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VSE CORP  
Form 10-Q  
October 31, 2006

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 Quarter Ended September 30, 2006

Commission File Number: 0-3676

VSE CORPORATION  
(Exact Name of Registrant as Specified in its Charter)

DELAWARE  
(State or Other Jurisdiction of  
Incorporation or Organization)

54-0649263  
(I.R.S. Employer  
Identification No.)

2550 Huntington Avenue  
Alexandria, Virginia  
(Address of Principal Executive Offices)

22303-1499      www.vsecorp.com  
(Zip Code)      (Webpage)

Registrant's Telephone Number, Including Area Code: (703) 960-4600

Securities registered pursuant to Section 12(b) of the Act:

Title of each class -----	Name of each exchange on which registered -----
Common Stock, par value \$.05 per share	NASDAQ Stock Market LLC

Securities registered pursuant to Section 12(g) of the Act: None

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. See definition of "accelerated filer and large accelerated filer" in Rule 12b-2 of the Exchange Act.  
(Check one):

Large accelerated filer  Accelerated filer  Non-accelerated filer

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

Number of shares of Common Stock outstanding as of October 31, 2006: 2,371,099.

VSE Corporation and Subsidiaries

### Forward Looking Statements

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This filing contains statements which, to the extent they are not recitations of historical fact, constitute "forward looking statements" under federal securities laws. All such statements are intended to be subject to the safe harbor protection provided by applicable securities laws. For discussions identifying some important factors that could cause actual VSE Corporation ("VSE" or the "Company") results to differ materially from those anticipated in the forward looking statements contained in this filing, see VSE's discussions captioned "Business," "Risk Factors," "Management's Discussion and Analysis of Financial Condition and Results of Operations" and "Notes to Consolidated Financial Statements" contained in VSE's Annual Report on Form 10-K for the fiscal year ended December 31, 2005 filed with the Securities and Exchange Commission (the "SEC"), together with the Annual Report on Form 10-K/A filed with the SEC on March 31, 2006 (collectively, "Form 10-K").

Readers are cautioned not to place undue reliance on these forward looking statements, which reflect management's analysis only as of the date hereof. The Company undertakes no obligation to publicly revise these forward looking statements to reflect events or circumstances that arise after the date hereof. Readers should carefully review the risk factors described in other documents the Company files from time to time with the SEC, including this and other Quarterly Reports on Form 10-Q to be filed by the Company subsequent to its Annual Report on Form 10-K and any Current Reports on Form 8-K filed by the Company.

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### PART I. Financial Information

#### Item 1. Financial Statements

VSE Corporation and Subsidiaries  
Consolidated Financial Statements

Consolidated Balance Sheets

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(in thousands except share and per share amounts)

September 30, December 31,

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	2006	2005
	----	----
	(Unaudited)	
<b>Assets</b>		
Current assets:		
Cash and cash equivalents . . . . .	\$ 6,034	\$12,717
Accounts receivable, principally		
U.S. Government, net . . . . .	59,124	43,926
Contract inventories . . . . .	6,121	4,273
Deferred tax assets . . . . .	1,029	1,033
Other current assets . . . . .	3,167	2,205
	-----	-----
Total current assets . . . . .	75,475	64,154
Property and equipment, net . . . . .	5,937	4,583
Deferred tax assets . . . . .	1,014	682
Goodwill . . . . .	1,054	1,054
Other assets . . . . .	4,474	3,393
	-----	-----
Total assets . . . . .	\$87,954	\$73,866
	=====	=====
<b>Liabilities and Stockholders' Equity</b>		
Current liabilities:		
Accounts payable . . . . .	\$38,950	\$29,752
Accrued expenses . . . . .	11,117	12,178
Dividends payable . . . . .	166	141
	-----	-----
Total current liabilities . . . . .	50,233	42,071
Deferred compensation . . . . .	2,088	1,589
Other liabilities . . . . .	100	55
	-----	-----
Total liabilities . . . . .	52,421	43,715
	-----	-----
Commitments and contingencies		
Stockholders' equity:		
Common stock, par value \$.05 per share,		
Authorized 15,000,000 shares; issued and		
outstanding 2,371,099 in 2006 and 2,359,611		
shares in 2005 . . . . .	119	118
Paid-in capital . . . . .	6,801	6,348
Deferred stock-based compensation . . . . .	-	(1)
Retained earnings . . . . .	28,613	23,686
	-----	-----
Total stockholders' equity . . . . .	35,533	30,151
	-----	-----
Total liabilities and stockholders' equity . .	\$87,954	\$73,866
	=====	=====

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The accompanying notes are an integral part of these balance sheets.

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VSE Corporation and Subsidiaries  
Consolidated Financial Statements

Consolidated Statements of Income (Unaudited)

(in thousands except share and per share amounts)

	For the three months ended September 30,		For the nine months ended September 30,	
	2006	2005	2006	2005
	----	----	----	----
Revenues . . . . .	\$ 103,630	\$ 76,600	\$ 261,774	\$ 215,201
Costs and expenses of contracts . . . . .	100,457	73,883	252,723	207,354
Gross profit. . . . .	3,173	2,717	9,051	7,847
Selling, general and administrative expenses . .	199	173	617	340
Interest income, net. . . . .	(56)	(43)	(276)	(84)
Income before income taxes. .	3,030	2,587	8,710	7,591
Provision for income taxes. .	1,141	1,000	3,309	2,935
Net income. . . . .	\$ 1,889	\$ 1,587	\$ 5,401	\$ 4,656
Basic earnings per share:				
Net income . . . . .	\$ 0.80	\$ 0.68	\$ 2.28	\$ 2.01
Basic weighted average shares outstanding	2,371,099	2,348,228	2,366,393	2,313,058
Diluted earnings per share:				
Net income. . . . .	\$ 0.78	\$ 0.66	\$ 2.23	\$ 1.95
Diluted weighted average shares outstanding	2,421,100	2,417,056	2,424,835	2,382,986
Dividends declared per share	\$ 0.07	\$ 0.00	\$ 0.20	\$ 0.11

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

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VSE Corporation and Subsidiaries  
Consolidated Financial Statements

Consolidated Statements of Stockholders' Equity (Unaudited)

(in thousands except per share data)

	Common Shares	Stock Amount	Paid-In Capital	Deferred Stock-Based Compensation	Retained Earnings	Total Stockholders' Equity
	-----	-----	-----	-----	-----	-----
Balance at December 31, 2005 . . . . .	2,360	\$ 118	\$ 6,348	\$ (1)	\$ 23,686	\$ 30,151
Net income for the period . .	-	-	-	-	5,401	5,401
Stock-based compensation . .	2	-	245	-	-	245
Exercised stock options . . .	9	1	116	-	-	117
Excess tax benefits from share-based payment arrangements . . . . .	-	-	92	-	-	92
Deferred stock-based compensation . . . . .	-	-	-	1	-	1
Dividends declared (\$.20) . .	-	-	-	-	(474)	(474)
	-----	-----	-----	-----	-----	-----
Balance at September 30, 2006 . . . . .	<u>2,371</u>	<u>\$ 119</u>	<u>\$ 6,801</u>	<u>\$ -</u>	<u>\$ 28,613</u>	<u>\$ 35,533</u>

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

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VSE Corporation and Subsidiaries  
Consolidated Financial Statements (Unaudited)

Consolidated Statements of Cash Flows

(in thousands)

