SI INTERNATIONAL INC
Form 10-Q
November 02, 2005

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 SEPTEMBER 24, 2005**
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 (State or other jurisdiction of incorporation or organization)	**52-2127278** (I.R.S. Employer Identification No.)
12012 Sunset Hills Road **Reston. Virginia** (Address of principal executive offices)	**20190-5869** (Zip Code)

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

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

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

As of October 25, 2005, there were 11,290,912 shares outstanding of the registrant s common stock.

SI INTERNATIONAL, INC.

FORM 10-Q

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PART I. **FINANCIAL INFORMATION**

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)

	September 24, 2005 (Unaudited)	December 25, 2004
Assets		
Current assets:		
Cash and cash equivalents	$ 26,443	$ 5,754
Accounts receivable, net	80,052	65,710
Other current assets	8,228	6,243
Total current assets	114,723	77,707
Property and equipment, net	5,329	4,971
Intangible assets, net	17,096	6,575
Other assets	5,680	2,142
Goodwill	174,056	120,712
Total assets	$ 316,884	$ 212,107
Liabilities and stockholders equity		
Current liabilities:		
Note Payable Line of Credit	$	$ 28,954
Current portion of long term debt	1,000	
Accounts payable	18,192	11,225
Accrued expenses and other current liabilities	26,123	15,314
Deferred revenue		289
Note payable former owner of acquired business	2,280	
Total current liabilities	47,595	55,782
Long-term debt, net of current portion	98,750	
Note payable former owner of acquired business		2,280
Other long-term liabilities	9,450	8,975
Stockholders equity:		
Common stock $0.01 par value per share; 50,000,000 shares authorized; 11,279,825 and 11,047,533 shares issued and outstanding as of September 24, 2005 and December 25, 2004, respectively	113	111
Additional paid-in capital	132,267	128,192
Deferred compensation	(103)	(208)
Retained earnings	28,812	16,975
Total stockholders equity	161,089	145,070
Total liabilities and stockholders equity	$ 316,884	$ 212,107

See accompanying notes

SI International, Inc. and Subsidiaries

Consolidated Statements of Operations

(Amounts in thousands, except per share data)

Unaudited

	Three Months Ended		Nine Months Ended	
	Sept. 24, 2005	**Sept. 25, 2004**	**Sept. 24, 2005**	**Sept. 25, 2004**
Revenue	$ 101,775	$ 72,926	$ 281,475	$ 192,710
Costs and expenses:				
Direct costs	62,743	49,106	173,944	121,435
Indirect costs	28,723	17,615	80,231	53,974
Depreciation and amortization	504	516	1,586	1,704
Amortization of intangible assets	612	171	1,680	477
Total operating expenses	92,582	67,408	257,441	177,590
Income from operations	9,193	5,518	24,034	15,120
Other income (expense)	64	(62)	(22)	(62)
Interest expense	(1,690)	(693)	(4,446)	(1,964)
Income before provision for income taxes	7,567	4,763	19,566	13,094
Provision for income taxes	2,989	1,881	7,729	5,172
Net income	$ 4,578	$ 2,882	$ 11,837	$ 7,922
Earnings per common share:				
Basic net income per common share	$ 0.41	$ 0.34	$ 1.06	$ 0.94
Diluted net income per common share	$ 0.39	$ 0.33	$ 1.02	$ 0.89
Basic weighted-average shares outstanding	11,227	8,483	11,140	8,471
Diluted weighted-average shares outstanding	11,698	8,840	11,595	8,897

<u>See accompanying notes</u>

SI International, Inc. and Subsidiaries

Consolidated Statements of Cash Flows

(Amounts in thousands)

