

WIRELESS FACILITIES INC
Form 10-Q
November 09, 2006

UNITED STATES SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES
EXCHANGE ACT OF 1934 FOR THE QUARTERLY PERIOD ENDED SEPTEMBER 30, 2006

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

Commission file number 0-27231

WIRELESS FACILITIES, INC.

(Exact name of Registrant as specified in its charter)

Delaware
(State or other jurisdiction of
incorporation or organization)

13-3818604
(I.R.S. Employer
Identification No.)

4810 Eastgate Mall

San Diego, CA 92121

(858) 228-2000

(Address, including zip code, and telephone number, including
area code, of Registrant's principal executive offices)

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer or a non-accelerated filer (as defined in Rule 12b-2 of the Exchange Act):

Large Accelerated Filer

Accelerated Filer

Non-Accelerated Filer

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

As of November 2, 2006, 73,883,950 shares of the registrant's common stock were outstanding.

WIRELESS FACILITIES, INC.
 FORM 10-Q
 FOR THE QUARTERLY PERIOD ENDED SEPTEMBER 30, 2006
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PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

WIRELESS FACILITIES, INC.
CONSOLIDATED BALANCE SHEETS
(in millions, except par value and number of shares)
(Unaudited)

	December 31, 2005	September 30, 2006
Assets		
Current assets:		
Cash and cash equivalents	\$ 12.9	\$ 12.9
Accounts receivable, net	109.6	107.8
Note receivable		9.6
Prepaid expenses	2.3	3.0
Employee loans and advances, net	0.4	0.3
Other current assets	4.6	7.8
Current assets of discontinued operations	46.7	0.6
Total current assets	176.5	142.0
Property and equipment, net	14.6	16.1
Goodwill	119.9	119.9
Other intangibles, net	7.4	6.1
Deferred tax assets	13.2	12.9
Investments in unconsolidated affiliates	2.1	2.1
Other assets	0.9	0.8
Non current assets of discontinued operations	1.7	
Total assets	\$ 336.3	\$ 299.9
Liabilities and Stockholders' Equity		
Current liabilities:		
Accounts payable	\$ 22.9	\$ 18.8
Accrued expenses	18.0	13.3
Accrued compensation	13.0	15.5
Accounts payable - related party	0.8	
Line of credit		8.0
Billings in excess of costs on completed contracts	4.3	4.0
Deferred tax liabilities	0.9	
Tax contingencies	1.8	1.7
Accrual for contingent acquisition consideration	8.2	0.1
Accrual for unused office space	0.5	0.3
Income taxes payable	2.0	2.5
Capital lease obligations and other short-term debt	0.3	0.3
Current liabilities of discontinued operations	30.1	0.5
Total current liabilities	102.8	65.0
Capital lease obligations and debt, net of current portion	0.4	0.2
Accrual for unused office space, net of current portion	1.2	1.0
Other liabilities	1.3	1.2
Other long term liabilities of discontinued operations	0.3	0.2
Total liabilities	106.0	67.6
Commitments and contingencies (Notes 7 and 11)		
Stockholders' equity:		
Preferred stock, 5,000,000 shares authorized, Series B Convertible Preferred Stock, \$.001 par value; 25,483 and 10,000 shares outstanding at December 31, 2005 and September 30, 2006, respectively (liquidation preference \$12.7 and \$5.0, respectively)		
Common Stock, \$.001 par value, 195,000,000 shares authorized; 72,188,449 and 73,883,950 shares issued and outstanding at December 31, 2005 and September 30, 2006, respectively		
Additional paid-in capital	324.9	327.8
Accumulated deficit	(91.7)	(94.0)
Accumulated other comprehensive loss	(2.9)	(1.5)
Total stockholders' equity	230.3	232.3
Total liabilities and stockholders' equity	\$ 336.3	\$ 299.9

See accompanying notes to unaudited consolidated financial statements.

WIRELESS FACILITIES, INC.
CONSOLIDATED STATEMENTS OF OPERATIONS
(in millions, except per share amounts)
(Unaudited)

	Three months ended September 30,		Nine months ended September 30,	
	2005	2006	2005	2006
Revenues	\$ 94.5	\$ 84.3	\$ 280.5	\$ 254.4
Cost of revenues	74.3	69.0	217.7	209.3
Gross profit	20.2	15.3	62.8	45.1
Selling, general and administrative expenses	17.2	16.1	51.2	47.2
Contingent acquisition consideration	(2.5)		(2.5)	0.1
Operating income (loss)	5.5	(0.8)	14.1	(2.2)
Other income (expense), net:				
Interest income, net		0.1	0.2	0.5
Foreign currency loss	(0.1)		(0.2)	(0.2)
Other expenses, net			(0.3)	
Other income (expense), net	(0.1)	0.1	(0.3)	0.3
Income (loss) before provision for income taxes	5.4	(0.7)	13.8	(1.9)
Provision for income taxes	0.7	0.4	3.9	0.6
Income (loss) from continuing operations	4.7	(1.1)	9.9	(2.5)
Income from discontinued operations	0.5	0.2	2.2	0.2
Net income (loss)	\$ 5.2	\$ (0.9)	\$ 12.1	\$ (2.3)
Basic earnings (loss) per common share:				
Income (loss) from continuing operations	\$ 0.06	\$ (0.01)	\$ 0.13	\$ (0.03)
Income from discontinued operations	0.01	0.00	0.03	0.00
Net income (loss)	\$ 0.07	\$ (0.01)	\$ 0.16	\$ (0.03)
Diluted earnings (loss) per common share:				
Income (loss) from continuing operations	\$ 0.06	\$ (0.01)	\$ 0.13	\$ (0.03)
Income from discontinued operations	0.01	0.00	0.03	0.00
Net income (loss)	\$ 0.07	\$ (0.01)	\$ 0.16	\$ (0.03)
Weighted average common shares outstanding:				
Basic	74.2	73.9	74.0	73.3
Diluted	75.3	73.9	75.4	73.3

See accompanying notes to unaudited consolidated financial statements.

WIRELESS FACILITIES, INC.
CONSOLIDATED STATEMENTS OF CASH FLOWS
(in millions)
(Unaudited)

	Nine months ended September 30,	
	2005	2006
Operating activities:		
Net income (loss) from continuing operations	\$ 9.9	\$ (2.5)
Adjustments to reconcile net income to net cash provided by (used in) operating activities:		
Depreciation and amortization	5.9	6.1
Deferred income taxes	4.3	(0.6)
Net loss on disposition of fixed assets	0.6	0.3
Stock-based compensation	0.1	2.4
Changes in assets and liabilities, net of acquisitions:		
Accounts receivable	(3.7)	1.8
Prepaid expenses	(1.3)	(0.7)
Other assets	(2.5)	(2.9)
Accounts payable	(1.7)	(4.9)
Accrued expenses	5.0	(4.7)
Accrued compensation	5.5	2.5
Tax contingencies	0.1	(0.1)
Accrued contingent acquisition consideration	(2.5)	0.3
Billings in excess of costs on completed contracts	(1.2)	(0.3)
Accrual for unused office space	(0.7)	(0.4)
Income tax payable	(1.7)	0.5
Other liabilities	(0.1)	(0.1)
Net cash provided by (used in) continuing operations	16.0	(3.3)
Investing activities:		
Sale/maturity of short-term investments	7.6	
Cash paid for contingent acquisition consideration	(16.0)	(8.4)
Proceeds from the disposition of discontinued operations		9.3
Cash paid for acquisitions, net of cash acquired	(33.4)	
Capital expenditures	(5.7)	(6.5)
Net cash used in investing activities from continuing operations	(47.5)	(5.6)
Financing activities:		
Proceeds from issuance of common stock	1.7	0.5
Proceeds from issuance of common stock under employee stock purchase plan	1.8	
Borrowings under line of credit		12.0
Repayment under line of credit		(4.0)
Repayment of capital lease obligations	(0.3)	(0.2)
Net cash provided by financing activities from continuing operations	3.2	8.3
Cash flows of discontinued operations (Revised see Note 1(l))		
Operating cash flows	(8.0)	(0.7)
Investing cash flows	(0.8)	
Net cash flows of discontinued operations	(8.8)	(0.7)
Effect of exchange rate on cash and cash equivalents	0.4	1.3
Net decrease in cash and cash equivalents	(36.7)	0.0
Cash and cash equivalents at beginning of period	52.0	12.9
Cash and cash equivalents at end of period	\$ 15.3	\$ 12.9

See accompanying notes to unaudited consolidated financial statements.

WIRELESS FACILITIES, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

(1) Organization and Summary of Significant Accounting Policies

(a) Description of Business

Wireless Facilities, Inc. (WFI) was initially incorporated in the state of New York on December 19, 1994, commenced operations in March 1995 and was reincorporated in Delaware in 1998. WFI conducts business in three segments: Wireless Network Services, Government Network Services and Enterprise Network Services. WFI is an independent, global provider of outsourced communications and security systems engineering and integration services for the wireless communications industry through its Wireless Network Services division (WNS), the U.S. government through its Government Network Services division (GNS) (which is operated through WFI s wholly-owned subsidiary, WFI Government Services, Inc.), and enterprise customers through its Enterprise Network Services division (ENS).

(b) Basis of Presentation

The information as of September 30, 2006, and for the three months and nine months ended September 30, 2005 and 2006 is unaudited. In the opinion of management, these unaudited consolidated financial statements include all adjustments, consisting of normal recurring adjustments, necessary for a fair presentation of our financial position, results of operations and cash flows for the interim periods presented. The results have been prepared in accordance with the instructions to Form 10-Q and do not necessarily include all information and footnotes necessary for presentation in accordance with accounting principles generally accepted in the United States. These unaudited consolidated financial statements should be read in conjunction with the consolidated financial statements and the related notes included in WFI s annual consolidated financial statements for the year ended December 31, 2005, filed on Form 10-K on April 3, 2006 with the United States Securities and Exchange Commission. Interim operating results are not necessarily indicative of operating results expected in subsequent periods or for the year as a whole.

(c) Principles of Consolidation

The consolidated financial statements include the accounts of WFI and its wholly-owned and majority-owned subsidiaries. WFI and its subsidiaries are collectively referred to herein as the Company.

In 2003, the Company acquired three privately-held companies as part of its Enterprise Network Solutions segment (now Enterprise Network Services) which provides voice, data, security, system design, deployment, integration and monitoring for enterprise networks. In 2004, the Company acquired two privately-held companies as part of its Government Network Services segment which provides systems engineering, systems integration and the outsourcing of technical services such as operational test and evaluation and program management. In 2005, the Company acquired one privately-held company as part of its Government Network Services segment which provides services including network engineering, network infrastructure support, information assurance, application development, and managed services, including network maintenance and monitoring, to government agencies. See Note 6 for additional details regarding these acquisitions.

All inter-company transactions have been eliminated in consolidation. Investments in unconsolidated affiliates are accounted for using the cost method and equity method. The cost method is used for companies in which the Company owns less than 20% and for which the Company has no significant influence.