	For the nine months ended September 30,	
	2006	2005
	----	----
Cash flows from operating activities:		
Net income . . . . .	\$ 5,401	\$ 4,656
Adjustments to reconcile net income to net cash provided by (used in) operating activities:		
Depreciation and amortization . . . . .	1,310	1,010
Loss on sale of property and equipment . . . . .	9	2
Deferred taxes . . . . .	(328)	(381)
Stock-based compensation . . . . .	245	-
Tax benefit of options exercised . . . . .	-	684
Change in operating assets and liabilities:		
(Increase) decrease in:		
Accounts receivable, net. . . . .	(15,198)	(6,079)
Contract inventories . . . . .	(1,848)	4,973
Other current assets and noncurrent assets . . . . .	(2,118)	(1,298)
Increase (decrease) in:		
Accounts payable and deferred compensation . . . . .	9,697	5,250
Accrued expenses . . . . .	(1,061)	3,450
Other liabilities . . . . .	45	28
	-----	-----
Net cash (used in) provided by operating activities	(3,846)	12,295
	-----	-----
Cash flows from investing activities:		
Purchase of property and equipment . . . . .	(2,598)	(1,272)
	-----	-----

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Net cash used in investing activities	(2,598)	(1,272)
	-----	-----
Cash flows from financing activities:		
Net repayment of bank loans . . . . .	-	(1,578)
Dividends paid . . . . .	(449)	(369)
Excess tax benefits from share-based payment arrangements . . . . .	92	-
Proceeds from the exercise of options of common stock .	118	552
	-----	-----
Net cash used in financing activities	(239)	(1,395)
	-----	-----
Net (decrease) increase in cash and cash equivalents . . .	(6,683)	9,628
Cash and cash equivalents at beginning of period . . .	12,717	130
	-----	-----
Cash and cash equivalents at end of period . . . . .	\$ 6,034	\$ 9,758
	=====	=====

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

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### VSE CORPORATION AND SUBSIDIARIES NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Unaudited)

#### Basis of Presentation

The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States for interim financial information and the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by accounting principles generally accepted in the United States for complete financial statements. In the opinion of management, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation have been included. Operating results for the three and nine months ended September 30, 2006 are not necessarily indicative of the results that may be expected for the year ending December 31, 2006. For further information refer to the consolidated financial statements and footnotes thereto included in the VSE Corporation Annual Report on Form 10-K for the year ended December 31, 2005, as amended. The Company operates within one reportable segment.

#### Use of Estimates in the Preparation of Financial Statements

The preparation of financial statements in conformity with accounting principles generally accepted in the United States requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. Significant estimates affecting the financial statements include the allowance for doubtful accounts, accruals for loss contracts, contract disallowance reserves, self

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insured health claims and estimated cost to complete on firm fixed-price contracts.

### Contract Inventories

The components of contract inventories as of September 30, 2006 and December 31, 2005 were as follows (in thousands):

	2006	2005
	----	----
Work in process . . . . .	\$ 6,121	\$ 9,965
Less: Progress payments and customer advances received . . . . .	-	(5,692)
	-----	-----
Total contract inventories	\$ 6,121	\$ 4,273
	=====	=====

Contract inventories consist of materials purchased, and other expenditures for use in a contract to modify and apply a protective system, the Tanker Ballistic Protection System ("TBPS") to military vehicles for the U.S. Army.

Although these costs are classified as inventories for accounting purposes, they are similar in nature to materials and direct supplies purchased for use in performance on the Company's other contracts in that they are solely and directly attributable to the contract and will be billed to the customer within a relatively short time. These materials and direct supplies will not be restocked to maintain any permanent inventory levels. Contract inventories are relieved when units are delivered and revenue is recognized.

Work in process inventories consist of amounts for materials, supplies and other expenditures for which work has been performed but for which the end unit has not yet been completed and accepted. Work in process inventories at September 30, 2006 and December 31, 2005 included applicable indirect cost

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### VSE CORPORATION AND SUBSIDIARIES NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Unaudited)

burdens, including general and administrative costs totaling approximately \$809 thousand and \$1.3 million, respectively. Indirect cost burdens, including general and administrative costs charged to cost of sales from inventories for the periods ended September 30, 2006 and December 31, 2005 totaled \$2.9 million and \$3.4 million, respectively.

### Debt

VSE has a loan agreement with a bank under which credit is made available to the Company in the form of revolving loans or letters of credit. The maximum amount of credit available to the Company is \$15 million, subject to certain conditions, including a borrowing formula based on billed receivables. The expiration date of the loan agreement is May 31, 2008.

The loan agreement contains terms whereby the Company may borrow against the revolving loan and at any time and from time to time can prepay such borrowings in whole or in part without premium or penalty. There are collateral requirements by which Company assets secure amounts outstanding, restrictive covenants that include minimum tangible net worth and profitability



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requirements, a limit on annual dividends, and other affirmative and negative covenants. As of September 30, 2006 the Company has not been notified by the bank, nor is the Company aware of any default under the loan agreement.

The Company pays a fixed annual commitment fee of \$20 thousand, interest on any revolving loan borrowings at a prime-based rate or an optional LIBOR-based rate, and fees on any letters of credit that are issued. As of September 30, 2006 and December 31, 2005, there were no revolving loan amounts outstanding. There were no letters of credit in effect as of September 30, 2006. Interest expense incurred on the loan for the nine months ended September 30, 2006 and 2005 was approximately \$0 and \$1 thousand, respectively.

### Stock-based Compensation

#### 2006 Restricted Stock Plan

On May 2, 2006, the Company's stockholders approved the VSE Corporation 2006 Restricted Stock Plan (the "2006 Plan"). Under the 2006 Plan, not more than a total of 125,000 shares of VSE common stock ("VSE Stock") may be issued. The shares issued under the 2006 Plan may, at the Company's option, be either shares held in treasury or shares originally issued. On June 27, 2006, the Company granted 1,800 shares of restricted VSE Stock to the Company's outside Directors under the 2006 Plan. The fair market value on the grant date was \$31.50 per share. The shares issued vested immediately and cannot be sold, transferred, pledged or assigned before the second anniversary of the grant date.

#### Stock Option Plans

On December 30, 2005, VSE's board of directors (the "Board") discontinued, until and unless the Board determined otherwise, awarding options, both discretionary and nondiscretionary, to purchase VSE Stock under VSE's 2004 Stock Option Plan (the "2004 Plan"). The options outstanding under the 2004 Plan, as of December 30, 2005, were not affected by this Board action. In addition, the options to purchase VSE Stock under VSE's 1998 Stock Option Plan (the "1998 Plan") were not affected by this Board action.

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### VSE CORPORATION AND SUBSIDIARIES NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Unaudited)

The primary reason for the Board's suspension of option awards under the 2004 Plan was the potential impact on VSE's results of operations from the application of FASB Statement No. 123(R), "Share-Based Payment" ("SFAS 123(R)") to share-based payments to employees, including stock option awards.

#### 2004 Stock Option Plan

As of September 30, 2006 options issued under the 2004 Plan for 66,750 shares of VSE Stock remained outstanding. Each option granted under the 2004 Plan was issued at the fair market value of VSE Stock on the date of grant. Each option vests 25% on date of award and 25% on each anniversary date thereafter, becoming 100% vested as of the third anniversary date of award. The 2004 Plan will terminate on the earliest of May 1, 2014, or the date on which all options issued under the 2004 Plan have been exercised, expire, or have been terminated.