Unaudited

	Nine Months Ended September 24, 2005	Nine Months Ended September 25, 2004
Cash flows from operating activities:		
Net income	$ 11,837	$ 7,922
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	1,586	1,704
Amortization of intangible assets	1,680	477
Income tax benefit for stock option exercises	1,179	
Stock-based compensation	93	98
Amortization of deferred financing costs	513	343
Changes in operating assets and liabilities, net of effect of acquisitions:		
Accounts receivable, net	(1,865)	(4,025)
Other current assets	(1,896)	919
Other assets	(823)	(543)
Accounts payable and accrued expenses	12,788	1,325
Deferred revenue	(289)	(3,058)
Other long term liabilities	1,180	1,507
Net cash provided by operating activities	25,983	6,669
Cash flows from investing activities:		
Purchase of property and equipment	(1,537)	(1,050)
Cash paid for acquisition of MATCOM International Corp.	(82)	(66,086)
Cash paid for acquisition of Bridge Technology Corporation	(197)	
Cash paid for acquisition of Shenandoah Electronic Intelligence, Inc., net of cash assumed	(73,874)	
Net cash used in investing activities	(75,690)	(67,136)
Cash flows from financing activities:		
Proceeds from exercise of stock options	2,910	390
Net (repayments) borrowings under line of credit	(28,954)	16,000
Proceeds from long-term debt	100,000	30,000
Repayments of long-term debt	(250)	(3,000)
Payments of debt issuance costs	(3,231)	(1,202)
Repayments of capital lease obligations	(79)	(109)
Net cash provided by financing activities	70,396	42,079
Net change in cash and cash equivalents	20,689	(18,388)
Cash and cash equivalents, beginning of period	5,754	23,252
Cash and cash equivalents, end of period	$ 26,443	$ 4,864
Supplemental disclosures of cash flow information:		
Cash payments for interest	$ 3,465	$ 1,368
Cash payments for income taxes	$ 3,045	$ 4,817
Purchases of assets under capital lease	$ 126	$

See accompanying notes

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SI International, Inc. and Subsidiaries

Notes to consolidated financial statements

(Unaudited)

1. Basis of Presentation

The accompanying unaudited consolidated financial statements of SI International, Inc. and its subsidiaries have been prepared in accordance with accounting principles generally accepted in the United States for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and 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 nine months ended September 24, 2005 are not necessarily indicative of the results that may be expected for the year ending December 31, 2005. For further information, refer to the financial statements and footnotes included in SI International s Annual Report on Form 10-K for the year ended December 25, 2004. References to the Company, we, us and our refer to SI International, Inc. and its subsidiaries.

2. Summary of significant accounting policies:

Principles of consolidation

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

Use of estimates

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

Reporting periods

The Company s fiscal year is based on the calendar year and ends each year on the Saturday nearest, but not falling after, December 31 of that year, and our fiscal quarters end on the Saturday nearest but prior to the applicable quarterly month end. As a result, our fiscal year may be comprised of 52 or 53 weeks. The fiscal quarters and nine-month periods presented in this Form 10-Q include 13 weeks and 39 weeks, respectively.

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.

Revenue Recognition

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

Significant customers

Revenue generated from contracts with the Federal government or prime contractors doing business with the Federal government accounted for a significant percent of revenues in the fiscal quarter and nine months ending September 24, 2005 and September 25, 2004.

	Three Months Ended		Nine Months Ended	
	September 24, 2005	September 25, 2004	September 24, 2005	September 25, 2004
Department of Defense	46.8%	53.2%	46.6%	52.0%
Federal civilian agencies	51.5	42.9	51.6	44.3
Commercial entities	1.7	3.9	1.8	3.7
Total revenue	100.0%	100.0%	100.0%	100.0%

For the three and nine months ended September 24, 2005 we had one contract that generated more than 10% of our revenue. For the three and nine months ended September 24, 2005, our C4I2TSR contract with the U.S Air Force Space Command represented approximately 19.4% and 18.0% of our revenue, respectively. The C4I2TSR contract represented approximately 21.0% of our revenue for the three months ended September 25, 2004 and 15.5% of revenue for the first nine months of 2004.