(d) Fiscal Calendar

On November 7, 2006, the Board of Directors (the Board) of the Company approved a change in the fiscal year end from the last Friday in December to December 31. Concurrently, the Board approved a change in the interim fiscal periods to provide that the last day of the fiscal quarter shall be the last day of the calendar month of each quarter. As a result, the third fiscal quarter of fiscal 2006, which would have ended on September 29, 2006, ended as of September 30, 2006. Prior to this change in fiscal year, the Company operated and reported using a 52-53 week fiscal year ending the last Friday in December. As a result, a fifty-third week was added every five or six years. Under the prior reporting system, each 52 week fiscal year consisted of four equal quarters of 13 weeks each, and each 53 week fiscal year consists of three 13 week quarters and one 14 week quarter. The change in fiscal year and interim fiscal periods will not be applied to periods prior to the quarter ended September 30, 2006, and, consistent with prior reports, all prior fiscal periods presented or discussed in this report have been presented as ending on the last day of the nearest calendar month. In reliance on Exchange Act Release No. 26589, the Company will not file a transition report covering the transition period from December 30, 2006 to December 31, 2006.

(e) Inventory

Inventories are stated at the lower of cost or market and are included in other current assets in the accompanying balance sheets. The Company regularly reviews inventory quantities on hand, future purchase commitments with its suppliers, and the estimated utility of its inventory. If the Company review indicates a reduction in utility below carrying value, it reduces its inventory to a new cost basis. As of September 30, 2006 and December 31, 2005, the Company had \$2.2 million and \$1.1 million, respectively, of inventories which were reflected in Other Current Assets on the Consolidated Balance Sheet.

(f) Revenue Recognition

The Company provides services to customers under three primary types of contracts: fixed-price; time and materials; and cost reimbursement. The Company realizes a significant portion of its revenue from long-term contracts and accounts for these contracts under the provisions of Statement of Position (SOP) 81-1, Accounting for Performance of Construction-Type and Certain Production-Type Contracts. Revenue on fixed-price contracts is recognized using the percentage-of-completion method of accounting based on the ratio of total costs incurred to date compared to estimated total costs to complete the contract. Estimates of costs to complete include materials, direct labor, overhead, and allowable general and administrative expenses (for government contracts). While the Company generally does not incur a material amount of set-up fees for its projects, such costs, if any, are excluded from the estimated total costs to complete the contract. Cost estimates are reviewed monthly on an individual contract basis, and are revised periodically throughout the life of the contract such that adjustments to profit resulting from revisions are made cumulative to the date of the revision. In certain instances in which the Company is awarded work on a phase by phase basis rather than on a total project basis such as the Company's large deployment program, it is impractical to estimate the final outcome of the project margin, but it is certain that the Company will not incur a loss on the project, the Company may record revenue equal to cost incurred, at a zero profit margin. In the event that the cost incurred to date may be in excess of the funded contract value, the Company may defer those costs until the associated contract value has been funded by the customer. As of September 30, 2006, the Company deferred costs of \$1.0 million in excess of funded contract value and has recorded this amount in other current assets. There was no comparable balance as of December 31, 2005. Once the estimate of the final outcome of the project margin is determined, the Company will record revenue using the percentage-of-completion method of accounting based on the ratio of total costs incurred to date compared to the estimated total costs to complete the project. The full amount of an estimated loss associated with a contract is accrued and charged to operations in the period it is determined that it is probable a loss will be realized from the performance of the contract.

Significant management judgments and estimates, including the estimated costs to complete projects, which determine the project's percentage of completion and profit margin must be made and used in connection with the revenue recognized in any accounting period. In the future, the Company may realize actual results that differ from current estimates and the differences could be material.

Accordingly, the revenue the Company recognizes in a given financial reporting period depends on (1) the costs the Company has incurred for individual projects, (2) the Company's then current estimate of the total remaining costs to complete the individual projects and (3) current estimated contract value associated with the projects. In the Company's wireless network services business, the estimated contract value and costs are impacted by the estimated number and mix of site types that we may be assigned. If, in any period, we significantly increase or decrease our estimate of the total costs to complete a project, and/or reduce or increase the associated contract value, revenue for that period would be impacted. To the extent that the Company's estimates fluctuate over time or differ from actual results, gross margins in subsequent periods may vary significantly from previous estimates. Material differences may result in the amount and timing of the Company's revenue for any period if management made different judgments or utilized different estimates. In the event the Company is unable to provide reliable cost estimates on a given project, the Company records revenue using the completed contract method. There are no contracts for which the Company utilized the completed contract method for the quarter and nine months ended September 30, 2006 and September 30, 2005.

Many of the Company's contracts are master service agreements under which the Company is contracted to provide services to deploy a pre-determined and specific number of sites in specific geographic markets. These agreements are typically recognized on multiple projects to account for revenue under the combination or segmentation guidelines of SOP 81-1. These contractual arrangements with the Company's customers typically include milestone billings. The milestone billing clauses relate specifically to the timing of customer billings and payment schedules, and are independent of the Company's right to payment and the timing of when revenue is recognized. Under the terms of substantially all of the Company's contracts, if a contract is terminated without proper cause by the customer, if the customer creates unplanned/unreasonable time delays, or if the customer modifies the contract tasks/scope, the Company has contractual rights to reimbursement in accordance with the terms and conditions regarding payment for work performed, but not yet billed (i.e., unbilled trade accounts receivable) at a gross profit margin that is consistent with the overall project margin. Furthermore, certain additional provisions compensate the Company for additional or excess costs incurred, whereby any scope reductions (i.e., reduction in original number of sites awarded) or other modifications are subject to reimbursement of costs incurred to date with a reasonable profit margin based on the contract value and completed work at that time. The inherent aforementioned risks associated with the presence of potential partial milestone billings or reductions in scope are reflected in the Company's ongoing periodic assessment of the total contract value and the associated revenue recognized. Total net unbilled accounts receivable at December 31, 2005 and September 30, 2006 were \$51.0 million and \$50.4 million, respectively. The Company periodically performs work under authorizations to proceed or work orders from its customers for which a formal purchase order may not be received until after the work has commenced. As of September 30, 2006, approximately \$7.6 million of the Company's unbilled accounts receivable balance were under unapproved change orders or claims. The Company expects that substantially all of the unbilled balances as of December 31, 2005 and September 30, 2006 will be billed within one year as billing and performance milestones are achieved.

Revenue from certain time and materials and fixed-price contracts are recognized when realized or realizable and earned, in accordance with Staff Accounting Bulletin (SAB) 101, as revised by SAB 104 (recognized when services are rendered at contracted labor rates, when materials are delivered and when other direct costs are incurred). Additionally, based on management's periodic assessment of the

collectibility of its accounts receivable, credit worthiness and financial condition of customers, the Company determines if collection is reasonably assured prior to the recognition of revenue.

The Company's government network services business with the U.S. government and prime contractors to the U.S. government is generally performed under cost reimbursable plus fixed fee, fixed-price or time and material contracts. Cost reimbursable contracts for the government provide for reimbursement of costs plus the payment of a fee. The Company records the fee as costs are incurred. Under fixed-price contracts, the Company agrees to perform certain work for a fixed price. Under time and materials contracts, the Company is reimbursed for labor hours at negotiated hourly billing rates and is reimbursed for travel and other direct expenses at actual costs plus applied general and administrative expenses. Under certain of the Company's contractual arrangements, the Company may also recognize revenue for out-of-pocket expenses in accordance with EITF 01-14 Income Statement Characterization of Reimbursements Received for Out-of-Pocket Expenses Incurred. Depending on the contractual arrangement, these expenses may be reimbursed with or without a fee.

Under certain of its contracts, the Company provides supplier procurement services and materials for its customers. The Company records revenue on these arrangements on a gross or net basis in accordance with EITF 99-19, Reporting Revenue Gross as a Principal versus Net as an Agent, depending on the specific circumstances of the arrangement. The Company considers the following criteria, among others, for recording revenue on a gross or net basis:

- (1) Whether the Company acts as a principal in the transaction;
- (2) Whether the Company takes title to the products;
- (3) Whether the Company assumes risks and rewards of ownership, such as risk of loss for collection, delivery or returns;
- (4) Whether the Company serves as an agent or broker, with compensation on a commission or fee basis; and
- (5) Whether the Company assumes the credit risk for the amount billed to the customer subsequent to delivery.

(g) Income Taxes

The Company records deferred tax assets and liabilities for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases and operating loss and tax credit carryforwards. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be realized. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enactment date.

The Company maintains a valuation allowance on the portion of the deferred tax assets for which it is more likely than not that the Company will not realize the benefits of these tax assets in future tax periods. The valuation allowance is based on estimates of future taxable income by tax jurisdiction in which the Company operates, the number of years over which the deferred tax assets will be recoverable, and scheduled reversals of deferred tax liabilities.

In assessing the realizability of deferred tax assets, management considers, on a periodic basis, whether it is more likely than not that some portion or all of the deferred tax assets will not be realized. For U.S. purposes, the Company is in a cumulative book tax profit position as of September 30, 2006 and consideration is given to future taxable income, including the reversal of temporary differences, in evaluating the recoverability of its U.S. deferred tax assets and the corresponding valuation allowance related to the assets. Unlike the Company's U.S. tax position, its foreign operations are in a cumulative

book loss position. Pursuant to the provisions of SFAS No. 109, Accounting for Income Taxes, limited consideration is given to the Company's future foreign income in determining the recoverability of its foreign deferred tax assets and the related valuation allowance. Accordingly, management believes the current valuation allowance on deferred tax assets is sufficient and properly stated at September 30, 2006.

(h) *Comprehensive Income (Loss)*

Comprehensive income (loss) consists of net income and other gains and losses affecting shareholders' investment that, under accounting principles generally accepted in the United States of America are excluded from net income (loss).

The components of other comprehensive income (loss) are as follows:

	For the Three Months Ended September 30		For the Nine Months Ended September 30	
	2005	2006	2005	2006
Net income (loss)	\$ 5.2	\$ (0.9)	\$ 12.1	\$ (2.3)
Foreign currency translation adjustment	0.7	0.2	0.7	1.4
Other comprehensive income	0.7	0.2	0.7	1.4
Comprehensive income (loss)	\$ 5.9	\$ (0.7)	\$ 12.8	\$ (0.9)

The following table summarizes the components of accumulated other comprehensive income (loss):

	December 31, 2005	September 30, 2006
Cumulative foreign currency translation adjustment	(2.9)	(1.5)
Accumulated other comprehensive (loss)	\$ (2.9)	\$ (1.5)

(i) *Stock-based Compensation*

Effective January 1, 2006, the Company adopted the provisions of Statement of Financial Accounting Standards No. 123R (SFAS 123R), Share-Based Payments, which requires the measurement and recognition of compensation expense for all share-based payment awards to employees and directors based on estimated fair values. SFAS 123R supersedes the Company's previous accounting methodology using the intrinsic value method under Accounting Principles Board Opinion APB No. 25, Accounting for Stock Issued to Employees. Under the intrinsic value method, no share-based compensation expense related to stock option awards granted to employees had been recognized in the Company's Consolidated Statements of Operations, as all stock option awards granted under the plans had an exercise price equal to or greater than the market value of the common stock on the date of grant. The Company has no awards with market or performance conditions.