#### 1998 Stock Option Plan

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As of September 30, 2006, options issued under the 1998 Plan for 121,125 shares of VSE Stock remained outstanding. The 1998 Plan will terminate on the earliest of May 6, 2008, or the date on which all options issued under the 1998 Plan have been exercised, expire, or have been terminated.

### Accounting for Stock-based Compensation

Prior to January 1, 2006, the Company had followed the provisions of SFAS 123, "Accounting for Stock-Based Compensation," as amended by SFAS 148, "Accounting for Stock-Based Compensation-Transition and Disclosure." Accordingly, the Company accounted for stock-based compensation under Accounting Principles Board (APB) Opinion No. 25, "Accounting for Stock Issued to Employees," and related interpretations, using the intrinsic value method. Effective January 1, 2006, the Company adopted the fair value recognition provisions of SFAS 123(R), using the modified-prospective-transition method. Under that transition method, compensation cost recognized as of September 30, 2006 includes compensation cost for all share-based payments granted prior to, but not yet vested as of January 1, 2006, based on the grant date fair value estimated in accordance with the original provisions of Statement 123. Results for prior periods have not been restated.

As a result of adopting SFAS 123(R) on January 1, 2006, the Company's net income for the period ended September 30, 2006, was approximately \$117 thousand lower or approximately \$.05 per share basic and diluted than if it had continued to account for share-based compensation under Opinion 25. The total compensation cost not yet recognized in the Company's income before income taxes as of September 30, 2006 is approximately \$244 thousand, to be recognized over approximately 1.25 years.

Prior to the adoption of SFAS 123(R), the Company presented all tax benefits of deductions resulting from the exercise of stock options as operating cash flows in the Statement of Cash Flows. SFAS 123(R) requires the cash flows resulting from the tax benefits resulting from tax deductions in excess of the compensation cost recognized for those options (excess tax benefits) to be classified as financing cash flows. Approximately \$92 thousand in excess tax benefits classified as cash provided by financing activities for the nine months ended September 30, 2006 would have been classified as cash provided by operating activities if the Company had not adopted SFAS 123(R).

The following table illustrates the effect on net income and earnings per share if the Company had applied the fair value recognition provisions of SFAS 123(R) to options granted under the Company's stock option plans for the

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### VSE CORPORATION AND SUBSIDIARIES NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Unaudited)

periods ending September 30, 2005. For purposes of this pro forma disclosure, the value of the options is estimated using a Black-Scholes-Merton option-pricing formula and amortized to expense over the options' vesting periods.

	Three Months Ended September 30, 2005	Nine Months Ended September 30, 2005
Net income, as reported	\$1,587	\$4,656
Add: Total stock-based employee compensation expense as reported under intrinsic value method		

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(APB No. 25) for all awards, net of related tax effects	-	-
Deduct: Total stock-based compensation expense determined under fair value based method (SFAS No. 123) for all awards, net of related tax effects		
	(61)	(173)
	-----	-----
Pro forma net income	\$1,526	\$4,483
	=====	=====
Earnings per share:		
Basic - as reported	\$ 0.68	\$ 2.01
Diluted - as reported	\$ 0.66	\$ 1.95
Basic - pro forma	\$ 0.65	\$ 1.94
Diluted - pro forma	\$ 0.63	\$ 1.88

The fair value of the options was estimated on the date of grant using the Black-Scholes option pricing model. The following assumptions were used in the pricing calculations for 2005. In 2006, no such assumptions were made as no options were granted:

	2005
	----
Risk free interest rate	3.28%
Dividend yield	0.79%
Expected life	3 years
Expected volatility	60.50%

Set forth below is a summary of the Company's stock option activity for the nine months ended September 30, 2006 and 2005:

	2006	Weighted Average Exercise Price	2005	Weighted Average Exercise Price
	----	-----	----	-----
Number of shares under stock options:				
Outstanding at beginning of period	197,563	\$15.83	211,625	\$ 9.51
Granted	-	-	70,000	25.17
Exercised	(9,688)	12.02	(72,812)	7.60
Forfeited	-	-	(4,750)	11.90
	-----	-----	-----	-----
Outstanding at end of period	187,875	\$16.02	204,063	\$15.51
	=====	=====	=====	=====
Exercisable at end of period	136,750	\$14.06	104,626	\$13.95
	=====	=====	=====	=====

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VSE CORPORATION AND SUBSIDIARIES  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
(Unaudited)

	2006		2005
	----		----
Weighted average remaining			

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contractual life	2 Years	3 Years
Weighted average fair value of options granted	-	\$4.70

The aggregate intrinsic values of outstanding, exercisable and exercised stock options as of September 30, 2006 and 2005 are as follows (in thousands):

	2006	2005
	----	----
Outstanding stock options	\$2,644	\$3,977
Exercisable stock options	\$2,193	\$2,390
Exercised stock options	\$ 94	\$ 69

The total fair value of stock options vested for the nine months ended September 30, 2006 and 2005 was \$0 and approximately \$163 thousand, respectively.

Set forth below is a summary of the Company's nonvested stock option activity for the nine months ended September 30, 2006 and 2005:

	2006	Weighted Average Grant Date Fair Value	2005	Weighted Average Grant Date Fair Value
	----	-----	----	-----
Nonvested stock options at beginning of period	51,125	\$ 8.41	49,687	\$ 3.66
Granted	-	-	70,000	10.37
Vested	-	-	(17,500)	10.37
Forfeited	-	-	(2,750)	3.13
	-----	-----	-----	-----
Nonvested stock options at end of period	51,125	\$ 8.41	99,437	\$ 7.22
	=====	=====	=====	=====

### Earnings Per Share

Basic earnings per share have been computed by dividing net income by the weighted average number of shares of common stock outstanding during each period. Shares issued during the period and shares reacquired during the period are weighted for the portion of the period that they were outstanding. Diluted earnings per share have been computed in a manner consistent with that of basic earnings per share while giving effect to all potentially dilutive common shares that were outstanding during each period. Potentially dilutive common shares include incremental common shares issuable upon exercise of stock options.

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2006	2005	2006	2005
	----	----	----	----
Basic weighted average common shares outstanding	2,371,099	2,348,228	2,366,393	2,313,058
Diluted effect of options	50,001	68,828	58,442	69,928
	-----	-----	-----	-----
Diluted weighted average common shares outstanding	2,421,100	2,417,056	2,424,835	2,382,986
	=====	=====	=====	=====

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VSE CORPORATION AND SUBSIDIARIES  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
(Unaudited)

### Litigation

The Company is a party to, or has property subject to, litigation during the normal course of business. In the opinion of management, the resolution of any such litigation will not have a material adverse effect on the Company's results of operations or financial position. However, the results of any legal proceedings cannot be predicted with certainty.

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

#### Executive Overview

#### VSE Organization

VSE's business operations consist primarily of services performed by the Company's unincorporated divisions and wholly owned subsidiary. The Company uses multiple operating entities to bid on and perform contract work. The term "VSE" or "Company" refers to VSE and its divisions and subsidiaries unless the context indicates operations of the parent company only.

Unincorporated divisions include BAV Division ("BAV"), Communications and Engineering Division ("CED"), Coast Guard Division ("VCG"), Fleet Maintenance Division ("FMD"), Management Sciences Division ("MSD"), Systems Engineering Division ("SED"), and Engineering and Logistics Division ("ELD") beginning in 2006. Energetics Incorporated ("Energetics") is currently VSE's only active subsidiary.