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):

	September 24, 2005	December 25, 2004
Deferred loan costs	$ 4,968	$ 1,737
Accumulated amortization	(1,350)	(837)
	$ 3,618	$ 900

Fair value of financial instruments

The Company s financial instruments consist primarily of cash and cash equivalents, accounts receivable, accounts payable, credit facilities, and notes payable. In management s opinion, the carrying amounts of these financial instruments approximate their fair values at September 24, 2005 and December 25, 2004.

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 25, 2004 and has adopted the interim disclosure provisions for its financial reports for the quarter and nine months ended September 24, 2005.

	Three Months Ended		Nine Months Ended	
	September 24, 2005	September 25, 2004	September 24, 2005	September 25, 2004
Net income - as reported	$ 4,578	$ 2,882	$ 11,837	$ 7,922
Add: total stock-based employee compensation expense as reported under intrinsic value method (APB No. 25) for all awards, net of tax	19	19	56	59
Deduct: Total stock-based compensation expense determined under fair value based method (SFAS No. 123) for all awards, net of tax	(790)	(528)	(2,166)	(1,567)
Net income - pro forma	$ 3,807	2,373	$ 9,727	6,414
Basic earnings per share - as reported	$ 0.41	0.34	$ 1.06	0.94
Diluted earnings per share - as reported	$ 0.39	0.33	$ 1.02	0.89
Basic earnings per share - pro forma	$ 0.34	0.28	$ 0.87	0.76
Diluted earnings per share - pro forma	$ 0.33	0.27	$ 0.84	0.72

Earnings per share

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

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

	Three Months Ended		Nine Months Ended	
	September 24, 2005	September 25, 2004	September 24, 2005	September 25, 2004
Net Income - Basic and Diluted	$ 4,578	$ 2,882	$ 11,837	$ 7,922
Weighted average share calculation:				
Basic weighted average shares outstanding	11,227	8,483	11,140	8,471
Treasury stock effect of stock options	471	357	455	426
Diluted weighted average shares outstanding	11,698	8,840	11,595	8,897

Reclassifications

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

New accounting pronouncements

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

As permitted by Statement 123, the Company currently accounts for share-based payments to employees using Opinion 25 s intrinsic value method and, as such, generally recognizes no compensation cost for employee stock options. Accordingly, the adoption of Statement 123(R) s fair value method will have a significant impact on our results of operations, although it will have no impact on our overall financial position. The impact of adoption of Statement 123(R) cannot be predicted at this time because it will depend on levels of share-based payments granted in the future. However, had we adopted Statement 123(R) in prior periods, the impact of that standard would have approximated the impact of Statement 123 as described in the disclosure of pro forma net income and earnings per share in the Stock-Based Compensation section of this note to our consolidated financial statements. Statement 123(R) also requires the benefits of tax deductions in excess of recognized compensation cost to be reported as a financing cash flow, rather than as an operating cash flow as required under current literature. This requirement will reduce net operating cash flows and increase net financing cash flows in periods after adoption.

In July 2005, the FASB issued an Exposure Draft of a proposed Interpretation, *Accounting for Uncertain Tax Positions an Interpretation of FASB Statement No. 109*. The proposed Interpretation (if adopted in its current form) would apply to all open tax positions accounted for in accordance with FAS 109, *Accounting for Income Taxes,* including those acquired in business combinations. Under the proposed Interpretation, the recognition of a tax benefit would occur when it is probable that the position would be sustained upon audit. The proposed Interpretation refers to FASB Statement No. 5, *Accounting for Contingencies,* definition of probable, which represents a level of assurance that is substantially higher than more likely than not. The Board noted that, in determining if the probable threshold has been met, it should be assumed that the taxing authority will examine the tax position. The proposed Interpretation differs from current rules which allow for the recognition of a tax benefit if it is more likely than not that the position would be sustained upon audit. The proposed Interpretation, as currently drafted (and if adopted) would be effective for fiscal years ending after December 15, 2005. It is not certain that the Interpretation will be adopted with the current effective date. Management is in the process of determining the effect of this proposal on its financial statements.

