months ended September 30, 2003 compared to \$40.5 million for the nine months ended September 30, 2002. The increase in revenue is a result of the Company's larger account executive team spending increased time with clients combined with two key structural changes in the industry: higher defense and homeland security spending and an increased rate of retirement by crucial personnel among SM&A's clients which led to an increased need for SM&A's services. We have increased the average number of people working on projects to 196 from 154 for the nine months ended September 30, 2003 and 2002, respectively.

Gross Margin. Gross margin increased \$8.3 million, or 50.2%, to \$24.9 million, for the nine months ended September 30, 2003 as compared to \$16.6 million for the nine months ended September 30, 2002. As a percentage of revenue, gross margin increased to 44.3% compared to 40.9% for the nine months ended September 30, 2002. The increase is attributable to our continued focus on gross margin targets and cost controls relating to travel expenses incurred while providing our services.

Selling, General and Administrative Expenses. Selling, general and administrative expenses consist principally of salary and benefit costs for executive and administrative personnel, professional services and other general corporate activities. Selling, general and administrative expenses increased \$1.6 million, or 18.0%, to \$10.5 million for the nine months ended September 30, 2003, as compared to \$8.9 million for the nine months ended September 30, 2002. As a percentage of revenue, selling, general and administrative expenses decreased to 18.6% for the nine months ended September 30, 2003, as compared to 21.9% for the same period of the prior year. The increase in expenses is attributed to an increase in the number of account executives, increases in our director and officer liability and healthcare insurance premiums, and increases in our professional services fees.

Operating Income. Operating income was \$14.4 million for the nine months ended September 30, 2003 compared to \$7.7 million for the nine months ended September 30, 2002, an increase of \$6.7 million. As a percentage of revenue, operating income increased to 25.7% for the nine months ended September 30, 2003, from 19.0% in the same period of the prior year. Operating income increased due to the increased revenue and gross margin, partially offset by an increase in selling, general and administrative expenses, as discussed above.

Interest Income (Expense), net. Interest income (expense), net was \$42,000 for the nine months ended September 30, 2003 as compared to (\$890,000) for the nine months ended September 30, 2002. Included in interest for the nine months ended September 30, 2002 is interest on borrowings on our line of credit under which we had no borrowings in 2003.

Unrealized Gain on Interest Rate Swap. For the nine months ended September 30, 2002, we recognized a gain of \$5,000 resulting from changes in the fair value of our interest rate swap agreement. The swap agreement was terminated in July 2002.

Income Tax Expense. Our effective income tax rate for the nine months ended September 30, 2003 and 2002 was 34.1% and 38.6%, respectively. In March 2003, the Internal Revenue Service completed their examination of our income and payroll taxes for the calendar years 1998 through 2001. Based on the conclusion of the examination, we adjusted our tax accounts leading to a one-time income tax adjustment of \$1.0 million or \$0.05 per diluted share in the first quarter of 2003. During the second quarter of fiscal 2002, we received an income tax refund of \$145,000, which decreased our income tax expense. The excess refund was due primarily to a change in tax law relating to alternative minimum taxes. Our effective tax rate for future quarters is expected to be approximately 41.0%.

Table of Contents**ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (continued)****LIQUIDITY AND CAPITAL RESOURCES**

Net Cash Provided by Operating Activities. For the nine months ended September 30, 2003, net cash provided by operating activities of \$5.6 million reflected our net income of \$9.5 million offset by a \$4.0 million increase in our accounts receivable balance. The increase in our accounts receivable balance is related to our increase in sales. Our day sales outstanding (DSO) remains consistent with historical levels.

Net Cash Used in Investing Activities. For the nine months ended September 30, 2003, net cash used in investing activities was \$347,000 which related to the purchase of fixed assets.

Net Cash Provided by Financing Activities. For the nine months ended September 30, 2003, net cash of \$1.7 million was provided by proceeds received from the issuance of common stock under our Employee Stock Purchase Plan and from the exercise of stock options.