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### VSE Customers and Services

The Company is engaged principally in providing engineering, design, logistics, management and technical services to the U.S. Government (the "government"), other government prime contractors, and commercial entities. The largest customer for the Company's services is the U.S. Department of Defense ("Defense"), including agencies of the U.S. Navy, Army, and Air Force.

Navy - A large percentage of VSE's work is performed for the U.S. Navy. BAV is a major provider of engineering, management, logistics, training, and technical assistance in support of the Navy's Foreign Military Sales ("FMS") ship transfer program. FMD supports the Navy by providing a variety of services, including ship systems installation efforts, combat systems inspections, ship repair and overhaul availability planning, weapons management, ordnance alterations, and air combat logistics.

Army/Army Reserve - VSE also performs a significant amount of its work for the U.S. Army and U.S. Army Reserve. VSE, through SED and ELD, provides these customers equipment refurbishment services, military vehicle protection systems, engineering and technical support for ground weapons, logistics and training services, material procurement support, and prototype development support for combat vehicles. MSD provides the Army, as well as other government agencies and commercial organizations, with training services in quality systems and product, process, and management optimization. CED provides management oversight and coordinates support efforts for a variety of government work orders on a large Army contract.

Other - Energetics provides the Department of Energy and other government and industry customers with expert consulting services that typically include program planning and analysis, R&D management services, technology assessment and performance metrics, communications and outreach, and conference planning. VCG provides services to the U.S. Coast Guard that are similar to the work performed by BAV for the U.S. Navy and its FMS customers. The Company provides support and other services to the U.S. Air Force, U.S. Postal Service and U.S. Department of Treasury.

### BAV Ship Transfer Program

VSE's BAV Division provides the U.S. Navy with program management, engineering, technical and logistical support services associated with the sale, lease, and transfer of Navy ships to foreign governments. This program has been the Company's single largest revenue producer in recent years. Revenues generated by this program have typically accounted for a significant percentage of VSE's consolidated revenues. Revenues from this program accounted for approximately 33% and 43% of consolidated revenues during the nine month periods ended September 30, 2006 and 2005, respectively. The level of revenues and associated

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profits resulting from fee income generated by this program varies depending on a number of factors, including the timing of ship transfers and associated support services ordered by foreign governments and economic conditions of potential customers worldwide. The Company has experienced significant quarterly and annual revenue fluctuations and anticipates that future quarterly and annual revenues will be subject to variation due to changes in the level of activity associated with the Navy's ship transfer program. The transfer of four U.S. Navy ships to Taiwan under this program was a major contributor to the Company's revenues in 2004 and 2005, and has continued contributing to the Company's revenues in 2006.

The original contract associated with this program was a ten-year cost-plus

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award fee contract awarded in 1995 with a total ceiling value of more than \$1 billion. BAV was awarded a second contract in April 2005 to continue work on this program. The new contract is a five-year cost-plus award fee contract with a total ceiling value of approximately \$544 million. The Navy began issuing orders on the new contract in the second quarter of 2005 and ceased issuing orders for new work on the original contract at that time. BAV work associated with the transfer of four ships to Taiwan under delivery orders issued on the original contract was substantially completed in September 2006.

Contract terms under both the original and new contracts specify base fee payments and award fee payments to BAV. Base fee payments are determined by level of contract activity and base fee income is recognized each month. Award fee payments are determined by performance and level of contract activity. A contract modification authorizing the award fee payment is issued subsequent to the period in which the work is performed. The Company does not recognize award fee income until the fees are fixed and determinable, generally upon contract notification confirming the award fee. Award fees are made three times during the year. Accordingly, the Company typically has three quarterly reporting periods per year that include the recognition of BAV award fee income and one quarterly reporting period that does not include BAV award fee income. Due to such timing, and to fluctuations in the level of revenues, profits as a percentage of revenues will fluctuate from period to period. The Company recognized BAV award fee income in the three month periods ended June 30 and March 31, 2006. Award fee income was not recognized during the three month period ended September 30, 2006. In 2005, the Company recognized BAV award fee income in each of the three month periods ended March 31, June 30, and December 31 and did not recognize any BAV award fee income in the three month period ended September 30.

### TBPS Program

VSE's SED Division performs work on a program to provide a protection system, the Tanker Ballistic Protection System ("TBPS"), for vehicles deployed by the U.S. Army in Iraq. Under this program, SED applies a polyurethane based ballistic coating system and necessary Add-on Armor Panels for Army Fuel Dispensing Tankers as protection from hostile fire. Delivery of completed vehicle protection systems began in January 2005.

SED has performed on the TBPS program under multiple firm fixed price per unit contracts. Subsequent to program implementation, VSE has received modifications to consolidate contracting activity into fewer contracts and to adjust the number of tankers based on Army tanker availability and needs, and the possibility remains that there may be future contract modifications as the Army's needs change. The total contract ceiling value on the TBPS Program contracts is approximately \$76 million, and the remaining available contract ceiling on the TBPS Program contracts is approximately \$23 million as of September 30, 2006. Contract value on the TBPS contracts is fully funded at the time of award or modification. Currently, contractual coverage for work on the TBPS program runs through May 2007 and the Company expects to complete work in 2007.

The TBPS Program contributed significantly to VSE revenues in 2005 and has provided significant revenues in 2006. The work performed on this program also significantly increases the amount of fixed price contract work performed by the Company. In general, fixed price contract work has higher risk and profit

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margins than work on other contract types. Accordingly, the TBPS program has presented, and is expected to continue to present, VSE's business with both increased profit margins and risk of loss.

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### CED Army Equipment Support Program

In December 2005, VSE's CED Division was awarded a task order on its Rapid Response support contract to provide maintenance and logistics services in support of U.S. Army equipment in Iraq and Afghanistan. Services provided under this program include deployed sustainment management, deployed logistics and repairs management, unique system training and curriculum support, resource management, and acquisition and administrative support. Work on this program began in 2006.

The task order for this program is time and materials, with substantially all of the services provided by CED's subcontractor. CED will provide certain program management services. The contract task order has a base year valued at approximately \$139 million and an additional one-year option period valued at approximately \$212 million. This program is expected to contribute significantly to VSE's revenues in 2006 and 2007, however, VSE's profit margins on subcontract work are generally lower than on work performed by Company personnel.

### Government Procurement Policies and Practices

VSE's business is subject to the risks arising from economic conditions and political factors that may impact the budgets and program funding of customers served through VSE's contracts. VSE's revenues have historically been subject to annual fluctuations resulting from changes in the level of Defense spending. Future budgetary and funding decisions by government lawmakers or Defense restructuring efforts could affect the types and level of services provided by VSE to its government customers and could potentially have a material adverse impact on the Company's results of operations or financial condition.

The revenues of the Company depend on its ability to win new contracts and on the amount of work ordered by the government under the Company's existing contracts. The Company's ability to win new contracts is affected by government acquisition policies and procedures, including government procurement practices that in some years have tended toward bundling work efforts under large comprehensive ("omnibus") management contracts. This emphasis on large contracts presents challenges to winning new contract work, including making it more difficult for the Company to qualify as a bidder, increasing the level of competition due to the award of fewer contracts, and forcing the Company into competition with larger organizations that have greater financial resources and larger technical staffs. Competing for these contracts requires the Company to use teams of subcontractors to be able to offer the range of technical competencies needed to do the work. While the use of subcontractors on a large scale basis allows the Company to compete for this work, profit margins on subcontract work are lower than on work performed by Company personnel, thereby reducing the Company's overall profit margins.