3. Acquisitions:

On February 9, 2005, we completed the purchase of Shenandoah Electronic Intelligence, Inc. (SEI). SEI is a provider of critical business process outsourcing primarily for the Department of Homeland Security (DHS). SEI s services include: data and records management; applications processing; file and mail management; analytical support services; and secure optical card processing.

As a result of this acquisition, we gained approximately 1,700 additional employees and increased our leased space to 28 offices and three warehouses at various U.S. locations for an aggregate of approximately 536,263 square feet in 15 states (including approximately 27,090 square feet that are sub-leased through the remaining terms of our primary leases).

Under the terms of the definitive stock purchase agreement, we acquired SEI for $75 million in cash, subject to certain adjustments totaling approximately $0.6 million. The transaction was funded through cash-on-hand and borrowings from a new $160 million credit facility, which replaced the Company s previous $80 million credit facility. The purchase price is subject to adjustment as a result of certain tax elections. The Company, in conjunction with the SEI stockholders, have made a 338(h)(10) tax election. The definitive stock purchase agreement also provides that the SEI stockholders will retain certain non-operating assets and contingent accounts receivable.

Approximately $53.4 million of the purchase consideration has been allocated to goodwill based primarily on the excess of the purchase price over the estimated fair value of net assets acquired, and approximately $12.2 million of the purchase price has been assigned to identifiable intangible assets on the basis of contractual customer relationships. The contractual customer relationships are being amortized using an accelerated method over their estimated remaining life of 14 years.

The total purchase price paid, including transaction costs of $1.0 million, has been preliminarily allocated as follows (in thousands):

Cash	$	2,958
Accounts receivable		12,093
Prepaid expense and other current assets		353
Property and equipment		331
Accounts payable & accrued expenses		(4,730)
Contractual customer relationships		12,200
Goodwill		53,432
Total consideration	$	76,637

On December 20, 2004, the Company completed the purchase of Bridge Technology Corporation, a provider of information technology and information management. The acquisition supports the company s strategic growth plan to broaden its customer base into the intelligence agencies, and strengthen its portfolio of mission-critical solutions. Under the terms of the acquisition agreement, the Company acquired Bridge Technology for $30 million, subject to working capital and other adjustments totaling approximately $1.7 million. Of the purchase price, $29.4 million was paid in cash and the $2.3 million was held as note payable to be paid in June, 2006. Approximately $26.2 million of the purchase consideration has been allocated to goodwill, and approximately $2.2 million of the purchase price has been assigned to identifiable intangible assets on the basis of contractual customer relationships. The contractual customer relationships are being amortized using an accelerated method over their estimated remaining life of 6 years.

On January 21, 2004, the Company completed the purchase of MATCOM International Corp., a provider of information technology, systems engineering, logistics, and training. Under the terms of the merger agreement, the Company acquired MATCOM for $65.8 million. Approximately $54.6 million of the purchase consideration has been allocated to goodwill, and approximately $5.0 million of the purchase price has been assigned to identifiable intangible assets on the basis of contractual customer relationships. The contractual customer relationships are being amortized using an accelerated method over their estimated remaining life of 11 years.

The following unaudited proforma combined condensed statements of operations (in thousands, except per share) set forth the consolidated results of operations of the Company for the three and nine months ended September 24, 2005 and September 25, 2004 as if the above described acquisitions had occurred at the beginning of each period presented. This unaudited proforma information does not purport to be indicative of the actual results that would actually have occurred if the combination had been in effect for the three and nine months ended September 24, 2005 and September 25, 2004.

	Three Months Ended		Nine Months Ended	
	September 24, 2005	**September 25, 2004**	**September 24, 2005**	**September 25, 2004**
Revenue	$ 101,775	$ 98,496	$ 289,900	$ 266,553
Net income	$ 4,578	$ 3,918	$ 11,785	$ 10,141
Diluted earnings per share	$ 0.39	$ 0.44	$ 1.02	$ 1.14

In accordance with the purchase accounting method, the operations of MATCOM, Bridge Technology and SEI have been included in the Company s statements of operations since the respective dates of acquisition.

