VERSAR INC
Form 10-Q
November 10, 2005

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-Q

(Mark One)
[X] QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15 (d) OF THE SECURITIES EXCHANGE ACT OF 1934.

For the Quarterly Period Ended September 30, 2005

Commission File Number 1-9309

VersarInc.

(Exact name of registrant as specified in its charter)

DELAWARE	54-0852979
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
6850 Versar Center Springfield, Virginia	22151
(Address of principal executive offices)	(Zip Code)

Registrant's telephone number, including area code (703) 750-3000

Not Applicable

(Former name, former address and former fiscal year, if changed since last report.)

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 X No

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Exchange Act).

Yes No X

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes ______ No X ______

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practical date.

Class of Common Stock	Outstanding at November 1, 2005
$.01 par value	8,038,465

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VERSAR, INC. AND SUBSIDIARIES

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VERSAR, INC. AND SUBSIDIARIES
Consolidated Balance Sheets
(In Thousands)

	September 30, 2005	July 1, 2005
ASSETS	(Unaudited)	
Current assets		
Cash and cash equivalents	$ 1,765	$ 132
Accounts receivable, net	11,852	14,577
Prepaid expenses and other current assets	1,401	2,017
Deferred income taxes	765	308
Total current assets	15,783	17,034
Property and equipment, net	1,795	1,855
Deferred income taxes	---	457
Goodwill	776	776
Other assets	833	790
Total assets	$ 19,187	$ 20,912
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities		
Bank line of credit	$ ---	$ 777
Accounts payable	3,509	3,958
Accrued salaries and vacation	1,828	1,490
Other liabilities	1,512	2,642
Liabilities of discontinued operations, net	235	280
Total current liabilities	7,084	9,147
Other long-term liabilities	1,059	1,041
Liabilities of discontinued operations, net	87	172
Total liabilities	8,230	10,360
Commitments and contingencies		
Stockholders' equity		
Common stock, $.01 par value; 30,000,000 shares authorized; 8,026,751 shares and 7,924,116 shares issued September 30, 2005 and July 1, 2005, respectively;		

8,011,246 and 7,908,611 shares outstanding at September 30, 2005 and July 1, 2005, respectively	80	79
Capital in excess of par value	22,407	22,119
Accumulated deficit	(11,458)	(11,574)
Treasury stock	(72)	(72)
Total stockholders' equity	10,957	10,552
Total liabilities and stockholders' equity	$ 19,187	$ 20,912

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

VERSAR, INC. AND SUBSIDIARIES
Consolidated Statements of Operations
(Unaudited - in thousands, except per share amounts)

	For the Three-Month Periods Ended	
	September 30, 2005	October 1, 2004
GROSS REVENUE	$ 13,502	$ 18,958
Purchased services and materials, at cost	5,040	9,914
NET SERVICE REVENUE	8,462	9,044
Direct costs of services and overhead	6,875	7,038
Selling, general and administrative expenses	1,451	1,490
OPERATING INCOME	136	516
OTHER EXPENSE		
Interest expense	20	13
INCOME FROM CONTINUING OPERATIONS	116	503
LOSS FROM DISCONTINUED OPERATIONS	---	(96)
NET INCOME	$ 116	$ 407
INCOME PER SHARE FROM CONTINUING OPERATIONS - BASIC AND DILUTED	$ 0.01	$ 0.06

LOSS PER SHARE FROM DISCONTINUED OPERATIONS - BASIC AND DILUTED	$ ---	$ (0.01)
NET INCOME PER SHARE - BASIC AND DILUTED	$ 0.01	$ 0.05
WEIGHTED AVERAGE NUMBER OF SHARES OUTSTANDING - BASIC	7,988	7,846
WEIGHTED AVERAGE NUMBER OF SHARES OUTSTANDING - DILUTED	8,412	8,312

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

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VERSAR, INC. AND SUBSIDIARIES
Consolidated Statements of Cash Flows
(Unaudited - in thousands)