The Company adopted SFAS 123R using the modified prospective transition method. Under this transition method, compensation expense recognized during the nine months ended September 30, 2006 included: (a) compensation expense for all share-based awards granted prior to, but not yet vested, as of December 31, 2005, based on the grant date fair value estimated in accordance with the original provisions of SFAS 123, and (b) compensation expense for all share-based awards granted subsequent to December 31, 2005, based on the grant date fair value estimated in accordance with the provisions of SFAS 123R. In accordance with the modified prospective transition method, the Company's consolidated financial statements for prior periods have not been restated to reflect the impact of SFAS 123R. The Company adopted SFAS 123R as of January 1, 2006 and had \$0.7 million and \$2.4 million related to non-vested equity awards that was expensed during the three and nine months ended September 30, 2006, respectively.

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The Company had the following three stock option plans under which shares were available for grant at September 30, 2006: the 1999 Equity Incentive Plan (the 1999 Plan), the 2000 Non-Statutory Stock Option Plan (the 2000 Plan) and the 2005 Equity Incentive Plan (the 2005 Plan).

The 1999 Plan permits the granting of incentive stock options or non-statutory stock options which are exercisable for up to ten years after the grant date. The 2000 Plan permits the granting of non-statutory stock options, which are exercisable for a period following the date of grant as determined by the Board of Directors (generally ten years). The 2005 Plan permits the granting of incentive stock options, non-statutory stock options and other types of grants or awards, which are exercisable for up to ten years after the grant date. All stock options granted under these plans are granted at the fair market value on the date of grant and historically options have been granted with vesting over a 4 year period. A cumulative total of 15.9 million, 6.5 million and 3.5 million of common stock have been authorized for issuance under the 1999 Plan, 2000 Plan and 2005 Plan, respectively.

In 2005, the Company accelerated options to avoid recognition of future compensation expense that the Company would have otherwise recognized in its Consolidated Statement of Operations with respect to these options upon the adoption of SFAS 123R. The future expense that was eliminated as a result of the acceleration of vesting of these options was approximately \$18.4 million. At the end of December 2005, vesting was accelerated for all options which had an exercise price per share equal to or greater than \$6.50. In addition, in December 2005, the Company repriced options to reduce future expense for those options with an exercise price per share greater than 120% of the closing market price of the Company's common stock on December 29, 2005.

The Company records compensation expense for employee stock options based on the estimated fair value of the options on the date of grant using the Black-Scholes option-pricing model and the weighted average assumptions (annualized percentages) included in the following table. Awards with graded vesting are recognized using the straight-line method. The weighted-average estimated fair value of employee stock options granted during the three and nine months ended September 30, 2006 was \$1.23 and \$2.47 per share, respectively.

	Three months ended		Nine months ended			
	September 30,		September 30,			
	2005	2006	2005	2006	2005	2006
Expected life:(1)						
Stock options	4 years	3.8 years	4 years	3.7 years		
Purchase plan	6 months		6 months			
Risk-free interest rate(2)	4.0	% 5.0	% 4.0	% 4.6		
Volatility(3)	73	% 58.9	% 73	% 61.6		
Forfeiture rate(4)	23.7		23.7			
Dividend yield(5)						

(1) The expected life of stock options granted under the Plans is based upon historical exercise patterns which the Company believes are representative of future behavior. The expected life of shares under the Purchase Plan represents the amount of time remaining in the offering period.

(2) The risk-free interest rate is based on U.S. Treasury yields in effect at the time of grant with a term equal to the expected term of the options.

(3) The Company estimates the implied volatility of its common stock at the date of grant based on an equally weighted average of trailing volatility and market based implied volatility for the computation.

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(4) Forfeitures are estimated at the time of grant based upon historical information. Forfeitures will be revised, if necessary, in subsequent periods if actual forfeitures differ from estimates. Previously, under APB25, the Company recognized forfeitures as they were incurred.

(5) The Company has no history or expectation of paying dividends on its common stock.

The following table shows the amounts recognized in the financial statements for the three and nine months ended September 30, 2006 for share-based compensation related to employees (in millions, except per share data). In addition, for the nine months ended September 30, 2006, there was no incremental tax benefit from stock options exercised in the period.

	Three months ended September 30, 2006	Nine months ended September 30, 2006
Cost of revenues	\$ 0.2	\$ 0.9
Selling, general and administrative	0.5	1.5
Total cost of employee share-based compensation included in operating loss, before income tax	0.7	2.4
Amount of income tax recognized in earnings		
Amount charged against income	\$ 0.7	\$ 2.4
Impact on net income (loss) per common share:		
Basic	\$ (0.01)	\$ (0.03)
Diluted	\$ (0.01)	\$ (0.03)

A summary of the status of the Company's stock option plan as of September 30, 2006 and of changes in options outstanding under the plan during the nine months ended September 30, 2006 is as follows:

	Number of Shares (000 s)	Weighted- Average Exercise Price per Share	Weighted- Average Remaining Contractual Term (in years)	Aggregate Intrinsic Value (000 s)
Options outstanding at December 31, 2005	13,193	\$ 6.17		
Options granted	512	5.00		
Options exercised	(147)	3.84		
Options forfeited or expired	(1,672)	6.49		
Options outstanding at September 30, 2006	11,886	\$ 6.10	6.9	\$ 36.4
Options vested and exercisable at September 30, 2006	9,281	\$ 6.18	6.4	\$ 36.4

As of September 30, 2006, there was \$7.5 million of unamortized compensation cost related to non-vested stock option awards, which is expected to be recognized over a remaining weighted-average vesting period of 2.6 years.

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For purposes of pro forma disclosures under SFAS 123 for the three and nine months ended September 30, 2005, the estimated fair value of share-based awards was assumed to be amortized to expense over the vesting period of the award. There is no pro forma presentation for the three and nine months ended September 30, 2006 as the Company adopted SFAS 123R as of January 1, 2006, as discussed above. The pro forma effects of recognizing estimated compensation expense under the fair value method on net income and earnings per common share were as follows (in millions, except per share data):

	Three months ended September 30, 2005	Nine months ended September 30, 2005
Net income	\$ 5.2	\$ 12.1
Add back: Actual stock-based compensation expense included in net earnings	0.0	0.1
Deduct: Total stock-based employee compensation expense determined under fair value based method for all awards	(7.3)	(13.9)
Pro forma net (loss)	\$ (2.1)	\$ (1.7)
Earnings (loss) per common share:		
Basic as reported	\$ 0.07	\$ 0.16
Basic pro forma	\$ (0.03)	\$ (0.02)
Diluted as reported	\$ 0.07	\$ 0.16
Diluted pro forma	\$ (0.03)	\$ (0.02)
Weighted average shares:		
Basic as reported and pro forma	74.2	74.0
Diluted as reported and pro forma	75.3	75.4

(j) *Use of Estimates*

The preparation of financial statements in conformity with Generally Accepted Accounting Principles in the United States (US GAAP) requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, the 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. Such estimates include revenue recognition, allowance for doubtful accounts, valuation of long-lived assets including identifiable intangibles and goodwill, accounting for income taxes including the related valuation allowance on the deferred tax asset, accruals for partial self-insurance, contingencies and litigation and contingent acquisition consideration. In the future, the Company may realize actual results that differ from the current reported estimates and if the estimates that we have used change in the future, such changes could have a material impact.

(k) *Reclassifications*

The accompanying statements of cash flows separately reflect the operating and investing portions of the cash flows attributable to the Company's discontinued operations for each of the periods presented. These amounts were reported on a combined basis as a single amount in prior statements of cash flows. In addition, the balance sheets and statements of operations have been reclassified to present the discontinued operations.

(2) **Recent Accounting Pronouncements**

In November 2005, the FASB issued Staff Position (FSP) FAS123R-3, Transition Election to Accounting for the Tax Effects of Share-Based Payment Awards. This FSP requires an entity to follow either the transition guidance for the additional-paid-in-capital pool as prescribed in SFAS No. 123R,

Share-Based Payment, or the alternative transition method as described in the FSP. An entity that adopts SFAS No. 123R using the modified prospective application may make a one-time election to adopt the transition method described in this FSP. An entity may take up to one year from the later of its initial adoption of SFAS No. 123R or the effective date of this FSP to evaluate its available transition alternatives and make its one-time election. This FSP became effective in November 2005. We continue to evaluate the impact that the adoption of this FSP could have on our financial statements.

In November 2005, the FASB issued FSP FAS115-1/124-1, The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments, which addresses the determination as to when an investment is considered impaired, whether that impairment is other than temporary, and the measurement of an impairment loss. This FSP also includes accounting considerations subsequent to the recognition of an other-than-temporary impairment and requires certain disclosures about unrealized losses that have not been recognized as other-than-temporary impairments. The guidance in this FSP amends FASB Statements No. 115, Accounting for Certain Investments in Debt and Equity Securities, and No. 124, Accounting for Certain Investments Held by Not-for-Profit Organizations, and APB Opinion No. 18, The Equity Method of Accounting for Investments in Common Stock. We adopted this FSP during the three months ended March 31, 2006 and it did not have a material impact on our financial statements.

In February 2006, the FASB issued FASB Statement No. 155, Accounting for Certain Hybrid Financial Instruments. This Statement amends FASB Statements No. 133, Accounting for Derivative Instruments and Hedging Activities, and No. 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities. This statement resolves issues addressed in Statement No. 133 Implementation Issue No. D1, Application of Statement 133 to Beneficial Interests in Securitized Financial Assets. This statement: (a) permits fair value remeasurement for any hybrid financial instrument that contains an embedded derivative that otherwise would require bifurcation, (b) clarifies which interest-only strips and principal-only strips are not subject to the requirements of Statement No. 133, (c) establishes a requirement to evaluate interests in securitized financial assets to identify interests that are freestanding derivatives or that are hybrid financial instruments that contain an embedded derivative requiring bifurcation, (d) clarifies that concentrations of credit risk in the form of subordination are not embedded derivatives, (e) amends Statement 140 to eliminate the prohibition on a qualifying special purpose entity from holding a derivative financial instrument that pertains to a beneficial interest other than another derivative financial instrument. This statement is effective for all financial instruments acquired or issued after the beginning of an entity's first fiscal year that begins after September 15, 2006. We do not expect this statement to have a material impact on the Company.

In March 2006, the FASB issued FASB Statement No. 156, Accounting for Servicing of Financial Assets. Statement 156 amends FASB Statement No. 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities, and requires all separately recognized servicing assets and servicing liabilities to be initially measured at fair value, if practicable, and permits an entity to subsequently measure those servicing assets and servicing liabilities at fair value. This statement is effective for fiscal years beginning after September 15, 2006. We do not expect this statement to have a material impact on the Company.

In July 2006, the FASB issued FASB Interpretation No. 48 (FIN 48) Accounting for Uncertainty in Income Taxes which prescribes a recognition threshold and measurement process for recording in the financial statements uncertain tax positions taken or expected to be taken in a tax return. Additionally, FIN 48 provides guidance on the derecognition, classification, accounting in interim periods and disclosure requirements for uncertain tax positions. The accounting provisions of FIN 48 will be effective for the Company beginning December 30, 2006. The Company is in the process of determining the effect, if any, the adoption of FIN 48 will have on its financial statements.