In April 2003, the Company renewed its previous revolving credit agreement. The renewed agreement allows for borrowings up to \$10.0 million at the prime rate minus one half of one percent (-0.50%) per annum or LIBOR plus two and one quarter percent (2.25%) per annum. The new revolving credit agreement expires in April 2004. Borrowings under the revolving credit agreement are secured by a lien on substantially all of the Company's assets. The agreement requires the Company to comply with certain financial covenants pertaining to its tangible net worth, ratio of total liabilities to tangible net worth, and ratio of current assets to current liabilities (as defined in the agreement) and also contains certain negative covenants which, among other things, restricts the Company's ability to incur additional indebtedness of more than \$1.0 million in excess of the \$10.0 million credit agreement and make capital expenditures in excess of \$2.0 million without the prior written approval of the lender. At September 30, 2003, we had no outstanding borrowings under the line of credit.

The Company's contractual obligations are as follows at September 30, 2003:

Contractual Obligations Payments Due By Period (In thousands)	Contractual Obligations				
	Total	1 Year or Less	2-3 Years	4-5 Years	After 5 Years
Operating leases	\$2,243	\$ 584	\$1,204	\$455	\$
Operating leases related to discontinued operations, net of subleases	1,464	524	398	542	—
Total	\$3,707	\$1,108	\$1,602	\$997	\$

Operating leases related to discontinued operations represent office space previously occupied by the Emergent-East and Emergent-Central divisions. The amounts above represent the remaining lease commitments over the term of the leases. We have entered into subleases for two of our properties. These subleases cover a portion of our lease commitments and we expect these subleases to continue in effect for the life of our lease obligations. The Company is continuing the process of identifying sub-lessees for our remaining leased property related to discontinued operations or negotiating lease buy-outs with the lessors.

We believe that we have sufficient working capital, availability under the line of credit and cash generated by continuing operations to fund operations for at least the next twelve months.

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**ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS
(cont d)**

RISK FACTORS

In addition to the other information in this Quarterly Report on Form 10-Q, the following factors should be considered carefully in evaluating our business and prospects.

Our business depends substantially on the defense industry.

Our proposal management business depends substantially on U.S. Government expenditures for defense products. Any decline in the future defense, information technology or homeland security procurement expenditures could effect the opportunities available to our clients and, indirectly, us. A number of factors could contribute to such a decline in opportunities, including:

Loss of political support for current or increased levels of spending;

Changes of Presidential Administration, particularly changes from one political party to another, that typically result in a mass reordering of priorities that reduce new proposal activity for up to a year;

Threat scenarios evolving away from global conflicts to regional conflicts; and

Spending for ongoing operations, such as the War on Terrorism, crowding out spending for procurement of new systems and research and development spending.

In the event expenditures for products of the type manufactured by our clients are reduced and not offset by other new programs or products, there will be a reduction in the volume of contracts or subcontracts to be bid upon by our clients and, as a result, a reduction in the volume of proposals managed by us. Unless offset, such reductions could materially and adversely affect our business, operating results and financial condition.

We rely on a relatively limited number of clients.

We derive a significant portion of revenue from continuing operations from a relatively limited number of clients. In 2002, our seven largest customers accounted for 92.9% of our revenue. Clients typically retain our services as needed on an engagement basis rather than pursuant to long-term contracts, and a client can usually terminate the engagement at any time without a significant penalty. Moreover, there can be no assurance that existing clients will continue to engage us for additional assignments or do so at the same revenue levels. The loss of any significant client could materially and adversely affect our business, financial condition and results of operations. In addition, the level of services required by an individual client may diminish over the life of the relationship, and there can be no assurance we will be successful in establishing relationships with new clients as this occurs.

The markets in which we operate are highly competitive.

The market for proposal management services in the procurement of government and commercial contracts for aerospace and defense work is a niche market with a number of competitors. We are the largest provider of such services and principally compete with the in-house capability of our clients. In addition, numerous smaller proposal management companies compete in this highly specialized industry. With sufficient resources in the form of money and excellent talent with current security clearances, our competitors could erode our current market share and such a reduction could materially and adversely affect our business, operating results and financial condition.