	For the Three-Month Periods Ended	
	September 30, 2005	October 1, 2004
Cash flows from operating activities		
Net income	$ 116	$ 407
Adjustments to reconcile net income to net cash provided by operating activities		
Depreciation and amortization	192	182
Provision for doubtful accounts receivable	---	1
Share based compensation	4	---
Changes in assets and liabilities		
Decrease in accounts receivable	2,725	53
Decrease (increase) in prepaids and other assets	583	(115)
(Decrease) increase in accounts payable	(449)	1,001
Increase (decrease) in accrued salaries and vacation	338	(38)
Decrease in other liabilities	(1,112)	(153)
Net cash provided by continuing operating activities	2,397	1,338

Changes in net liabilities of discontinued operations	(130)	(10)
Net cash provided by operating activities	2,267	1,328
Cash flows used in investing activities		
Purchase of property and equipment	(107)	(71)
(Increase) in life insurance policies cash surrender value	(35)	(10)
Net cash used in investing activities	(142)	(81)
Cash flows from financing activities		
Net payments on bank line of credit	(777)	---
Proceeds from issuance of common stock	285	31
Net cash (used in) provided by financing activities	(492)	31
Net increase in cash and cash equivalents	1,633	1,278
Cash and cash equivalents at the beginning of the period	132	817
Cash and cash equivalents at the end of the period	$ 1,765	$ 2,095
Supplementary disclosure of cash flow information:		
Cash paid during the period for		
Interest	$ 23	$ 9
Income taxes	10	5

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

VERSAR, INC. AND SUBSIDIARIES
Notes to Consolidated Financial Statements

(A) Basis of Presentation

The accompanying consolidated financial statements are presented in accordance with the requirements of Form 10-Q and consequently do not include all of the disclosures normally required by generally accepted accounting principles or those normally made in Versar, Inc.'s Annual Report on Form 10-K/A filed with the United States Securities and Exchange Commission. These financial statements should be read in conjunction with the Company's Annual Report filed on Form 10-K/A for the year ended July 1, 2005 for additional information.

The accompanying consolidated financial statements include the accounts of Versar, Inc. and its wholly-owned subsidiaries ("Versar" or the "Company"). All significant intercompany balances and transactions have been eliminated in consolidation. The financial information has been prepared in accordance with the Company's customary accounting practices. In the opinion of management, the information reflects all adjustments necessary for a fair presentation of the Company's consolidated financial position as of September 30, 2005, and the results of operations for the three-month periods ended September 30, 2005 and October 1, 2004. The results of operations for such periods, however, are not necessarily indicative of the results to be expected for a full fiscal year.

(B) Accounting Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America 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 may differ from those estimates.

(C) Contract Accounting

Contracts in process are stated at the lower of actual cost incurred plus accrued profits or net estimated realizable value of incurred costs, reduced by progress billings. The Company records income from major fixed-price contracts, extending over more than one accounting period, using the percentage-of-completion method. During performance of such contracts, estimated final contract prices and costs are periodically reviewed and revisions are made as required. The effects of these revisions are included in the periods in which the revisions are made. On cost-plus-fee contracts, revenue is recognized to the extent of costs incurred plus a proportionate amount of fee earned, and on time-and-material contracts, revenue is recognized to the extent of billable rates times hours delivered plus material and other reimbursable costs incurred. Losses on contracts are recognized when they become known. Disputes arise in the normal course of the Company's business on projects where the Company is contesting with customers for collection of funds because of events such as delays, changes in contract specifications and questions of cost allowability or collectibility. Such disputes, whether claims or unapproved change orders in the process of negotiation, are recorded at the lesser of their estimated net realizable value or actual costs incurred and only when realization is probable and can be reliably estimated. Claims against the Company are recognized where loss is considered probable and reasonably determinable in amount. Management reviews outstanding receivables on a regular basis and assesses the need for reserves taking into consideration past collection history and other events that bear on the collectibility of such receivables.

(D) Income Taxes

At September 30, 2005, the Company had approximately $4.3 million in deferred tax assets which primarily relate to net

operating loss and tax credit carryforwards. Since the Company had experienced losses in previous years, management recorded a valuation allowance of approximately $3.5 million against the net deferred tax asset. The valuation allowance is adjusted periodically based upon management's assessment of the Company's ability to derive benefit from the deferred tax assets.