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In September 2006, the SEC issued Staff Accounting Bulletin No. 108, *Guidance re: the Use of a Cumulative Effect Adjustment to Correct Immaterial Misstatements* (SAB 108). SAB 108 expresses the SEC Staff's views regarding the process of quantifying financial statement misstatements. SAB 108 addresses the diversity in practice in quantifying financial statement misstatements and the potential under current practice for the build up of improper amounts on the balance sheet. SAB 108 will be effective for the Company for the year ending December 31, 2006. The cumulative effect of the initial application of SAB 108 will be reported in the carrying amounts of assets and liabilities as of the beginning of the fiscal year, with the offsetting balance to retained earnings. The Company is in the process of determining the impact, if any, the adoption of SAB 108 will have on its financial statements.

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements* (SFAS 157). This new standard provides guidance for using fair value to measure assets and liabilities and information about the extent to which companies measure assets and liabilities at fair value, the information used to measure fair value, and the effect of fair value measurements on earnings. This framework is intended to provide increased consistency in how fair value determinations are made under various existing accounting standards which permit, or in some cases require, estimates of fair market value. SFAS 157 also expands financial statement disclosure requirements about a company's use of fair value measurements, including the effect of such measures on earnings. The provisions of SFAS 157 are effective for financial statements issued for fiscal years beginning after November 15, 2007. While the Company is currently evaluating the provisions of SFAS 157, the adoption is not expected to have a material impact on its financial statements.

(3) Net Income (loss) Per Common Share

The Company calculates net income (loss) per share in accordance with the provisions of SFAS No. 128, *Earnings Per Share*. Under SFAS No. 128, basic net income (loss) per common share is calculated by dividing net income (loss) by the weighted-average number of common shares outstanding during the reporting period. The Company adopted EITF No. 03-6 *Participating Securities and the Two-Class Method Under FASB Statement No. 128* on January 1, 2005. In accordance with EITF No. 03-6, the Company determined that its Series B Convertible Preferred Stock were participating securities and therefore were required to be included in the weighted average basic shares if dilutive. Diluted net income (loss) per common share reflects the effects of potentially dilutive securities. Weighted average shares used to compute basic and diluted net income (loss) per share are presented below (in millions):

	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2005	2006	2005	2006
Net income (loss)	\$ 5.2	\$ (0.9)	\$ 12.1	\$ (2.3)
Shares used in basic per share amounts:				
Weighted average common shares outstanding	74.2	73.9	74.0	73.3
Shares used in diluted per share amounts:				
Dilutive effect of stock options	1.1		1.4	
Dilutive weighted average shares	75.3	73.9	75.4	73.3
Basic net income (loss) per share	\$ 0.07	\$ (0.01)	\$ 0.16	\$ (0.03)
Diluted net income (loss) per share	\$ 0.07	\$ (0.01)	\$ 0.16	\$ (0.03)
Anti-dilutive weighted shares from stock options excluded from calculation	9.3	11.9	6.2	12.4
Average per share market value of common stock	\$ 5.87	\$ 2.32	\$ 6.45	\$ 3.62
Average outstanding stock option price per share	\$ 8.38	\$ 6.21	\$ 8.38	\$ 6.21

(4) Significant Transactions

(a) Discontinued Operations Scandinavia

During the second quarter of 2004, the Company made the decision to sell or otherwise divest its Network Management business in Scandinavia, which had previously been reported in its Wireless Network Services segment. WFI determined that this entity met the criteria to classify it as held for sale. Accordingly, WFI has reflected this operation as discontinued in accordance with SFAS No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets. After actively marketing to sell this business for one quarter, the Company made the decision to wind-down this operation in the third quarter of 2004.

As of December 31, 2005 and September 30, 2006, there were zero assets of discontinued operations and \$0.1 million and \$0.05 million of liabilities of discontinued operations for December 31, 2005 and September 30, 2006, respectively.

(b) Discontinued Operations Latin American Operations

In December 2005, the Company's Board of Directors made the decision to exit the Company's Mexican operations and certain of its other deployment businesses in South America. Prior to this decision, these operations had been reported in its Wireless Network Services segment. The Company determined that these operations meet the criteria to be classified as held for sale. Accordingly, WFI has reflected these operations as discontinued in accordance with SFAS No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets. The South American operations were substantially shut down as of the end of December 2005.

On February 17, 2006, the Company entered into an Equity Purchase Agreement to sell all of the stock of its wholly owned subsidiaries (i) WFI de Mexico, S. de R.L. de C.V., (ii) WFI de Mexico, Servicios de Administracion, S. de R.L. de C.V., (iii) WFI de Mexico, Servicios de Ingenieria, S. de R.L. de C.V., (iv) WFI Services de Mexico S.A. de C.V., (v) WFI Asesoría en Administracion, S.C; and (vi) WFI Asesoría en Telecomunicaciones, S.C. (the Mexico Operations) to Sakoki LLC. The transaction closed on March 10, 2006. Refer to Note 10 Related Party Transactions for further discussion of the purchaser, Sakoki, LLC.

The Equity Purchase Agreement provides that the Company will receive total approximate cash consideration of \$18.0 million, subject to adjustment for the closing net asset calculation, with \$1.5 million payable in cash on signing of the equity Purchase Agreement and \$16.5 million payable by means of a secured promissory note payable in installments through December 31, 2006, subject to adjustments. The note is secured by pledges of assets and a personal guaranty. The total consideration approximates the net book value of operations, including \$13.2 million of contingent liabilities.

The final closing balance sheet as of February 17, 2006 resulted in net asset adjustments aggregating to a total approximate \$18.9 million consideration, \$1.5 million which was paid on February 17, 2006, with the remaining \$17.4 million payable by means of the promissory note in installments through December 31, 2006 with an interest rate of 7.5% per annum. On June 26, 2006, the Company entered into an Addendum with the buyer to finalize the closing net asset calculations, pursuant to which the parties agreed that the resulting total purchase price was \$18.9 million. The Addendum also provided for a conditional waiver that permits the purchaser to make the payment due on August 17, 2006 by September 29, 2006, and for the installments due on November 17, 2006 and December 31, 2006 to be made on or before December 29, 2006. Failure to make the payments on such later dates will result in a restoration of the original terms of the note. The first scheduled note payment of \$3.3 million was received from the buyer on May 19, 2006, and the second scheduled note payment of \$5.5 million was received in installments of \$5.2 million on September 29, 2006 and \$0.3 million on October 10, 2006. The remaining

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note receivable balance of \$9.6 million which includes accrued interest through September 30, 2006, and includes the \$0.3 million payment received on October 10, 2006, is reflected on the Company's Consolidated Balance Sheet as of September 30, 2006. The unpaid principal will continue to accrue interest at the rate of 7.5% per annum.

The impact of the divestiture has been reflected in the consolidated balance sheets as of September 30, 2006. There was no gain or loss realized on the sale since the business was sold at its net carrying value.

For the quarter ended September 30, 2006, our other discontinued operations in Latin America had revenues of \$0.6 million and a net income of \$0.2 million. For the nine months ended September 30, 2006, these operations had revenues of \$6.5 million and net income of \$0.2 million.

The components of the current and non-current assets and liabilities for the Latin American operations are included in the accompanying balance sheet as discontinued operations as of (in millions):

	December 31, 2005	September 30, 2006
Cash	\$ 3.2	\$ 0.4
Restricted cash	0.6	0.2
Accounts receivable, net	34.5	
Prepaid expenses	0.2	
Income tax receivable	2.3	
Other current assets	5.9	
Current assets of discontinued operations	\$ 46.7	\$ 0.6
Property, plant and equipment	\$ 1.5	\$
Other assets	0.2	
Non-current assets of discontinued operations	\$ 1.7	\$
Accounts payable	\$ (3.9)	\$ (0.2)
Accrued expenses	(6.6)	
Tax contingencies	(13.2)	
Billings in excess of cost	(0.6)	
Deferred tax liability	(0.1)	
Other current liabilities	(5.6)	(0.2)
Current liabilities of discontinued operations	\$ (30.0)	\$ (0.4)
Non-current liabilities of discontinued operations	\$ (0.3)	\$ (0.2)

The restricted cash of \$0.2 million, is a result of a 2005 regulation in Argentina that requires a percentage of each loan advanced by the Company to the Argentinean Subsidiary be held in a one-year fixed account at zero interest.

(5) Investments in Unconsolidated Affiliates

Tactical Survey Group, Inc. (TSG)

On February 23, 2004, the Company paid an additional \$1.0 million in cash to acquire an 11% interest in Tactical Survey Group, Inc. (TSG), a privately-held company that provides expertise in developing, deploying and integrating tactical survey systems for use in government and commercial applications. Pursuant to the provisions of APB Opinion No. 18, "The Equity Method of Accounting for Investments in Common Stock", this investment was accounted for under the equity method of accounting due to the presence of significant influence deemed to exist based on the significant number of contracts that the Company has entered into with TSG and the presence of a WFI employee on TSG's board of directors.

During the third quarter of 2006, TSG was awarded a prime contract from a government customer and the Company has entered into a subcontract agreement with TSG to support them on this government contract. As such, TSG is no longer considered a significant subcontractor to the Company. This factor, combined with the lack of current representation on TSG's board of directors resulted in the Company concluding effective September 29, 2006 that significant influence no longer existed. Accordingly, the investment in TSG no longer met the conditions for the use of the equity method of accounting and has been accounted for under the cost method effective September 29, 2006. There were no equity earnings related to this investment during the period this investment was accounted for under the equity method of accounting. The balance of the Company's investment in TSG at December 31, 2005 and September 30, 2006 totaled \$1.2 million and has been classified on the consolidated balance sheet under the caption Investments in unconsolidated affiliates.

The Company evaluates the realizability of its investment in TSG according to the provisions of APB Opinion No. 18 and EITF Issue 03-1. The Company periodically obtains and reviews the financial statements of TSG. Based on this review, and the facts listed above, there is no indication that a decrease in value of the TSG investment has occurred which is other than temporary and the Company has concluded that the carrying value of its investment in TSG has not been impaired as of September 29, 2006.

CommVerge Solutions, Inc.

The Company has an investment in CommVerge Solutions, Inc., a privately-held wireless network planning and deployment company. The balance of the Company's investment in CommVerge Solutions, Inc. at December 31, 2005 and September 30, 2006 totals \$0.9 million. This investment is accounted for under the cost method and has been classified on the consolidated balance sheet under the caption Investments in unconsolidated affiliates. One of the Company's directors is also a director of CommVerge Solutions, Inc.

Management periodically obtains and reviews the most recent financial performance and financial forecasts available from CommVerge which may include information regarding project status and current progress of the business. Based on this review, there is no indication that a decrease in value of the CommVerge investment has occurred which is other than temporary and the Company has concluded that the carrying value of its investment in CommVerge has not been impaired as of September 30, 2006.