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ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (continued)

We rely heavily upon our key senior management personnel and our ability to recruit and maintain skilled professionals.

Our success is highly dependent upon the efforts, abilities, and business generation capabilities and project execution of our three principal executive officers, our account executives, and senior staff such as our Vice President of Recruiting and Vice President of Operations. In particular, Steven S. Myers, Chief Executive Officer and Chairman of the Board, Cathy L. Wood, Executive Vice President, Chief Financial Officer and Corporate Secretary, and Bennett C. Beaudry, President and Chief Operating Officer have a significant role in our success. The loss of the services of these key individuals, for any reason, could materially and adversely affect our business, operating results and financial condition.

Our business involves the delivery of professional services and is highly labor-intensive. Our success depends largely on our general ability to attract, develop, motivate and retain highly skilled professionals. The loss of some or a significant number of our professionals or the inability to attract, hire, develop, train and retain additional skilled personnel could have a serious negative effect on us, including our ability to obtain and successfully complete important engagements and thus maintain or increase our revenue.

Quarterly results may fluctuate.

We may experience fluctuations in future quarterly operating results due to a number of factors, including the size, timing and duration of client engagements.

Our stock price is subject to significant volatility.

Our common stock was first publicly traded on January 29, 1998 after our initial public offering at \$12.00 per share. Between January 29, 1998 and September 30, 2003, the closing sale price has ranged from a high of \$31.13 per share to a low of \$0.75 per share. The market price of our common stock could continue to fluctuate substantially due to a variety of factors, including:

Quarterly fluctuations in results of operations;

Adverse circumstances affecting the introduction, or market acceptance of new services we offer;

Announcements of new services by competitors;

Loss of key employees;

Changes in the regulatory environment or market conditions affecting the defense and aerospace industry;

Changes in earnings estimates and ratings by analysts;

Lack of market liquidity resulting from a relatively small amount of public stock float;

Changes in generally accepted accounting principles;

Sales of common stock by existing holders; and

The announcement and market acceptance of proposed acquisitions and dispositions.

Principal shareholder has significant control.

At September 30, 2003, Steven S. Myers, Chief Executive Officer and Chairman of the Board, beneficially owned or controlled approximately 28.7% of our outstanding common stock and will have the ability to control or significantly influence the election of directors and the results of other matters submitted to a vote of shareholders. This concentration of ownership may have the effect of delaying or preventing a change in control and may adversely affect the ability of other holders of our common stock to pass shareholder resolutions and control our actions. Our Board of Directors is currently comprised entirely of individuals nominated with the approval of Mr. Myers.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

The Company currently has no instruments that are sensitive to market risk.

ITEM 4. CONTROLS AND PROCEDURES

(a) Evaluation of disclosure controls and procedures.

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In accordance with Rule 13a-15(b) of the Securities Exchange Act of 1934 (the Exchange Act), within 90 days prior to the filing date of this quarterly report on Form 10-Q, an evaluation was carried out under the supervision and with the participation of the Company s management, including the Company s Chairman and Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of the Company s disclosure controls and procedures (as defined in Rule 13a-14(c) and 15d-14(c) under the Exchange Act). Based upon their evaluation of these disclosure controls and procedures, the Chairman and Chief Executive Officer and the Chief Financial Officer concluded that the disclosure controls and procedures were effective as of the date of such evaluation to ensure that material information relating to the Company, including its consolidated subsidiaries, was made known to them by others within those entities, particularly during the period in which this quarterly report on Form 10-Q was being prepared.

(b) Changes in internal controls

There were not any significant changes in the Company s internal controls or other factors that could significantly affect these controls subsequent to the date of their evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

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PART II OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

We are involved in routine litigation incidental to the conduct of our business. There are currently no material pending litigation proceedings to which we are a party or to which any of our property is subject.

ITEM 2. CHANGES IN SECURITIES AND USE OF PROCEEDS

Not Applicable.

ITEM 3. DEFAULTS UPON SENIOR SECURITIES

Not Applicable.

ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

Not Applicable.

ITEM 5. OTHER INFORMATION

In April 2003, we entered into a contract with the Precept Group, for which one of our members of our Board of Directors serves as the President and CEO. We agreed to retain the Precept Group to assist us in the development and implementation of a competency based human resources evaluation system. The contract value was determined through a review of prevailing market rates for such services. Under this contract, we paid none and \$15,000 during the three and nine months ended September 30, 2003.

In April 2002, we entered into a contract with ProView, a subsidiary of the Precept Group, for which one of our members of our Board of Directors serves as the President and CEO. We agreed to outsource our employee benefits administration, which requires us to pay a monthly fee based on the number of participating employees. ProView provides enrollment activity administration, benefit and billing administration, COBRA processing, flexible spending account administration and a human resources intranet website. The contract value was determined through a review of prevailing market rates for such services. Under this contract, we paid \$6,000 and \$18,000 during the three and nine months ended September 30, 2003.

During June 2002, we entered into a right of offset and barter agreement with SummitJets, Inc. (SummitJets), which is owned by our CEO. The agreement provides for the offset of the existing accounts receivable and accounts payable balances between the companies. After giving effect to the offset, SM&A was owed \$114,000, which amounts SummitJets agreed to pay in the form of credits to use SummitJets aircraft. The \$114,000 owed represents expenses incurred related to a former location sharing agreement for rent and related utilities. In June 2002, SummitJets moved into their own facilities and cancelled the existing location sharing agreement. During the three months ended March 31, 2003, total credits used were \$48,000 and are included in Selling, General and Administrative Expenses. SummitJets paid the Company the remaining credits owed of \$17,000 and the contract was terminated.

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ITEM 6. EXHIBITS AND REPORTS ON FORM 8-K

INDEX TO EXHIBITS

- (a) Exhibits (numbered in accordance with item 601 of Regulation S-K).
- 2.1 Stock Purchase and Sale Agreement, by and among the Registrant, Steven Myers Holding Inc. and L-3 Communications Corporation. ⁽¹⁾
- 2.2 Amendment No.1 to Stock Purchase and Sale Agreement, by and among the Registrant, Steven Myers Holding Inc. and L-3 Communications Corporation. ⁽²⁾
- 3.1 Amended and Restated Articles of Incorporation. ⁽³⁾
- 3.2 Amended and Restated Bylaws of the Registrant. ⁽⁴⁾
- 4.1 Registration and Antidilution Rights Agreement, by and among the Registrant and the Holders listed on the signature pages thereto. ⁽⁵⁾
- 4.2 Controlling Shareholder Agreement, by and among the Registrant, Steven S. Myers as Common Stockholder and the Purchasers listed on the signature pages thereto. ⁽⁶⁾
- 4.3 Registration Rights Agreement, by and among the Registrant and certain shareholders of Space Applications Corporation identified therein. ⁽⁷⁾
- 4.4 Registration Rights Agreement, by and among the Registrant and certain shareholders of Decision-Science Applications, Inc. set forth therein. ⁽⁸⁾
- 10.1 Amended and Restated 1997 Stock Option Plan and related form of Stock Option Agreement. ⁽⁹⁾
- 10.2 Amended and Restated Employee Stock Purchase Plan. ⁽¹⁰⁾
- 10.3 Office Facility Lease. ⁽¹¹⁾
- 10.4 Employment Agreement of Steven S. Myers. ⁽¹²⁾
- 10.5 Amendment No. 1 to Employment Agreement of Steven S. Myers. ⁽¹³⁾
- 10.6 Amendment No. 2 to Employment Agreement of Steven S. Myers. ⁽¹⁴⁾
- 10.7 Amendment No. 3 to Employment Agreement of Steven S. Myers. ⁽¹⁵⁾
- 10.8 Employment Agreement of Cathy L. Wood. ⁽¹⁶⁾
- 10.9 Amendment No. 1 to Employment Agreement of Cathy L. Wood. ⁽¹⁷⁾
- 10.10 Amendment No. 2 to Employment Agreement of Cathy L. Wood. ⁽¹⁸⁾
- 10.11 Employment Agreement of Bennett C. Beaudry. ⁽¹⁹⁾
- 10.12 Amendment No. 1 to Employment Agreement of Bennett C. Beaudry. ⁽²⁰⁾
- 10.13 Accounts Receivable Loan Agreement dated January 10, 2002, by and between the Registrant and City National Bank, a national banking association. ⁽²¹⁾