The use of subcontractors on government contracts also raises certain performance and financial risks to VSE because government prime contractors are responsible for performing to the requirements of the contract and ensuring compliance with U.S. Government regulations relative to the performance by subcontractors.

Other government procurement practices that can affect the Company's revenues are: 1) the length of contracts issued, which may vary depending on changes in contracting regulations and other factors; 2) the use of past performance criteria that may preclude entrance into new government markets; and 3) government social programs that limit contract work to small, woman, veteran, or minority owned businesses. Additional risk factors that could potentially affect the Company's results of operations are the government's right to terminate contracts for convenience, the government's right to not exercise



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all of the option periods on a contract, and funding delays caused by government political or administrative actions.

### Global Economic Conditions and Political Factors

VSE's business is subject to the risks arising from global economic conditions and political factors associated with current and potential customers served through VSE's contracts with the U.S. Government. An economic slowdown in countries served under the BAV Ship Transfer Program could potentially affect sales. Failure by the government of a potential foreign customer to approve and fund acquisition of U.S. Navy ships serviced under this program could affect sales. In any one year, a significant amount of the Company's revenues may result from sales on the BAV Ship Transfer Program to a single foreign government. BAV sales to Egypt have historically comprised a large percentage of the Company's total sales in any one year. Work associated with the transfer of four ships to Taiwan under the BAV Ship Transfer Program during 2004, 2005, and 2006 comprised a large percentage of total revenues.

The current international situation posed by potential terrorist activity and the continuing conflict in the Middle East could increase the political risks for revenues from the BAV Ship Transfer, TBPS, and CED Army Equipment Support Programs.

### Concentration of Revenues From Continuing Operations (in thousands) For the nine months ended September 30,

Source of Revenue	2006 Revenues	%	2005 Revenues	%
BAV Taiwan	\$ 39,100	15	\$ 47,978	22
BAV Egypt	38,231	15	40,432	19
BAV Other	8,000	3	4,390	2
Total BAV	85,331	33	\$ 92,800	43
TBPS Program	22,887	9	25,938	12
CED Army Equipment Support	66,252	25	-	-
VSE Other	87,304	33	96,463	45
Total Revenues	\$261,774	100	\$215,201	100

International tensions can also affect work by FMD on U.S. Navy ships when they are deployed outside of U.S. Navy facilities and are unavailable for maintenance work during this time period. The equipment refurbishment services offered by ELD are subject to fluctuations resulting from changes in U.S. military actions internationally. Adverse results arising from these global economic and political risks could impact the Company's results of operations.

### Management Outlook

The growth trend established by VSE's record high revenues and profits in 2004 and 2005 is expected to continue in 2006. The major contributors to 2006 results are: 1) the Taiwan Ship Transfer work performed by BAV; 2) performance on the TBPS Program; 3) new work performed on the CED Army Equipment Support Program; 4) growth in ELD's Equipment Refurbishment Services provided to the U. S. Army

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Reserve; and 5) additional work provided by Significant IDIQ Contracts. VSE revenues and profits will also benefit in the fourth quarter of 2006 and in future years from the award of a Treasury Seized Property Management Contract.

Taiwan Ship Transfer. The Taiwan ship transfer effort performed by BAV continued through the first nine months of 2006, enabling BAV to maintain revenue levels at or slightly below 2005 revenues. Although work on the Taiwan ship transfer was substantially completed in September 2006, funded backlog on the BAV Ship Transfer Program was approximately \$74 million as of September 30, 2006.

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TBPS Program. SED began delivery of completed vehicle protection systems on this program in 2005, and work on the program increased during the first three quarters of 2005. Changes in production schedules can result from operating in an uncertain and volatile environment in Iraq, changing Army needs, technical specification issues, weather and facility location changes. Such changes caused work on this program to level off during the fourth quarter of 2005 and the first quarter of 2006, resulting in slightly decreased revenues from this program during the first nine months of 2006 as compared to 2005. Production levels increased again beginning in the second quarter of 2006 and the program is expected to generate revenues in 2006 equal to or greater than revenues generated in 2005. Funded backlog on the TBPS program was approximately \$23 million as of September 30, 2006.

CED Army Equipment Support Program. This program represents new work beginning in 2006 and is expected to contribute substantially to Company revenues in 2006 and 2007. Revenues from this program during the first nine months of 2006 were approximately \$66 million and a majority of the \$139 million base year task order is expected to be realized in 2006. The contract task order for this program is incrementally funded, with funded backlog of approximately \$40 million as of September 30, 2006.

Equipment Refurbishment Services. VSE has provided the U. S. Army Reserve with military vehicle and equipment refurbishment services for several years. Beginning in 2006, VSE formed ELD to continue the performance of these services. ELD revenues from these services have increased during the first nine months of 2006 and ELD is expecting further increases in 2006 and future years.

Significant IDIQ Contracts. VSE has three multiyear, multiple award, indefinite delivery, indefinite quantity ("IDIQ") contracts that have large nominal ceiling amounts with no funding committed at the time of award. VSE is one of several awardees on each contract. While future VSE revenue from these contracts cannot be predicted with certainty, the award of these contracts provides the Company with the opportunity to compete for work that may contribute to future revenue growth, including new work in 2006. These three contracts are described below.

VSE's CED Division has a multiyear Rapid Response support contract awarded by the U.S. Army Communications-Electronics Command (CECOM) in January 2003. The contract enhances the Company's revenue producing capabilities by allowing it to provide services through any of VSE's operating entities or through third party subcontractors for various end user government customers. If all options are exercised, this contract has a potential total nominal ceiling of approximately \$2.9 billion over an eight-year period. While it is not likely that the full ceiling amount will be realized, this contract has generated revenues for VSE of approximately \$37 million and \$27 million during 2005 and 2004, respectively. The CED Army Equipment Support Program has generated approximately \$66 million in revenues during the nine months ended September 30, 2006, adding significantly to this contract's and the Company's revenues in 2006. VSE continues to pursue new orders on this contract that present potential revenue opportunities for the future.

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VSE's FMD Division has a contract with the U.S. Navy, SeaPort Enhanced, awarded in April 2004, which includes a five-year base period and two five-year option periods. This contract is a procurement vehicle for the Navy to order services from a wide range of contractors to support all phases of naval ship and shipboard weapons systems acquisition and life-cycle support. While this award does not guarantee any revenues for VSE, the Company is one of several contractors eligible to bid for services during the life of the contract. Over the first two years, FMD has generated only minor amounts of revenue from this contract. In May 2006, FMD was awarded a \$20.5 million, three-year order on this contract to support the Navy's Joint Program Office for Cartridge Actuated Devices and Propellant Actuated Devices. Work on this order began in June 2006 and is expected to contribute to 2006 and future years revenue growth.

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FMD also has a contract, awarded in September 2004, with the U.S. Navy to provide engineering and technical services to support Naval Sea Systems Command maintenance, overhaul, repair, and alteration of systems aboard ships. This contract has a total nominal contract ceiling amount of \$1.022 billion over a five-year period if all option periods are exercised. VSE is one of several awardees eligible to share in the potential total contract ceiling amount. Since the date of the contract award, FMD has been awarded delivery orders with ceilings valued at approximately \$44 million on this contract, of which approximately \$39 million has been funded. Although it is not likely that the full \$1.022 billion ceiling amount will be realized, this contract presents potential future revenue opportunities.