(6) Acquisitions

The following table summarizes the changes in the carrying amounts of goodwill and other indefinite and finite-life intangible assets for the nine months ended September 30, 2006, are as follows (in millions):

	Wireless Network Services	Enterprise Network Services	Government Network Services	Total
Goodwill				
Balance as of December 31, 2005	\$ 25.5	\$ 18.3	\$ 76.1	\$ 119.9
Acquisition				
Accrual for contingent consideration				
Adjustment				
Balance as of September 30, 2006	25.5	18.3	76.1	119.9
Other intangibles, net				
Balance as of December 31, 2005		1.1	6.3	7.4
Acquisition				
Amortization expense		(0.2)	(1.1)	(1.3)
Balance as of September, 2006		0.9	5.2	6.1
Total goodwill and other intangibles, net	\$ 25.5	\$ 19.2	\$ 81.3	\$ 126.0

(7) Contingent Acquisition Consideration

In connection with certain business acquisitions, the Company may agree to make additional future payments to sellers contingent upon achievement of specific performance-based milestones by the acquired entities. Pursuant to the provisions of SFAS No. 141, such amounts are accrued, and therefore, recorded by the Company when the contingency is resolved beyond a reasonable doubt and, hence, the additional consideration becomes payable. A summary of the contingent acquisition consideration as of December 31, 2005 and September 30, 2006 is summarized in the following table.

Summary of Contingent Acquisition Consideration

	Suntech	Enco	DSI	Total
Balance as of December 31, 2005	6.9	0.8	0.5	8.2
(Release) accrual for contingent consideration	(0.1)	0.2	0.2	0.3
Payments	(6.8)	(0.9)	(0.7)	(8.4)
Balance as of September 30, 2006		0.1		0.1

Enterprise Network Services

During the three and nine months ended September 30, 2006, \$0.0 million and \$7.7 million, respectively, was paid to certain shareholders of the companies acquired in ENS. As of March 31, 2006, all earn-out performance periods have ended and there was no additional contingent consideration earned related to the ENS shareholders. The remaining balance of \$0.1 million as of September 30, 2006 is expected to be paid to the ENS shareholders in the fourth quarter of 2006.

Defense Systems, Incorporated

In connection with the Company's acquisition of Defense Systems, Incorporated (DSI) in August 2004, additional consideration of up to \$3.2 million could be earned by the former major stockholders of DSI over an 18 month period, based upon performance milestones related to certain

specified contracts. As of September 30, 2006, approximately \$2.8 million additional consideration had been earned and paid related to the contract milestones achieved by DSI. As of March 31, 2006, the performance period had ended and no further contingent consideration was due.

Madison Research Corporation

On October 2, 2006 the Company acquired Huntsville, Alabama based Madison Research Technology Corporation (MRC) as part of the Company's Government Network Services business. MRC offers a broad range of technical, engineering and IT solutions, and has developed core competencies in weapons system lifecycle support, integrated logistics, test and evaluation, commercial-off-the-shelf software and hardware selection and implementation, software development and systems lifecycle maintenance.

The purchase price was approximately \$69 million, subject to certain post-closing adjustments. The Company paid \$62.1 million at closing. The working capital adjustment due in December 2006 and the remaining \$6.9 million was held back to secure the Company's indemnity rights and will be released, subject to indemnity rights, in installments following 6, 12 and 18 months from the date of close. The Company entered into a new \$85 million credit facility with KeyBank National Association (KeyBank) to fund the acquisition, which replaced the Company's existing credit facility of \$15 million. Refer to Note 8 for further discussion. The results of operations of MRC will be included in the Company's consolidated statement of operations for the period from the acquisition date of October 2, 2006 in the Company's fourth quarter.

(8) Credit Agreement

On March 16, 2005, the Company entered into a credit agreement with KeyBank National Association (KeyBank) to provide a \$15.0 million senior credit facility. KeyBank was designated as the sole arranger and sole book manager. The facility had a 3-year term which could be expanded to a \$60.0 million credit facility. The Company intended to use the facility for general corporate purposes and to fund future acquisitions. As of September 30, 2006, \$8.0 million had been drawn to pay the contingent acquisition consideration payments due in the first two quarters of 2006. Interest on amounts outstanding under the credit facility accrued at the applicable margin over LIBOR or KeyBank's Prime Rate as determined by the credit agreement.

The terms of the original credit agreement required the Company to provide certain customary covenants for a credit agreement, including certain financial covenants. These financial covenants are computed as defined by the terms of the agreement. These financial covenants include a maximum senior leverage ratio of 1.5 to 1.0, a maximum total leverage ratio of 3.0 to 1.0, a minimum liquidity ratio of 1.35 to 1.0, and a minimum fixed charge coverage ratio of 1.25 to 1.0. As of September 30, 2006, the Company was in compliance with all covenants under this agreement.

On October 2, 2006, the Company entered into a new credit agreement with Key Bank to provide an \$85 million senior credit facility, which replaced the Company's existing \$15 million senior credit facility. The facility has a 5 year term with principal due in 2011 and interest payable on a monthly basis, and the facility can be expanded to a \$125 million credit facility to fund acquisitions. The capability to expand the facility to \$125 million is through December 31, 2006. The facility is collateralized by the assets of the Company. The Company has used the facility to fund its acquisition of Madison Research Corporation (MRC) and intends to use the facility for general corporate purposes and to fund future acquisitions. As of November 1, 2006, the Company has \$63 million drawn principally to fund the MRC acquisition and to extinguish the balance outstanding on the original facility.

The terms of the new credit agreement require the Company to provide certain customary covenants for a credit agreement, including certain financial covenants. These financial covenants are computed as defined by the terms of the agreement. These financial covenants include a maximum senior net debt

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leverage ratio of 4.0 to 1.0, a minimum liquidity ratio of 1.35 to 1.0, and a minimum fixed charge coverage ratio of 1.10 to 1.0.

(9) Segment Information

The Company organized its business along service lines to include three reportable segments: Wireless Network Services, Enterprise Network Services and Government Network Services. Revenues and operating income generated by the Company's reporting segments for the three and nine months ended September 30, 2005 and September 30, 2006 are as follows (in millions).

	Three months ended September 30,		Nine months ended September 30,	
	2005	2006	2005	2006
Revenues:				
Wireless Network Services	\$ 57.0	\$ 47.4	\$ 168.3	\$ 150.4
Enterprise Network Services	16.1	16.8	49.5	42.9
Government Network Services	21.4	20.1	62.7	61.1
Total revenues	\$ 94.5	\$ 84.3	\$ 280.5	\$ 254.4
Operating income (loss):				
Wireless Network Services	\$ (0.3)	\$ (2.4)	\$ 3.3	\$ (5.3)
Enterprise Network Services	3.7	(0.1)	4.8	(2.5)
Government Network Services	2.1	1.7	6.0	5.6
Total operating income (loss)	\$ 5.5	\$ (0.8)	\$ 14.1	\$ (2.2)

Revenues derived by geographic region are as follows (in millions):

	Three months ended September 30,		Nine months ended September 30,	
	2005	2006	2005	2006
Revenues:				
U.S.	\$ 86.7	\$ 78.0	\$ 251.5	\$ 233.9
Latin America	1.6	1.8	7.2	7.5
EMEA	6.2	4.5	21.8	13.0
Total revenues	\$ 94.5	\$ 84.3	\$ 280.5	\$ 254.4

The Company had sales to one customer totaling \$19.9 million (23.6%) and \$73.6 million (28.9%) of the Company's total revenues for the three and nine months ended September 30, 2006, respectively. Sales to this customer were \$27.5 million (29.1%) and \$72.5 million (25.8%) of the Company's total revenues for the three months and nine months ended September 30, 2005, respectively. The Company had sales to another customer totaling \$8.7 million (10.3%) and \$18.1 million (7.1%) of the Company's total revenues for the three and nine months ended September 30, 2006, respectively. Sales to this customer were \$4.6 million (4.9%) and \$9.4 million (3.4%) of the Company's total revenues for the three months and nine months ended September 30, 2005, respectively. Revenues for both customers are recorded in the Wireless Network Services operating unit.

(10) Related Party Transactions

On May 30, 2002, the Company issued an aggregate of 90,000 shares of Series B Convertible Preferred Stock, at an aggregate purchase price of \$45.0 million, in a private placement to entities affiliated with one of the directors of the Company (40,000 shares), to a brother of the Chairman and Chief Executive Officer of the Company (10,000 shares) and to an unrelated third-party investor (40,000 shares). The Company received \$44.9 million of net proceeds. Each share of Series B Convertible Preferred Stock

is initially convertible into 100 shares of Common Stock for a conversion price of \$5.00 per share, which was the fair market value of the common stock at the closing, at the option of the holder at any time, subject to certain provisions in the Series B Preferred Stock Purchase Agreement. The Series B Preferred Stock Purchase Agreement had a lock-up provision, which has expired prior to March 5, 2004, on which date 40,000 shares of Series B Convertible Preferred Stock were converted into 4,000,000 shares of the Company's Common Stock. On April 5, 2006, 15,483 shares of Series B Convertible Preferred Stock were converted into 1,548,300 shares of the Company's Common Stock.

Through September 30, 2006, the Company has received notices from the holders to convert an aggregate number of 80,000 shares of Series B Convertible Preferred Stock into an aggregate 8,000,000 shares of the Company's Common Stock. On December 31, 2005 and September 30, 2006, the total liquidated preference equaled \$12.7 million and \$5.0 million, respectively.

In 2003, in connection with the Company's acquisition of a company in its Enterprise Network Services business, the Company assumed certain facility lease obligations relating to facilities that were owned by the previous shareholders. The lease expense, which approximates \$0.2 million and \$0.2 million for the nine months ended September 30, 2005 and 2006, respectively, is reflected in the statement of operations.

On February 17, 2006, the Company entered into a definitive agreement to divest all of its operations in Mexico for total approximate cash consideration of \$18.0 million subject to adjustments for the closing net asset calculations, with \$1.5 million payable in cash on signing of the Equity Purchase Agreement and \$16.5 million by means of a secured promissory note payable in installments through December 2006, which approximates the net book value of the operations. The purchaser, Sakoki LLC, is a newly-formed entity controlled by Massih Tayebi. Although Massih Tayebi has no current role with the Company, he was a co-founder of the Company, having served as Chief Executive Officer from inception in 1994 through September 2000 and as a director from inception through April 2002. In addition, Massih Tayebi owns or controls approximately 11% of the total voting power of the Company's capital stock. He is also the brother of Masood Tayebi, the Company's current Chairman of the Board of Directors. Masood Tayebi has no personal financial interest in the transaction and will have no role with the entity that has purchased the Mexico Operations. The transaction was approved by the disinterested members of the Company's Board of Directors after consideration of other expressions of interest and an independent valuation analysis.