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Exhibits continued

- 10.14 Commercial Guaranty dated January 10, 2002, executed by Steven Myers & Associates, Inc. in favor of City National Bank, a national association. ⁽²²⁾
- 10.15 Revolving Loan Agreement dated April 25, 2003, by and between the Registrant and City National Bank, a national banking association. ⁽²³⁾
- 10.16 Revolving Note dated April 10, 2003, executed by SM&A, in favor of City National Bank. ⁽²⁴⁾
- 31.1 Certification of Chief Executive Officer Under Section 302 of the Sarbanes-Oxley Act of 2002. ⁽²⁵⁾
- 31.2 Certification of Chief Executive Officer Under Section 302 of the Sarbanes-Oxley Act of 2002. ⁽²⁶⁾
- 32.1 Certification of Chief Executive Officer Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. ⁽²⁷⁾
- 32.2 Certification of Chief Executive Officer Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. ⁽²⁸⁾

Footnote

- (1) Filed on November 27, 2001 as Exhibit 10.1 to the registrant's Current Report on Form 8-K and incorporated herein by reference.
- (2) Filed on December 14, 2001 as Exhibit 10.1 to the registrant's Current Report on Form 8-K and incorporated herein by reference.
- (3) Filed on March 15, 2002 as Exhibit 3.1 to the registrant's Current Report on Form 10-K and incorporated herein by reference.
- (4) Filed on May 3, 2002 as Exhibit 3.2 to the registrant's Current Report on Form 10-Q and incorporated herein by reference.
- (5) Filed on January 8, 2001 as Exhibit 99.5 to the registrant's Current Report on Form 8-K and incorporated herein by reference.
- (6) Filed on January 8, 2001 as Exhibit 99.6 to the registrant's Current Report on Form 8-K and incorporated herein by reference.
- (7) Filed on June 4, 1998 as Exhibit 2, Appendix E to the registrant's Current Report on Form 8-K and incorporated herein by reference.
- (8) Filed on August 21, 1998 as Exhibit 10.1 to the registrant's Current Report on Form 8-K and incorporated herein by reference.
- (9) Filed on April 17, 2001 as Exhibit 10.1 to the registrant's Current Report on Form 10-K and incorporated herein by reference.
- (10) Filed on April 29, 2002 as Exhibit C to the registrant's Current Report on Form 14A and incorporated herein by reference.
- (11) Filed on November 21, 1997 as Exhibit 10.3 to the registrant's Registration Statement 333-4075 on Form S-1 (Registration No. 333-4075) and incorporated herein by reference.
- (12) Filed on April 17, 2001 as Exhibit 10.17 to the registrant's Current Report on Form 10-K and incorporated herein by reference.
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- (24) Filed on July 31, 2003 as Exhibit 10.16 to the registrant's Current Report on Form 10-Q and incorporated herein by reference.
- (25) Filed herewith.
- (26) Filed herewith.
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(b) Reports on Form 8-K:

On July 29, 2003, the Company issued a press release announcing, among other things, that second quarter 2003 revenue was \$18.8 million compared to \$13.7 million for the same period a year ago, an increase of 38%. Net income for the second quarter 2003 was \$2.9 million or \$0.14 per diluted share, an increase of 123% from \$1.3 million, or \$0.07 per diluted share in the same period a year ago. The Company filed a Current Report on Form 8-K with the Securities and Exchange Commission on July 30, 2003.

On August 14, 2003, the Company issued a press release announcing that the Company's application for listing on The Nasdaq National Market had been approved. The Company filed a Current Report on Form 8-K with the Securities and Exchange Commission on August 15, 2003.

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