Treasury Seized Property Management Contract Award. In August 2006, VSE was awarded a contract to support the U.S. Department of the Treasury seized and forfeited general property program. This is a single award, cost-plus-incentive-fee contract that includes a base period of performance, four option periods, and award term provisions. The contract award was initially protested by the former incumbent contractor, but the protest was resolved in October 2006 and the contract is expected to contribute to VSE's revenues and profits beginning in the fourth quarter of 2006. If all option and award term periods are exercised, contract performance is expected to continue through September 30, 2014 and provide potential revenue over the life of the contract of approximately \$113 million, depending on service requirements.

### Funded Backlog

Revenues in government contracting businesses are dependent upon contract funding ("Bookings") and funded contract backlog is an indicator of potential future revenues. VSE received significant amounts of contract funding for the Taiwan Ship Transfer and the TBPS Program prior to 2006 that contributed to 2006 revenues. As the Taiwan Ship Transfer was completed and as tankers were completed on the TBPS Program, a significant amount of contract funding was used during the first nine months of 2006, resulting in an overall decline in funded contract backlog during this time. VSE has received a significant amount of contract funding for the CED Army Equipment Support Program in 2006, all of which is expected to generate revenue in 2006. During the remainder of 2006, VSE is expecting additional contract funding to be awarded to support the CED Army Equipment Support Program and the Treasury Seized Property Management Contract, most of which will result in revenues for 2007. A summary of VSE's Bookings, funded contract backlog, and revenues for the first nine months of 2006 is as follows.

(in millions)

Bookings for the nine months ended September 30, 2006      \$213

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Funded backlog as of September 30, 2006	\$226
Revenues for the nine months ended September 30, 2006	\$262

### Longer Term

The growth in VSE revenue and profits during 2004 and 2005, and the expected continuation of this growth in 2006, will present the Company with both challenges and opportunities for future years.

The biggest challenge VSE expects to face in future years is sustaining its recent level of growth. Certain work efforts that have supported VSE's growth in 2004, 2005 and in the nine month period ended September 30, 2006, are due to expire. VSE has received significant contributions to its revenue growth in 2004 from the Taiwan Ship Transfer work and in 2005 from both the Taiwan Ship Transfer work and the TBPS Program work. These two programs and the CED Army Equipment Support Program have also been among the largest contributors to VSE revenue in the first nine months of 2006. The expiration of these programs at various dates in 2006 and 2007 will reduce VSE annual revenues if the expiring work is not replaced by new or follow-on work.

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The Company believes it is well prepared to meet the challenge of replacing the expiring work. Opportunities associated with VSE's recent growth include a more competitive price structure with which to bid on future work, a wider range of employee skill sets, and a broader name recognition and past performance record for use in expanding the Company's customer base. In addition to proposals that the Company currently has under evaluation and in preparation, VSE is currently tracking multiple bidding opportunities for new contract work. Additionally, the larger revenue level and capital base improves the Company's ability to pursue larger programs and potential acquisition opportunities.

### Recent Accounting Pronouncements

#### Share-Based Payment

In December 2004, the Financial Accounting Standards Board issued SFAS 123(R), "Share-Based Payment," which is a revision to SFAS 123. SFAS 123(R) supersedes APB Opinion No. 25 and amends SFAS 95, "Statement of Cash Flows." Generally, the approach in SFAS 123(R) is similar to the approach described in SFAS 123. However, SFAS 123(R) requires all share-based payments to employees, including grants of employee stock options, to be recognized in the income statement based on their fair values. The Company adopted SFAS 123(R), using the modified prospective method, on January 1, 2006.

The impact of adopting SFAS 123(R) is expected to decrease income before income taxes by approximately \$252 thousand in 2006. The amount of stock-based compensation expense for the nine months ended September 30, 2006 was \$189 thousand. SFAS 123(R) also requires the benefits of tax deductions in excess of recognized compensation cost to be reported as a financing cash flow, rather than as an operating cash flow as required under the old method. The amount of financing cash flows from benefits of tax deductions in excess of recognized compensation cost for the nine months ended September 30, 2006 was \$92 thousand. The amount of operating cash flows from benefits of tax deductions in excess of recognized compensation cost for the nine months ended September 30, 2005 was \$684 thousand.

On December 30, 2005, VSE's board of directors (the "Board") directed VSE to discontinue awarding options, both discretionary and nondiscretionary, to

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purchase VSE Stock under VSE's 2004 Stock Option Plan (the "2004 Plan"). The options outstanding under the 2004 Plan as of December 30, 2005, and the options to purchase VSE Stock under VSE's 1998 Stock Option Plan (the "1998 Plan") are not affected by this Board action. The primary reason for the Board's suspension of option awards under the 2004 Plan was the potential impact on VSE's results of operations from the application of SFAS 123 (R) to share-based payments to employees, including stock option awards.

### Accounting for Uncertainty in Income Taxes

On July 13, 2006, the Financial Accounting Standards Board issued Interpretation No. (FIN) 48, "Accounting for Uncertainty in Income Taxes," which is effective January 1, 2007. The purpose of FIN 48 is to clarify and set forth consistent rules for accounting for uncertain tax positions in accordance with SFAS 109, "Accounting for Income Taxes." The cumulative effect of applying the provisions of this interpretation are required to be reported separately as an adjustment to the opening balance of retained earnings in the year of adoption. The Company is in the process of reviewing and evaluating FIN 48, and therefore the ultimate impact of its adoption is not yet known.

### Critical Accounting Policies

VSE's consolidated financial statements are prepared in accordance with accounting principles generally accepted in the United States, which require VSE to make estimates and assumptions. The Company believes the following critical accounting polices affect our more significant judgments, estimates

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and assumptions used in the preparation of its consolidated financial statements.

### Revenue Recognition

Substantially all of the Company's services are performed for its customers on a contract basis. The three primary types of contracts used are cost-type contracts, time and materials contracts, and fixed-price contracts. Revenues result from work performed on these contracts by the Company's employees and from pass-through of costs for material and work performed by subcontractors.

Revenues on cost-type contracts are recorded as contract allowable costs are incurred and fees earned. Profits on cost-type contracts are equal to the fees that are earned. The BAV contract terms specify award fee payments that are determined by performance and level of contract activity. Award fees are made three times during the year and a contract modification authorizing the award fee payment is issued subsequent to the period in which the work is performed. The Company does not recognize award fee income until the fees are fixed and determinable, generally upon contract notification confirming the award fee. Due to such timing, and to fluctuations in the level of revenues, profits as a percentage of revenues on this contract will fluctuate from period to period.

Revenues for time and materials contracts are recorded on the basis of contract allowable labor hours worked times the contract defined billing rates, plus the cost of materials used in performance on the contract. Profits on time and material contracts result from the difference between the cost of services performed and the contract defined billing rates for these services.

Revenue recognition methods on fixed-price contracts will vary depending on the nature of the work and the contract terms. On certain fixed-price contracts revenues are recorded as costs are incurred, using the percentage-of-completion

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method of accounting, because these contracts require design, engineering, and manufacturing performed to the customer's specifications. Revenues on fixed-price service contracts are recorded as work is performed. Revenues on fixed-price contracts that require delivery of specific items may be recorded based on a price per unit as units are delivered.

Certain direct and incremental contract costs have been deferred and reported as a current asset prior to the recognition of revenue. These costs are realizable beginning in August 2006 through January 2007. The amount of remaining costs classified as a current asset as of September 30, 2006 is approximately \$596 thousand.