The final closing balance sheet as of February 17, 2006 resulted in net asset adjustments aggregating to a total approximate \$18.9 million consideration, \$1.5 million which was paid on February 17, 2006, with the remaining \$17.4 million payable by means of the promissory note in installments through December 31, 2006 with an interest rate of 7.5% per annum. On June 26, 2006, the Company entered into an Addendum with the buyer to finalize the closing net asset calculations, pursuant to which the parties agreed that the resulting total purchase price was \$18.9 million. The Addendum also provided for a conditional waiver that permits the purchaser to make the payment due on August 17, 2006 by September 30, 2006, and for the installments due on November 17, 2006 and December 31, 2006 to be made on or before December 29, 2006. Failure to make the payments on such later dates will result in a restoration of the original terms of the note. The first scheduled note payment of \$3.3 million was received from the buyer on May 19, 2006, and the second scheduled note payment of \$5.5 million was received in installments of \$5.2 million on September 29, 2006 and \$0.3 million on October 10, 2006. The remaining note receivable balance of \$9.6 million which includes accrued interest through September 30, 2006, and includes the \$0.3 million payment received on October 10, 2006 is reflected on the Company's Consolidated Balance Sheet as of September 30, 2006. The unpaid principal will continue to accrue interest at the rate of 7.5% per annum.

(11) Legal Matters

Beginning in July 2001, the Company and certain of its former officers and directors (the Individuals) were named as defendants in a series of class action shareholder complaints filed in the U.S. District Court for the Southern District of New York, now consolidated into a single amended complaint captioned *In re Buy.com, Inc. Initial Public Offering Securities Litigation*, Case No. 01-CV-6323. In the amended complaint, filed in April 2002, the plaintiffs allege that the Company, the Individuals, and the underwriters of the Company's initial public offering (IPO) violated section 11 of the Securities Act of 1933 and section 10(b) of the Exchange Act of 1934 based on allegations that the Company's registration statement and prospectus failed to disclose material facts regarding the compensation to be received by, and the stock allocation practices of, the IPO underwriters. The complaint also contains claims against the Individuals for control person liability under Securities Act section 15 and Exchange Act section 20. The plaintiffs sought unspecified monetary damages and other relief. Similar complaints were filed in the same Court against hundreds of other public companies (Issuers) and the underwriters (Underwriters) that conducted IPOs of the Issuers' common stock in the late 1990s or in the year 2000 (the IPO Cases).

In August 2001, all of the IPO Cases were consolidated for pretrial purposes before United States Judge Shira Scheindlin of the Southern District of New York. In July 2002, the Company joined in a global motion to dismiss the IPO Cases filed by all of the Issuers (among others). In October 2002, the Court entered an order dismissing the Individuals from the IPO Cases without prejudice, pursuant to an agreement tolling the statute of limitations with respect to the Individuals. In February 2003, the Court issued a decision denying the motion to dismiss the Securities Act section 11 and Exchange Act section 10(b) claims against the Company.

In June 2003, the Issuers reached a tentative settlement agreement with the plaintiffs that would result in, among other things, (a) the dismissal with prejudice of all claims in the IPO Cases against the Issuers and their officers and directors and (b) a guarantee from the insurers of the Issuers to the plaintiffs that, if the plaintiffs recover less than \$1 billion from the Underwriters in the IPO Cases, the insurers would pay the difference between the actual recovery and \$1 billion. In June 2004, the Company executed a final settlement agreement with the plaintiffs. On February 15, 2005, the Court issued a decision certifying a class action for settlement purposes, and granting preliminary approval of the settlement subject to modification of certain bar orders contemplated by the settlement. On August 31, 2005, the Court reaffirmed class certification and preliminary approval of the modified settlement in a comprehensive Order. In addition, the Court approved the form of Notice to be sent to members of the settlement classes, which was published and mailed beginning November 15, 2005. On February 24, 2006, the Court dismissed litigation filed against certain underwriters in connection with the claims to be assigned to the plaintiffs under the settlement. The Court held a Final Settlement Fairness Hearing on the settlement on April 24, 2006. The final ruling is expected in the fourth quarter of 2006. The Company does not expect the settlement to have a material impact on its operations or cash flow. In addition, the settlement is still subject to statutory notice requirements as well as final judicial approval.

In August 2004, as a result of the Company's announcement on August 4, 2004 that it intended to restate its financial statements for the fiscal years ended December 31, 2000, 2001, 2002 and 2003, the Company and certain of its current and former officers and directors were named as defendants (Defendants) in several securities class action lawsuits filed in the United States District Court for the Southern District of California. These actions were filed on behalf of those who purchased, or otherwise acquired, the Company's common stock between April 26, 2000 and August 4, 2004. The lawsuits generally allege that, during that time period, Defendants made false and misleading statements to the investing public about the Company's business and financial results, causing its stock to trade at artificially inflated levels. Based on these allegations, the lawsuits allege that Defendants violated the Securities Exchange Act of 1934, and the plaintiffs seek unspecified damages. These actions have been consolidated into a single action in *In re Wireless Facilities, Inc. Securities Litigation*, Master File No. 04CV1589-JAH. The plaintiffs

filed their consolidated complaint in January 2005 and did not name the Company a defendant in that complaint. After the individual defendants filed their motion to dismiss, the plaintiffs requested leave to amend their complaint to add the Company as a defendant. Plaintiffs filed the First Amended Consolidated Class Action Complaint on April 1, 2005. Defendants filed their motion to dismiss this first amended complaint on April 14, 2005. The plaintiffs then requested leave to amend their first amended complaint. The plaintiffs filed their Second Amended Complaint on June 9, 2005, this time on behalf of those who purchased, or otherwise acquired, the Company's common stock between May 5, 2003 and August 4, 2004. Defendants filed their motion to dismiss this Second Amended Complaint on July 14, 2005. The motion to dismiss was taken under submission on October 20, 2005 and on March 8, 2006, the court granted the Defendants' motion. However, plaintiffs were granted the right to amend their complaint within 45 days and subsequently filed their Third Amended Consolidated Class Action Complaint on April 24, 2006. Defendants filed a motion to dismiss this complaint on June 8, 2006. Plaintiffs' opposition was filed on July 12, 2006, and Defendants' reply was filed on August 2, 2006. The motion and responsive briefs were taken under submission by the court in August 2006, and the judge has not made a decision on the motion. The Company believes that the allegations lack merit and intends to vigorously defend all claims asserted. It is impossible at this time to assess whether or not the outcome of these proceedings will or will not have a material adverse effect on the Company. We have not recorded any accrual for a contingent liability associated with this legal proceeding based on the Company's belief that a liability, while possible, is not probable and any range of potential future charge cannot be reasonably estimated at this time.

Two derivative lawsuits have been filed in the United States District Court for the Southern District of California against certain of the Company's current and former officers and directors: *Pedicini v. Wireless Facilities, Inc.*, Case No. 04CV1663; and *Roth v. Wireless Facilities, Inc.*, Case No. 04CV1810. These actions have been consolidated into a single action in *In re Wireless Facilities, Inc. Derivative Litigation*, Lead Case No 04CV1663-JAH. The factual allegations in these lawsuits are substantially similar to those in the class action lawsuits, but the plaintiffs in these lawsuits assert claims for breach of fiduciary duty, gross mismanagement, abuse of control, waste of corporate assets, violation of Sarbanes Oxley Act section 304, unjust enrichment and insider trading. The plaintiffs in these lawsuits seek unspecified damages and equitable and/or injunctive relief. The lead plaintiff filed a consolidated complaint on March 21, 2005. On May 3, 2005, the defendants filed motions to dismiss this action, to stay this action pending the resolution of the consolidated non-derivative securities case pending in the Southern District of California, and to dismiss the complaint against certain non-California resident defendants. Pursuant to a request by the Court, Defendants' motions have been withdrawn without prejudice. The parties have agreed that Defendants may refile their motions to dismiss, and to stay this action, after limited discovery is completed regarding the motion to dismiss the action against certain individual defendants based on lack of personal jurisdiction. This discovery was completed on June 14, 2006. Defendants' motion to dismiss the complaint against the non-California resident defendants was filed on July 14, 2006. In October 2006, with the personal jurisdiction motion body briefed by both sides, the court took the motion under submission. After the court rules on this jurisdictional motion, the parties will stipulate to a briefing schedule for the remaining motions to dismiss or to stay the action. The Company believes that the allegations lack merit and intends to vigorously defend all claims asserted. It is impossible at this time to assess whether or not the outcome of these proceedings will or will not have a material adverse effect on the Company. We have not recorded any accrual for a contingent liability associated with this legal proceeding based on the Company's belief that a liability, while possible, is not probable and any range of potential future charge cannot be reasonably estimated at this time.

In August and September 2004, two virtually identical derivative lawsuits were filed in California Superior Court for San Diego County against certain of the Company's current and former officers and directors. These actions contain factual allegations similar to those of the federal lawsuits, but the plaintiffs in these cases assert claims for violations of California's insider trading laws, breaches of fiduciary duty,

abuse of control, gross mismanagement, waste of corporate assets and unjust enrichment. The plaintiffs in these actions seek unspecified damages, equitable and/or injunctive relief and disgorgement of all profits, benefits and other compensation obtained by defendants. These lawsuits have been consolidated into one action and *In re Wireless Facilities, Inc. Derivative Litigation*, California Superior Court, San Diego County, Lead Case No. GIC 834253. The plaintiffs filed a Consolidated Shareholder Derivative Complaint on October 14, 2004. This action has been stayed pending a decision in federal court on a motion to dismiss the federal derivative lawsuits and on October 27, 2006, the court continued the stay pending the decisions on the federal derivative lawsuit. The parties will appear before the judge in April 2007 to apprise the court of the status of the federal action. The Company believes that the allegations lack merit and intends to vigorously defend all claims asserted. It is impossible at this time to assess whether or not the outcome of these proceedings will or will not have a material adverse effect on the Company. We have not recorded any accrual for a contingent liability associated with this legal proceeding based on the Company's belief that a liability, while possible, is not probable and any range of potential future charge cannot be reasonably estimated at this time.

In January 2005 a former independent contractor of the Company filed a lawsuit in Brazil against the Company's subsidiary, WFI do Brazil, to which he had been assigned for a period of time. He sought to be designated an employee of WFI do Brazil and entitled to severance and related compensation pursuant to Brazilian labor law. The individual sought back wages, vacation pay, stock option compensation and related benefits in excess of \$0.5 million. This matter was argued before the appropriate labor court in July 2005 and in July, 2006, the labor court awarded the individual the Brazilian currency equivalent of approximately \$0.3 million for his back wages, vacation pay and certain other benefits. The Company filed an appeal in the matter on July 20, 2006 and is challenging the basis for the award on several theories. The Company has accrued approximately \$0.3 million as of September 30, 2006 related to this matter. The Company intends to pursue the appeal of this award and is unable to determine the ultimate outcome of this matter.

In addition to the foregoing matters, from time to time, the Company may become involved in various lawsuits and legal proceedings that arise in the ordinary course of business. However, litigation is subject to inherent uncertainties, and an adverse result in these or other matters may arise from time to time that may harm the Company's business. The Company is currently not aware of any such legal proceedings or claims that we believe will have, individually or in the aggregate, a material adverse effect on our business, financial condition or operating results.