4. Accounts receivable:

Accounts receivable consists of the following (in thousands):

	September 24, 2005	December 25, 2004
Billed accounts receivable	$ 41,167	$ 33,247
Unbilled accounts receivable:		
Currently billable	33,083	26,400
Unbilled retainages and milestone payments expected to be billed within the next 12 months	6,409	5,714
Indirect costs incurred and charged to cost-plus contracts in excess of provisional billing rates	1,643	1,493
Total unbilled accounts receivable	41,135	33,607
Allowance for doubtful accounts	(2,250)	(1,144)
Accounts receivable, net	$ 80,052	$ 65,710

The currently billable amounts included as unbilled accounts receivable as of September 24, 2005 represent amounts that are billed during the following quarter of the current year. They are billings for services rendered prior to quarter-end, which are billed once necessary billing data has been collected and an invoice is produced.

5. Property and equipment:

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

	September 24, 2005	December 25, 2004
Computers and equipment	$ 8,358	$ 8,007
Software	2,357	1,904
Furniture and fixtures	2,061	1,576
Leasehold improvements	1,329	1,086
	14,105	12,573
Less Accumulated depreciation and amortization	(8,776)	(7,602)
Property and equipment, net	$ 5,329	$ 4,971

Property and equipment includes assets financed under capital lease obligations of approximately $309,000 and $332,000, net of accumulated amortization, as of September 24, 2005 and December 25, 2004, respectively.

6. Accrued expenses and other current liabilities:

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

	September 24, 2005	December 25, 2004
Accrued vacation	$ 6,519	$ 4,955
Accrued compensation	9,754	3,550
Accrued bonus	4,919	2,875
Other accrued liabilities	4,931	3,934
Accrued expenses and other current liabilities	$ 26,123	$ 15,314

7. Debt:

Debt, which is included in current and long term liabilities in the accompanying balance sheets, consists of the following (in thousands):

	September 24, 2005	December 25, 2004
Credit facilities:		
Line of credit at December 25, 2004, bears interest at LIBOR plus 275 to 350 basis points or a specified base rate plus 170 to 250 basis points, interest due monthly, principal due January 21, 2008	$	$ 28,954
Term loan at September 24, 2005, bears interest at LIBOR plus 225 to 250 basis points or a specified base rate plus 125 to 150 basis points, interest due monthly, twenty three $250,000 consecutive quarterly principal payments starting on June 30, 2005, and a final $94.25 million principal payment on February 9, 2011	99,750	
Total debt*	$ 99,750	$ 28,954

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* Excludes $2.3 million note payable in connection with the Bridge Technology acquisition as described below.

Prior to the closing of the SEI acquisition, the credit facility (the 2004 credit facility) consisted of a $30.0 million term loan and a $50.0 million secured revolving credit arrangement. The 2004 credit facility was secured by a pledge of substantially all of our current and future tangible and intangible assets, as well as those of our current and future subsidiaries, including accounts receivable, inventory and capital stock of our existing and future subsidiaries. In addition, the Company was required to maintain compliance with financial and nonfinancial covenants, including the requirement to maintain certain leverage and fixed charge ratios, as defined in the credit agreement, as well as certain annual limits on our capital expenditures.

Contemporaneous with the closing of our acquisition of SEI on February 9, 2005, the Company amended and restructured its prior credit facility and increased its borrowing capacity to $160 million, which is comprised of a $60 million five-year revolving credit facility and a $100 million six-year term loan facility. Borrowings available under the amended credit facility were used to further the acquisitions of Bridge Technology and SEI. In addition, the amended and restructured credit facility provides that up to an additional $75 million in uncommitted incremental term loan funds are available to the Company upon its request at any time for up to two years from the amendment date from one or more of the lenders under the credit facility.