Revenues by contract type for the nine months ended September 30, 2006 and 2005 were as follows (in thousands):

Contract Type	2006	%	2005	%
-----	-----	-	-----	-
Cost-type . . . . .	\$117,168	45	\$134,247	62
Time and materials.	112,016	43	45,998	22
Fixed-price . . . . .	32,590	12	34,956	16
	-----	---	-----	---
	\$261,774	100	\$215,201	100
	=====	===	=====	===

The Company will occasionally perform work at risk, which is work that is performed prior to the government formalizing funding for such work. Revenue related to work performed at risk is not recognized until it can be reliably estimated and its realization is probable. VSE recognizes this "risk funding" as revenue when the associated costs are incurred or the work is performed. VSE is at risk of loss for any risk funding not received. The Company provides for anticipated losses on contracts by a charge to income during the period in which losses are first identified. As of September 30, 2006, VSE has recognized approximately \$836 thousand in risk funding. The Company received funding modifications for approximately \$292 thousand of this amount in October 2006. VSE believes that it will receive funding for all or substantially all of this risk funding revenue.

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### Long-Lived Assets

In assessing the recoverability of long-lived assets, including goodwill and other intangibles, VSE must make assumptions regarding estimated future cash flows and other factors to determine the fair value of the respective assets. If these estimates or their related assumptions change in the future, VSE may be required to record impairment charges for these assets not previously recorded.

### Goodwill

Goodwill and intangible assets with indefinite lives are subject to a review for impairment at least annually. The Company performs its annual impairment test on September 30. As of September 30, 2006, the Company had approximately \$1.1 million of goodwill associated with its acquisition of Energetics in 1995. The Company has not recognized any reduction to the goodwill due to the impairment rules. If at some time in the future it is determined that impairment has occurred, such impairment could potentially have an adverse impact on the Company's results of operations or financial condition.

### Contingencies

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From time to time VSE is subject to proceedings, lawsuits, and other claims related to environmental, labor, and other matters. VSE is required to assess the likelihood of any adverse judgments or outcomes to these contingencies as well as potential ranges of probable losses and establish reserves accordingly. The amount of reserves required may change in future periods due to new developments in each matter or changes in approach to a matter such as a change in settlement strategy.

### Income Taxes

The carrying value of VSE net deferred tax assets is based on assumptions regarding VSE's ability to generate sufficient future taxable income to utilize these deferred tax assets. If the estimates and related assumptions regarding VSE's future taxable income change, VSE may be required to record valuation allowances against its deferred tax assets, resulting in additional income tax expense.

### Results of Operations

The following table sets forth certain items, including consolidated revenues, pretax income and net income from continuing operations, and the changes in these items for the nine month periods ended September 30, 2006 and 2005 (in thousands):

	Three Months		Nine Months		2006 Increase Compared to 2005	
	Ended September 30,		Ended September 30,		Three	Nine
	2006	2005	2006	2005	Months	Months
	-----	-----	-----	-----	-----	-----
Revenues . . . . .	\$103,630	\$76,600	\$261,774	\$215,201	\$27,030	\$46,573
	=====	=====	=====	=====	=====	=====
Income before income taxes . . . . .	\$ 3,030	\$ 2,587	\$ 8,710	\$ 7,591	\$ 443	\$ 1,119
Provision for income taxes . . . . .	1,141	1,000	3,309	2,935	141	374
	-----	-----	-----	-----	-----	-----
Income from continuing operations . . . . .	\$ 1,889	\$ 1,587	\$ 5,401	\$ 4,656	\$ 302	\$ 745
	=====	=====	=====	=====	=====	=====

Revenues increased by approximately 35% and 22% for the three and nine month periods ended September 30, 2006, as compared to the same periods of 2005. A substantial portion of the increases in revenues was attributable to revenues

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associated with the CED Army Equipment Support Program work, which started in January 2006. Increased revenues from ELD equipment refurbishment services and Energetics services also contributed to the Company's increases in revenues. The increases in revenues were partially offset by decreased revenues associated with decreases in the level of work performed under the BAV Ship Transfer Program, on FMD's Navy contracts, under the TBPS Program, and on VCG's contract with the U.S. Coast Guard.

Income before income taxes increased by approximately 17% and 15% for the three and nine month periods ended September 30, 2006, as compared to the same periods

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of 2005. The Company's income before income taxes was helped by increases in profits on the BAV Ship Transfer Program, on FMD contract work, and from Energetics. Also, the additional revenues generated by the CED Army Equipment Support Program work enabled the Company to spread corporate fixed costs over a larger revenue base, which further enhanced the overall Company income. Certain other work efforts experienced declines in profitability compared to the prior year, including decreases in profits on the TBPS Program, ELD's equipment refurbishment services, and MSD's management training services.

### Financial Condition

VSE's financial condition did not change materially during the nine months ended September 30, 2006. The Company's largest assets are its accounts receivable and the largest liabilities are its accounts payable and accrued expenses. Accounts receivable increased approximately \$15.2 million, and accounts payable increased approximately \$9.2 million during the first nine months of 2006. These increases and changes to other asset and liability accounts were due primarily to the increase in the level of business activity, contract delivery schedules, and the timing of associated billings to customers and subcontractor payments required to perform this work.

The increase in total stockholders' equity in this period resulted from earnings and dividend activity and from the exercise of stock options. In June 2006, VSE's Board of Directors authorized the Company to repurchase up to 50,000 shares of VSE Stock from time to time on the open market, subject to corporate objectives. As of September 30, 2006, the Company had not purchased any of these shares.

### Liquidity and Capital Resources

#### Cash Flows

Cash and cash equivalents decreased by approximately \$6.7 million during the nine months ended September 30, 2006. The decrease in cash and cash equivalents during this period resulted from cash used in operating activities of approximately \$3.8 million, cash used in investing activities of approximately \$2.6 million, and cash used in financing activities of approximately \$239 thousand. Investing activities consisted of expansion and improvement of facilities of approximately \$356 thousand and purchases of property and equipment, net of dispositions, of approximately \$2.2 million. Financing activities consisted of dividend payments and proceeds received from the issuance of VSE Stock under stock incentive plans.

Cash and cash equivalents increased by approximately \$9.6 million during the nine months ended September 30, 2005. The increase in cash and cash equivalents during this period resulted from cash provided by operating activities of approximately \$12.3 million, cash used in investing activities of approximately \$1.3 million, and cash used in financing activities of approximately \$1.4 million. Investing activities consisted of facilities related expenditures, including expenditures for facilities expansion and improvement, of approximately \$351 thousand and purchases of property and equipment, net of dispositions, of approximately \$921 thousand. Financing activities consisted of repayment of amounts previously borrowed on the Company's bank loan of approximately \$1.6 million, dividend payments, and

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proceeds received from the issuance of common stock due to the exercise of stock options.



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The difference between cash used in operating activities of approximately \$3.8 million in 2006 as compared to cash provided by operating activities of approximately \$12.3 million in 2005 is primarily due to an increase in the levels of accounts receivable and contract inventories on the TBPS program in 2006 as compared to 2005 and to changes in the level of accrued expenses.

Quarterly cash dividends were paid at the rate of \$.06 per share during each of the three months ended March 31 and June 30, 2006. Cash dividends of \$.07 per share were paid during the three months ended September 30, 2006. Pursuant to its bank loan agreement, the payment of cash dividends by VSE is subject to annual rate restrictions. VSE has paid cash dividends each year since 1973.