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

This report contains forward-looking statements. These statements relate to future events or our future financial performance. In some cases, you can identify forward-looking statements by terminology such as may, will, should, expect, plan, anticipate, believe, estimate, potential or continue, the negative of such terms or other comparable terminology. These statements are only predictions. Actual events or results may differ materially. Factors that may cause our results to differ include, but are not limited to: changes in the scope or timing of our projects; changes or cutbacks in spending by the U.S. Department of Defense, which could cause delays or cancellations of key government contracts; slowdowns in telecommunications infrastructure spending in the United States and globally, which could delay network deployment and reduce demand for our services; the timing, rescheduling or cancellation of significant customer contracts and agreements, or consolidation by or the loss of key customers; failure to successfully consummate acquisitions or integrate acquired operations; the rate of adoption of telecom outsourcing by network carriers and equipment suppliers; the rate of growth of adoption of WLAN and wireless security systems by enterprises; and competition in the marketplace which could reduce revenues and profit margins.

Although we believe that the expectations reflected in the forward-looking statements are reasonable, we cannot guarantee future results, levels of activity, performance or achievements. Moreover, neither we, nor any other person, assume responsibility for the accuracy and completeness of the forward-looking statements. We are under no obligation to update any of the forward-looking statements after the filing of this Quarterly Report on Form 10-Q to conform such statements to actual results or to changes in our expectations.

Certain of the information set forth herein, including costs and expenses that exclude the impact of stock compensation expense in 2006, may be considered non-GAAP financial measures. We believe this information is useful to investors because it provides a basis for measuring the operating performance of our business and our cash flow, excluding the effect of stock compensation expense that would normally be included in the most directly comparable measures calculated and presented in accordance with Generally Accepted Accounting Principles. Our management uses these non-GAAP financial measures along with the most directly comparable GAAP financial measures in evaluating our operating performance, capital resources and cash flow. Non-GAAP financial measures should not be considered in isolation from, or as a substitute for, financial information presented in compliance with GAAP, and non-financial measures as reported by WFI may not be comparable to similarly titled amounts reported by other companies.

The following discussion should be read in conjunction with our unaudited consolidated financial statements and the related notes and other financial information appearing elsewhere in this Form 10-Q. Readers are also urged to carefully review and consider the various disclosures made by us which attempt to advise interested parties of the factors which affect our business, including without limitation the disclosures made under the caption Management's Discussion and Analysis of Financial Condition and Results of Operations, under the caption Risks Related to Our Business, and the audited consolidated financial statements and related notes included in our Annual Report filed on Form 10-K, for the year ended December 31, 2005 and other reports and filings made with the Securities and Exchange Commission.

Overview

We are an independent provider of outsourced communications and security systems engineering and integration services for the wireless communications industry through our Wireless Network Services division (WNS), the U.S. government through our Government Network Services division (GNS), and enterprise customers through our Enterprise Network Services division (ENS). The principal services we provide include, but are not limited to, the design, deployment, integration, and the overall management of communications, information technology, and security networks. Our work for the wireless communications industry primarily involves radio frequency engineering, site development, project management and the installation of radio equipment networks. We also provide network management services, which involve day-to-day optimization and maintenance of wireless networks. Our work for the

federal government primarily involves systems engineering, systems integration, and the outsourcing of technical services such as operational test and evaluation and program management. Our work for enterprise customers primarily involves the design, deployment and integration of security and other in-building systems including access control and intrusion detection and is focused on opportunities to integrate wireless technology into enterprise networks, especially physical and electronic security systems and voice and data networks.

In December 2005, our Board of Directors made the decision to exit our Mexican operations and certain of our other deployment businesses in South America. Prior to this decision, these operations had been reported in our Wireless Network Services segment. We determined that these operations meet the criteria to be classified as held for sale. Accordingly, we have reflected these operations as discontinued in accordance with SFAS No. 144, Accounting for the Impairment of Disposal of Long-Lived Assets. Our South American deployment operations were substantially shut down as of the end of 2005. Accordingly, all results for these operations for all periods presented have been reflected as discontinued operations. All operating results discussed in results of operations relate to our continuing operations.

On February 17, 2006, we entered into a definitive agreement to divest all of our operations in Mexico for total approximate cash consideration of \$18.0 million, which approximates the net book value of the operations, including \$13.2 million of liabilities associated with a loss contingency. The transaction closed on March 10, 2006. The transaction was structured as a sale of our subsidiaries in Mexico, and the purchase price consisted of \$1.5 million in cash paid on February 17, 2006, plus a secured promissory note payable in installments through December 31, 2006. The note is secured by pledges of assets and a personal guaranty.

The final closing balance sheet as of February 17, 2006 resulted in net asset adjustments aggregating to a total approximate \$18.9 million consideration, \$1.5 million which was paid on February 17, 2006, with the remaining \$17.4 million payable by means of the promissory note in installments through December 31, 2006 with an interest rate of 7.5% per annum. On June 26, 2006, the Company entered into an Addendum with the buyer to finalize the closing net asset calculations, pursuant to which the parties agreed that the resulting total purchase price was \$18.9 million. The Addendum also provided for a conditional waiver that permits the purchaser to make the payment due on August 17, 2006 by September 30, 2006, and for the installments due on November 17, 2006 and December 31, 2006 to be made on or before December 29, 2006. Failure to make the payments on such later dates will result in a restoration of the original terms of the note. The first scheduled note payment of \$3.3 million was received from the buyer on May 19, 2006, and the second scheduled note payment of \$5.5 million was received in installments of \$5.2 million on September 29, 2006 and \$0.3 million on October 10, 2006. The remaining note receivable balance of \$9.6 million which includes accrued interest through September 30, 2006, and includes the \$0.3 million payment received on October 10, 2006. The unpaid principal will continue to accrue interest at the rate of 7.5% per annum.

The purchaser, Sakoki LLC, is a newly-formed entity controlled by Massih Tayebi. Although Massih Tayebi has no current role with us, he was one of our co-founders and served as our Chief Executive Officer from inception in 1994 through September 2000, and as a director from inception through April 2002. In addition, Massih Tayebi owns or controls approximately 11% of the total voting power of our capital stock. He is also the brother of Masood Tayebi, our Chairman of the Board of Directors. Masood Tayebi has no personal financial interest in the transaction and will have no role with the entity that is purchasing the Mexico operations.

Wireless Network Services contracts are primarily fixed-price contracts whereby revenue is recognized using the percentage-of-completion method of accounting under the provisions of Statement of Position (SOP) 81-1, Accounting for Performance of Construction Type and Certain Production Type Contracts. For contracts offered on a time and material basis, we recognize revenues as services are performed. We

typically charge a fixed monthly fee for ongoing radio frequency optimization and network operations and maintenance services. With respect to these services, we recognize revenue as services are performed. Our Government Network Services business with the U.S. government and prime contractors is generally performed under cost reimbursable, fixed-price or time and materials contracts. Cost reimbursable contracts for the government provide for reimbursement of costs plus the payment of a fee. Some cost reimbursable contracts include incentive fees that are awarded based on performance on the contract. Under fixed-price contracts, we agree to perform certain work for a fixed price. Under time and materials contracts, we are reimbursed for labor hours at negotiated hourly billing rates and reimbursed for travel and other direct expenses at actual costs plus applied general and administrative expenses.

Cost of revenues includes direct compensation, living, travel and benefit expenses for project-related personnel, payments to third-party sub-contractors, project-related incentive compensation based upon the successful achievement of certain project performance goals, allocation of corporate overhead costs of expendable computer software and equipment, and other direct project-related expenses. Direct compensation and benefits are computed based on standard costs and actual hours billed. We review and adjust these standard costs periodically to ensure they are comparable to actual costs.

Selling, general and administrative expenses include compensation and benefits for corporate service employees and similar costs for billable employees whose time and expenses cannot be assigned to a project (underutilization costs), expendable computer software and equipment, facilities expenses and other operating expenses not directly related and/or allocated to projects. General and administrative costs include all corporate and administrative functions that support existing operations and provide infrastructure to facilitate our future growth. Additionally, our sales personnel and senior corporate executives have, as part of their compensation packages, periodic and annual bonus/commission incentives based on the attainment of specified performance goals.

We consider the following factors when determining if collection of a receivable is reasonably assured: comprehensive collection history; results of our communications with customers; the current financial position of the customer; and the relevant economic conditions in the customer's country. If we have had no prior experience with the customer, we review reports from various credit organizations to ensure that the customer has a history of paying its creditors in a reliable and effective manner. If the financial condition of our customers were to deteriorate, and adversely affect their financial ability to make payments, additional allowances would be required. Additionally, on certain contracts whereby we perform services for a prime/general contractor, a specified percentage of the invoiced trade accounts receivable may be retained by the customer until we complete the project. We periodically review all retainages for collectibility and record allowances for doubtful accounts when deemed appropriate, based on our assessment of the associated risks. Total retainages included in accounts receivable were \$0.8 million at September 30, 2006.

Management currently considers the following events, trends and uncertainties to be important to understanding its financial condition and operating performance:

- We believe there remain opportunities for us to grow our domestic Wireless Network Services business in Land Mobile Radio (LMR), IP Fixed and Core Networks and in-building networks. We also see opportunities in spectrum clearing and frequency realignment activities related to the Federal Communication Commission's recent action on the reallocation of licenses in the 800 megahertz frequencies. We believe that we may continue to experience pressure on our operating margins in our Wireless Network Services legacy Radio Frequency (RF) engineering business as a result of aggressive pricing by our competitors. Within the WNS business, we are continuing our efforts to reduce the amount of high risk, turn key, firm fixed price contracting that we do in higher risk markets by being extremely selective with these projects, while focusing on lower risk market areas and modular work.

- We believe that our Government Network Services segment will build and expand our customer relationships within the U.S. Departments of Defense and Homeland Security by taking advantage of the significant opportunities for companies with substantial expertise in wireless technology. We believe we will experience continued growth in revenues and operating income from this operating segment. On October 2, 2006, we acquired Huntsville, Alabama-based Madison Research Corporation (MRC) as part of our GNS business. MRC offers a broad range of technical, engineering and IT solutions, and has developed core competencies in weapons system lifecycle support, integrated logistics, test and evaluation, commercial-off-the-shelf software and hardware selection and implementation, software development and systems lifecycle maintenance. The results of operations of MRC will be consolidated beginning from the closing date of October 2, 2006.
- We also believe that despite project delays and set backs in the first quarter and second quarter of this year that our Enterprise Network Services segment will grow. We continue to be optimistic about the opportunity to integrate wireless technology into municipality and enterprise networks, especially physical and electronic security systems, and voice and data networks.
- As of September 30, 2006, we have estimated our annual effective tax rate to be a negative 31% for the year ending December 31, 2006. The rate differs from the federal and state statutory rates primarily because of substantial losses of over \$3.2 million for the nine months ended September 30, 2006 incurred in our foreign operations for which we are not able to record any tax benefit. In addition, our effective tax rate is impacted by nondeductible permanent tax items, tax reserves, and a reduction to our valuation allowance for originating deductible differences. The provision recorded for the quarter of negative 63% is greater than our estimated annual effective tax rate because of discrete tax expense items relating to tax reserves and no tax benefit for losses in our international operations. To the extent our projections may change, which may impact our judgement regarding the realizability of our deferred tax assets and required valuation allowance, our annual effective tax rate for 2006 could change in future periods.