In connection with the amended credit facility, the Company incurred financing costs of $3.2 million. Such costs were capitalized as deferred financing costs on the balance sheet and are being amortized over the six year term of the new credit facility. As of September 24, 2005, the amounts outstanding under the term loan bore interest at LIBOR plus 250 basis points.

In connection with the Bridge Technology acquisition, the Company also has an outstanding note payable in the amount of $2.3 million, to be paid in June 2006, which is included in the accompanying balance sheet as Note payable former owner of acquired business.

8. Commitments and contingencies:

Leases

As of September 24, 2005, the Company had noncancelable operating leases, primarily for real estate, that expire over the next ten years. Rental expense during the quarter ended September 24, 2005 was approximately $2.0 million, compared to rental expense of approximately $1.6 million during the quarter ended September 25, 2004.

Contract cost audits

Payments to the Company on government cost reimbursable contracts are based on provisional or estimated indirect rates, which are subject to audit on an annual basis by the Defense Contract Audit Agency (DCAA). The cost audits result in the negotiation and determination of the final indirect cost rates that the Company may use for the period(s) audited. The final rates, if different from the provisional rates, may create an additional receivable or liability for the Company. The Company s revenue recognition policy calls for revenue recognized on all cost reimbursable government contracts to be recorded at provisional rates unless collectibility is reasonably assured for costs incurred at higher rates. To the extent the indirect rate differential creates a liability for the Company the differential is recognized as a reduction to revenue when identified.

Litigation and claims

From time to time, the Company is involved in litigation, claims and disputes that arise in the ordinary course of its business. In addition, the Company is subject to audit, review, and investigation by various agencies of the Federal government to determine compliance with applicable federal statutes and regulations. As a Federal government contractor, the Company is subject to audit by certain federal agencies to determine if the Company s performance and administration of its government contracts are compliant with contractual requirements and applicable federal statutes and regulations. While the Company cannot predict the ultimate outcome of legal proceedings, government audits, investigations, claims and disputes to which it is or may be subject, the Company currently believes, based upon information available to us as of the date of this filing, that any ultimate liability arising out of these matters will not have a material adverse effect on our financial position, results of operations, or cash flows.

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

9. Stockholders equity:

Stock option plan

In 2002, the Company adopted the 2002 Stock Incentive Plan, or the Plan, to grant stock options to purchase up to 1,600,000 shares of its common stock to its employees and employees of its affiliates. In March 2004, the Board of Directors increased the number of reserved shares by 160,000, so that the total number of reserved shares totaled 1,760,000. In March 2005, the Board of Directors increased the number of reserved shares by an additional 160,000 so that the total number of reserved shares totals 1,920,000. Further, in March 2005, the Board of Directors authorized the acceleration of vesting of certain stock awards under the Plan upon the occurrence of certain change of control events. With this change, future stock awards may include provisions for acceleration of vesting upon the occurrence of certain change of control events. The Board of Directors also authorized the amendment of certain prior stock option awards issued under the Plan such that the exercise price of each such award was greater than or equal to the closing market price of our common stock on Nasdaq as of March 11, 2005. With respect to such designated prior stock option awards, the Board of Directors authorized an amendment to the stock option award to provide for the acceleration of vesting upon the occurrence of certain change of control events.

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

As of September 24, 2005, the Company had issued and outstanding 1,534,225 stock options, and had 240,831 shares previously exercised pursuant to stock option grants, for a total of 1,775,056 shares exercised or stock options issued and outstanding under the Amended and Restated Plan against a ceiling of 2,920,000 shares of common stock authorized under this plan. As of September 24, 2005, the Company has issued and outstanding 107,622 stock options under stock option plans other than the Amended and Restated Plan. All such grants were made prior to the Company s initial public offering in November 2002, and no further grants will be made under these plans.