### Liquidity

The Company's internal sources of liquidity result primarily from operating activities, specifically from changes in the level of revenues and associated accounts receivable, inventories, and accounts payable from period to period, and from profitability. Significant increases or decreases in revenue and accounts receivable, inventories, and accounts payable can cause significant increases or decreases in internal liquidity.

Accounts receivable arise primarily from billings made by the Company to the government or other government prime contractors for services rendered, and payments received on accounts receivable represent the principal source of cash for the Company. Accounts receivable levels can be affected significantly by the timing of large materials purchases and subcontractor efforts used in performance on the Company's contracts. Accounts receivable levels are also affected by contract retainages, differences between the provisional billing rates authorized by the government compared to the costs actually incurred by the Company, differences between billable amounts authorized by contract terms compared to costs actually incurred by the Company, and government delays in processing administrative paperwork for contract funding.

Work on the TBPS program requires the Company to acquire inventories consisting of materials, supplies, and other expenditures for which end units have not yet been completed and accepted. Although these costs are classified as inventories for accounting purposes, they are similar in nature to materials and direct supplies purchased for use in performance on the Company's other contracts in that they are solely and directly attributable to the contract and will be billed to the customer within a relatively short time. All of the inventories are expected to be liquidated, billed, and collected as vehicle protection systems are completed and accepted by the government customer. These materials and direct supplies will not be restocked to maintain any permanent inventory levels.

Accounts payable arise primarily from purchases of subcontractor services and materials used by the Company in the performance of its contract work. Payments made on accounts payable, along with payments made to satisfy employee payroll and payroll associated expenses, make up the principal cash requirements of the Company. Accounts payable levels can be affected by changes in the level of contract work performed by the Company and by the timing of large materials purchases and subcontractor efforts used in performance on the Company's contracts.

Other cash requirements include income tax payments, the acquisition of capital assets for shop, office and computer support, and the payment of cash dividends. From time to time, the Company also invests in the expansion, improvement, and maintenance of its operational and administrative facilities. The growth in the level of equipment refurbishment services provided by ELD has required an increased level of investment in operational facilities during the first nine months of 2006 and will require additional investment in facilities during the

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remainder of 2006.

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VSE's external sources of liquidity consist of a revolving bank loan agreement that provides loan financing based on the Company's accounts receivable (see "Notes to Consolidated Financial Statements"). The bank financing complements the Company's internal sources of liquidity by providing increasing levels of borrowing capacity as accounts receivable levels increase. The bank loan agreement provided loan financing up to a maximum commitment of \$15 million as of September 30, 2006. The Company has determined that the current \$15 million commitment amount is adequate to cover known current and future liquidity requirements.

Performance of work under the Company's larger contracts that require significant amounts of subcontractor or material purchases have the potential to cause substantial requirements for working capital; however, management believes that cash flows from operations and the bank loan commitment are adequate to meet current operating cash requirements.

### Contractual Obligations

In January 2006, the Company signed a five-year facility lease for shop, office and warehouse space in Long Beach, Mississippi to begin in April 2006 for an aggregate amount of \$668 thousand. In April 2006, the Company signed an addendum to this lease to increase the amount of space leased and to defer the start date to May 2006. The revised aggregate amount of the lease is \$1.116 million.

In May 2006, the Company signed a three-year facility lease for shop and office space in Ladysmith, Virginia to begin in June 2006 for an aggregate amount of \$360 thousand. The Company simultaneously entered into a Real Estate Purchase Agreement for this property that gives the Company a 180 day option to buy the leased property for an amount of approximately \$1.5 million. In September 2006, the Company gave notice of its intention to exercise the option to purchase the property. Settlement of the purchase transaction is expected to occur in the fourth quarter of 2006.

See "Management's Discussion and Analysis of Financial Condition and Results of Operations" contained in VSE's Annual Report on Form 10-K for the fiscal year ended December 31, 2005, as amended for a summary of the Company's other contractual obligations.

### Asset Purchase Agreement

In July 2006, pursuant to an agreement with Giordano Automation Corp. ("Giordano"), VSE purchased certain assets of Giordano, including proprietary software, intellectual property rights, training materials, licenses, and warranties. The purchase price was \$575 thousand. The acquisition of these assets will allow the Company to pursue certain business opportunities.

### Inflation and Pricing

Most of the contracts performed by VSE provide for estimates of future labor costs to be escalated for any option periods provided by the contracts, while the non-labor costs included in such contracts are normally considered reimbursable at cost. VSE property and equipment consists principally of computer systems equipment, furniture and fixtures, and land and improvements. The overall impact of inflation on replacement costs of such property and

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equipment is not expected to be material to VSE's future results of operations or financial condition.

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### Disclosures About Market Risk

#### Interest Rates

VSE's bank loan financing provides available borrowing to the Company at variable interest rates. The Company has not borrowed significant amounts on the loan in recent years. Accordingly, the Company does not believe that any movement in interest rates would have a material impact on future earnings or cash flows. If VSE were to significantly increase borrowings on the current loan arrangement, future interest rate changes could potentially have a material impact.

#### Foreign Currency

While a significant amount of the Company's business results from the services provided by BAV related to the transfer of ships to foreign governments, the BAV contract payments are made by the U.S. Government in U.S. dollars. Additionally, most funding requirements to support work performed or services purchased in foreign countries are made in U.S. dollars, and the disbursements that are made in foreign currencies are reimbursable to BAV in post conversion dollars. Foreign currency transactions of other VSE divisions or subsidiaries are minimal. Accordingly, the Company does not believe that it is exposed to any material foreign currency risk.

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### VSE CORPORATION AND SUBSIDIARIES

#### Item 3. Quantitative and Qualitative Disclosures About Market Risks

See "Disclosures About Market Risk" in Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations.

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### Item 4. Controls and Procedures

As of the end of the period covered by this report, based on management's evaluation, with the participation of VSE's Chief Executive Officer and Chief Financial Officer, of the effectiveness of the disclosure controls and procedures (as defined in Rules 13a-15(e) or 15d - 15(e) under the Securities Exchange Act of 1934, as amended) our Chief Executive Officer and Chief Financial Officer have concluded that our disclosure controls and procedures are effective in ensuring that information required to be disclosed by us in reports filed or submitted under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission's rules and regulations.

There was no change in our internal control over financial reporting during our third quarter of fiscal 2006 that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

## PART II. Other Information

### Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

The Registrant did not purchase any of its equity securities during the period covered by this report.

Under the Registrant's bank loan agreement dividends may be paid in an annual aggregate amount of \$.60 per share, provided there is no default under the loan agreement.

### Item 6. Exhibits

(a) Exhibits.

Exhibit No.

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31.1	Section 302 CEO Certification
31.2	Section 302 CFO and PAO Certification
32.1	Section 906 CEO Certification
32.2	Section 906 CFO and PAO Certification

Pursuant to the requirements of the Securities Exchange Act of 1934, the Registrant has omitted all other items contained in "Part II. Other Information" because such other items are not applicable or are not required if the answer is negative or because the information required to be reported therein has been previously reported.

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VSE CORPORATION AND SUBSIDIARIES

SIGNATURES

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Pursuant to the requirements of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

VSE CORPORATION

Date: October 31, 2006

/s/ D. M. Ervine

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D. M. Ervine  
Chairman, President,  
Chief Executive Officer and  
Chief Operating Officer

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