Critical Accounting Principles and Estimates

We have identified the following critical accounting policies that affect our more significant judgments and estimates used in the preparation of our consolidated financial statements. The preparation of our financial statements in conformity with accounting principles generally accepted in the United States of America requires us to make estimates and judgments that affect the reported amounts of assets and liabilities, stockholders equity, revenues and expenses, and related disclosures of contingent assets and liabilities. On a periodic basis, as deemed necessary, we evaluate our estimates, including those related to revenue recognition, allowance for doubtful accounts, valuation of long-lived assets including identifiable intangibles and goodwill, accounting for income taxes including the related valuation allowance, accruals for partial self-insurance, contingencies and litigation and contingent acquisition consideration. We explain these accounting policies in the notes to the unaudited consolidated financial statements and at relevant sections in this discussion and analysis. These estimates are based on the information that is currently available and on various other assumptions that are believed to be reasonable under the circumstances. Actual results could vary from those estimates under different assumptions or conditions.

Revenue recognition. We derive a significant percentage of our revenue from long-term contracts and account for these contracts under the provisions of Statement of Position 81-1, *Accounting for Performance of Construction-Type and Certain Production-Type Contracts* . Revenue on time and materials contracts is recognized as services are rendered at contracted labor rates plus material and other direct costs incurred. The portion of our revenue derived from fixed-price contracts accounted for approximately 63.6% and 63.7% of our revenues for the three and nine months ended September 30, 2006, respectively. Revenue on fixed-price contracts is recognized using the percentage-of-completion method based on the ratio of total costs incurred to date compared to estimated total costs to complete the

contract. Estimates of costs to complete include material, direct labor, overhead, and allowable general and administrative expenses for our government contracts. These cost estimates are reviewed and, if necessary, revised monthly on a contract-by-contract basis. If, as a result of this review, we determine that a loss on a contract is probable, then the full amount of estimated loss is charged to operations in the period it is determined that it is probable a loss will be realized from the full performance of the contract. In certain instances in which it is impractical to estimate the final outcome of the project margin, but it is certain that we will not incur a loss on the project, we may record revenue equal to cost incurred, at zero margin. In the event that our cost incurred to date may be in excess of our funded contract value, we may defer those costs until the associated contract value has been funded by the customer. Once the final estimate of the outcome of the project margin is determined, we will record revenue using the percentage-of-completion method of accounting based on the ratio of total costs incurred to date compared to the estimated total costs to complete the project. Significant management judgments and estimates, including but not limited to the estimated costs to complete projects, must be made and used in connection with the revenue recognized in any accounting period. The revenue we recognize in a given reporting period depends on: (1) the costs we have incurred for individual projects; (2) our then current estimate of the total remaining costs to complete individual projects; and (3) the current estimated contract value associated with the projects. If, in any period, we increase or decrease our estimate of the total costs to complete a project, and/or reduce or increase the associated contract value, revenue for that period would be impacted. As a result, our gross margin in such period and in future periods may be affected. To the extent that our estimates fluctuate over time or differ from actual results, gross margins in subsequent periods may vary significantly from our estimates. Material differences may result in the amount and timing of our revenue for any period if management made different judgments or utilized different estimates.

A cancellation, schedule delay, or modification of a fixed-price contract which is accounted for using the percentage-of-completion method may adversely affect our gross margins for the period in which the contract is modified or cancelled. Under certain circumstances, a cancellation or negative modification could result in us having to reverse revenue that we recognized in a prior period, thus significantly reducing the amount of revenues we recognize for the period in which the adjustment is made. Correspondingly, a positive modification may positively affect our gross margins. In addition, a schedule delay or modifications can result in an increase in estimated cost to complete the project, which would also result in an impact to our gross margin.

In addition, many of our contracts include milestone billings. If a contract is terminated or if the scope of a contract changes prior to a milestone billing, the amount of revenue we recognize may change, based upon the specific termination clauses of the contract, which would affect our revenue and gross margin in the period in which the contract is terminated or the scope is changed.

During the reporting periods contained herein, we did experience revenue and margin adjustments of certain projects based on the aforementioned factors.

Allowance for doubtful accounts. We maintain an allowance for doubtful accounts for estimated losses resulting from the potential inability of certain customers to make required future payments on amounts due to us. Management determines the adequacy of this allowance by periodically evaluating the aging and past due nature of individual customer accounts receivable balances and considering the customer's current financial situation as well as the existing industry economic conditions and other relevant factors that would be useful towards assessing the risk of collectibility. If the future financial condition of our customers were to deteriorate, resulting in their inability to make specific required payments, additions to the allowance for doubtful accounts may be required. In addition, if the financial condition of our customers improves and collections of amounts outstanding commence or are reasonably assured, then we may reverse previously established allowances for doubtful accounts. Changes to estimates of contract value are recorded as adjustments to revenue and not as a component of the

allowance for doubtful accounts. We write off accounts receivable when they become uncollectible and payments subsequently received on such receivables are credited to the allowance for doubtful accounts.

Valuation of long-lived assets including intangible assets and goodwill. We recorded goodwill and finite-life intangible assets resulting from the recently and previously completed acquisitions. Management assesses the impairment of identifiable finite-life intangibles, long-lived assets and related goodwill whenever events or changes in circumstances indicate that the carrying value may not be recoverable, but at a minimum on an annual basis. Factors we consider relevant which could trigger an accelerated impairment review include, but are not limited to, the following:

- significant underperformance relative to historical or projected future operating results;
- significant changes in the manner of our use of the acquired assets or the strategy for our overall business;
- significant negative industry or economic trends;
- significant decline in our stock price for a sustained period; and
- our market capitalization relative to net book value.

When we determine that the carrying value of intangibles, long-lived assets and related goodwill may not be recoverable based upon the existence of one or more of the above indicators of impairment, we measure any impairment based substantially on a projected discounted future cash flow method using a discount rate determined by our management to be commensurate with the risk inherent in our current business model combined with other readily available and other relevant information. Net intangible assets, long-lived assets (including investments in unconsolidated affiliates), and goodwill was \$144.2 million as of September 30, 2006.

In accordance with Statement of Financial Accounting Standards (SFAS) No. 142, we do not amortize goodwill and indefinite lived intangible assets. In lieu of amortization, we are required to perform, at a minimum, an annual impairment review unless specific evidence identified as a triggering event would warrant an accelerated review of our goodwill and intangible assets with indefinite lives. The first step of the goodwill impairment test requires the Company to determine and compare the fair value of its defined reporting units to their carrying values as of the evaluation date. The fair value for each reporting unit is determined using an undiscounted cash flow valuation analysis. The carrying values of each reporting unit are determined by specifically identifying and allocating the assets and liabilities of the Company to each reporting unit based on headcount, relative revenues or costs, or other methods as deemed appropriate by management. If the estimated fair values exceed the carrying values for each reporting unit, there is no indication of impairment. Consequently, the second step of the impairment test will not be required.

Since the last annual impairment test as of December 31, 2005, there has been no indication of a triggering event that would warrant an accelerated review of our goodwill and intangible assets with indefinite lives.

Accounting for income taxes and tax contingencies. As part of the process of preparing our consolidated financial statements we are required to estimate our provision for income taxes in each of the tax jurisdictions in which we conduct business. This process involves estimating our actual current tax expense in conjunction with the evaluation and measurement of temporary differences resulting from differing treatment of certain items for tax and accounting purposes. These temporary timing differences result in the establishment of deferred tax assets and liabilities, which are recorded on a net basis and included in our consolidated balance sheet. We then assess on a periodic basis the probability that our net deferred tax assets will be recovered and, therefore realized from future taxable income and to the extent we believe that recovery is not more likely than not, a valuation allowance is established to mitigate such risk resulting in an additional related provision for income taxes during the period. If we are required to

further increase the valuation allowance in the future, it could have an adverse impact on our results of operations.

Significant management judgment is required in determining our provision for income taxes, our deferred tax assets and liabilities, tax contingencies and any required valuation allowance, including taking into consideration the probability of the tax contingencies being incurred. Management assesses this probability based upon information provided to us by our tax advisors, our legal advisors and similar tax cases. If at a later time our assessment of the probability of these tax contingencies changes, our accrual for such tax uncertainties may increase or decrease.

We have a valuation allowance at September 30, 2006, due to management's overall assessment of risks and uncertainties related to our future ability to realize and, hence, utilize certain deferred tax assets, primarily consisting of net operating losses, carryforward temporary differences and future tax deductions resulting from certain types of stock option exercises, before they expire. The assessed adequacy of valuation allowance is based on our current estimates of adjusted taxable income by each tax jurisdiction in which we operate and the period over which our deferred tax assets will be recoverable. In the event that actual results differ from these estimates or we adversely adjust these estimates in future periods, our financial position and results of operations could be materially impacted. Management believes the valuation allowance recorded at September 30, 2006 is properly stated.

The 2006 effective tax rate for annual and interim reporting periods could be impacted if certain tax items that are reserved for at September 30, 2006 are resolved at an amount which differs from our estimate. Finally, during 2006, if we are impacted by a change in the valuation allowance as of September 30, 2006 resulting from a change in judgment regarding the realizability of deferred tax assets beyond December 31, 2006, such effect will be recognized in the interim period in which the change occurs.

Accrual for partial self-insurance. We maintain an accrual for our health and workers compensation partial self-insurance, which is a component of total accrued expenses in the consolidated balance sheets. Management determines the adequacy of these accruals based on a monthly evaluation of our historical experience and trends related to both medical and workers compensation claims and payments, information provided to us by our insurance broker, industry experience and average lag period in which claims are paid. If such information indicates that our accruals require adjustment, we will, correspondingly, revise the assumptions utilized in our methodologies and reduce or provide for additional accruals as deemed appropriate. As of September 30, 2006, the accrual for our partial self-insurance programs approximated \$2.1 million. We also carry stop-loss insurance that provides coverage limiting our total exposure related to each medical and workers compensation claim incurred, as defined in the applicable insurance policies. The medical and workers compensation limits per claim are \$150,000 and \$250,000, respectively.

Contingencies and litigation. We are currently involved in certain legal proceedings. We estimate a range of liability related to pending litigation where the amount and range of loss can be estimated. We record our estimate of a loss when the loss is considered probable and estimable. Where a liability is probable and there is a range of estimated loss and no amount in the range is more likely than any other number in the range, we record the minimum estimated liability related to the claim in accordance with SFAS No. 5, Accounting for Contingencies. As additional information becomes available, we assess the potential liability related to our pending litigation and revise our estimates. Revisions in our estimates of potential liability could materially impact our results of operations. See Part II, Item 1 Legal Proceedings for additional information.

Share-Based Payments. Beginning in fiscal year 2006, we account for share-based compensation arrangements in accordance with the provisions of Statement of Financial Accounting Standards No. 123R (SFAS 123R) Share-Based Payments, which requires the measurement and recognition of compensation expense for all share-based payment awards to employees and directors based on estimated