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

The following discussion and analysis should be read in conjunction with the consolidated financial statements and related notes included elsewhere in this Form 10-Q. This discussion and analysis contains forward-looking statements that involve known and unknown risks, uncertainties, and other factors that may cause our actual results, level of activity, performance or achievements to be materially different from any future results, levels of activity, performance or achievements expressed or implied by such forward-looking statements. In some cases, you can identify these statements by forward-looking words such as anticipate, believe, could, estimate, expect, intend, may, plan, potential, should, will, and would or similar words. You should read statements that contain these words carefully because they discuss our future expectations, contain projections of our future results of operations or of our financial position, or state other forward-looking information. We believe that it is important to communicate our future expectations to our investors. However, there may be events in the future that we are not able to predict accurately or control. In particular, statements that we make in this section relating to the sufficiency of anticipated sources of capital to meet our cash requirements are forward- looking statements. Our actual results could differ materially from those anticipated in these forward-looking statements for many reasons, including as a result of some of the factors described below, elsewhere in this Form 10-Q and in the section entitled Risk Factors in our Form 10-K for the fiscal year ended December 25, 2004. You should not place undue reliance on these forward-looking statements, which apply only as of the date of the filing of this Form 10-Q.

Our fiscal year is based on the calendar year and ends each year on the Saturday nearest, but not falling after, December 31 of that year, and our fiscal quarter end on the Saturday nearest but prior to the applicable quarterly month end. As a result, our fiscal year may be comprised of 52 or 53 weeks. The fiscal quarters and nine-month periods presented in this Form 10-Q include 13 weeks and 26 weeks, respectively.

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

Overview

We are a provider of information technology and network solutions to the Federal government. Our clients include U.S. Air Force Space Command, the Department of State, the U.S. Army, the Department of Homeland Security, Federal Retirement Thrift Investment Board, the National Institutes of Health, the Department of Agriculture, U.S. Air Force Electronic Systems Center, the U.S. Navy and the intelligence community. We combine our technology and industry expertise to provide a full spectrum of state-of-the-practice solutions and services, from design and development to implementation and operations, which assist our clients in achieving mission success.

In the three and nine months ended September 24, 2005, we received 98.3% and 98.2%, respectively, of our revenues from services we provided to various departments and agencies of the Federal government and 1.7% and 1.8%, respectively, of our total revenues from work performed for commercial entities. In comparison, for the three months and nine months ended September 25, 2004, we received 96.1% and 96.3%, respectively, of our revenues from services we provided to Federal government agencies and 3.9% and 3.7%, respectively, of total revenues from work performed for commercial entities. The following table shows our revenues from the client groups listed as a percentage of total revenue. Revenue data for the Department of Defense includes revenue generated from work performed under engagements for both the Department of Defense and the intelligence community.

	Three Months Ended		Nine Months Ended	
	Sept. 24, 2005	Sept. 25, 2004	Sept. 24, 2005	Sept. 25, 2004
Department of Defense	46.8%	53.2%	46.6%	52.0%
Federal civilian agencies	51.5%	42.9%	51.6%	44.3%
Commercial entities	1.7%	3.9%	1.8%	3.7%
Total revenue	100.0%	100.0%	100.0%	100.0%

We have derived a substantial majority of our revenues from governmental contracts under which we act as a prime contractor. We also provide services indirectly as a subcontractor. We intend to focus on retaining and increasing the percentage of our business as prime contractor because it provides us with stronger client relationships. The following table shows our revenues as prime contractor and as subcontractor as a percentage of our total revenue for the following periods:

	Three Months Ended		Nine Months Ended	
	Sept. 24, 2005	Sept. 25, 2004	Sept. 24, 2005	Sept. 25, 2004
Prime contract revenue	74.8%	81.2%	74.7%	79.9%
Subcontract revenue	25.2%	18.8%	25.3%	20.1%
Total revenue	100.0%	100.0%	100.0%	100.0%

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

	Three Months Ended		Nine Months Ended	
	Sept. 24, 2005	Sept. 25, 2004	Sept. 24, 2005	Sept. 25, 2004
Cost reimbursable	29.5%	33.3%	28.4%	28.5%
Time and materials	44.5%	46.6%	48.8%	48.1%
Fixed price	26.0%	20.1%	22.8	