(E) Debt

Versar's line of credit facility with United Bank (the Bank) provides for advances up to $5,000,000 based upon qualifying receivables. Interest on borrowings is based on prime plus one and a half percent (7.75% as of September 30, 2005). The credit facility is guaranteed by the Company and each subsidiary individually and is collectively secured by accounts receivable, equipment and intangibles, plus all insurance policies on property constituting collateral. There were no outstanding borrowings on the credit facility as of September 30, 2005. The credit facility is subject to renewal in November 2005 and is subject to certain covenants related to the maintenance of financial ratios. These covenants require a minimum tangible net worth of $6,500,000, a maximum total liabilities to tangible net worth ratio not to exceed 2.5 to 1; and a minimum current ratio of at least 1.25 to 1. Failure to meet the covenant requirements gives the Bank the right to demand the amount due under the credit facility, which may impact the Company's ability to finance its working capital requirements. At September 30, 2005, the Company was in compliance with such financial covenants.

(F) Discontinued Operations and Restructuring Charges

In fiscal year 1998, the Company discontinued a significant portion of the operations of Science Management Corporation (SMC). As such, the Company disposed of portions of SMC and disposed of substantially all of the remaining assets and liabilities. At July 1, 2005, there was $32,000 remaining liability primarily related to settling the remaining benefit plan obligations of SMC. The Company is in the process of locating eligible participants and will make a final distribution.

In the fourth quarter of fiscal year 2005, management approved a plan to discontinue the operations of its biological laboratory facilities due to lack of business volume, market concentration and poor operating performance. The Company recorded $420,000 facility termination costs at the end of fiscal year 2005. During the first quarter of fiscal year 2006, approximately $98,000 was charged against the termination costs leaving an accrued liability of approximately $322,000. Management believes the balance is adequate to satisfy the remaining lease obligation.

(G) Contingencies

Versar and its subsidiaries are parties to various legal

actions arising in the normal course of business. The Company believes that the ultimate resolution of these legal actions will not have a material adverse effect on its consolidated financial position and results of operations. (See Part II, Item 1 - Legal Proceedings).

In September 2002, the Company recorded a non-recurring charge of $800,000 to reduce the Company's overall cost structure and to reduce costs in non-performing divisions. The costs included $450,000 for severance payments to terminated employees and $350,000 for costs to restructure certain leased facilities. At September 30, 2005, all of the severance obligations were satisfied. As of September 30, 2005, there is an accrual of approximately $137,000 to be utilized to reduce the facility costs for vacant space at the Company's headquarters in Springfield, Virginia.

(H) Goodwill and Other Intangible Assets

On January 30, 1998, Versar completed the acquisition of The Greenwood Partnership, P.C. subsequently renamed Versar Global Solutions, Inc. or VGSI. The transaction was accounted for as a purchase. Goodwill resulting from this transaction was approximately $1.1 million. In fiscal year 2003, the Company adopted the Statement of Financial Accounting Standards (SFAS) No. 142, "Goodwill and Other Intangible Assets" which eliminated the amortization of goodwill, but requires the Company to test such goodwill for impairment annually. Currently, the carrying value of goodwill is approximately $776,000 relating to the acquisition of VGSI, which is now part of the Infrastructure and Management Services (IMS) reporting unit. The IMS business segment was combined with the Engineering and Construction business segment during fiscal year 2005 and continues to

operate under the IMS segment name, because many of the services provided were similar to the Company's remediation business, and the two segments shared similar customers and business opportunities, and were duplicative in nature. Such a combination provided a more efficient use of resources and more effective management of the business operations. In performing its goodwill impairment analysis, management has utilized a market-based valuation approach to determine the estimated fair value of the IMS reporting unit. Management engages outside professionals and valuation experts, as necessary, to assist in performing this analysis. An analysis was performed on public companies and company transactions to prepare a market-based valuation. Based upon the analysis as of July 1, 2005, the estimated fair value of the IMS reporting unit was $23 million which is in excess of the carrying amount of the net assets of the reporting unit by a substantial margin.

On April 15, 2005, the Company acquired the Cultural Resources Group from Parsons Infrastructure & Technology Group, Inc., a subsidiary of Parsons Corporation for a purchase price of

approximately $260,000 in cash. The Cultural Resources Group, based in Fairfax County, Virginia provides archaeological, cultural and historical services to federal, state and municipal clients across the country. The acquisition will expand the Company's existing and future capabilities in cultural resources work. Their expertise will enhance and compliment Versar's environmental core business. The Cultural Resources Group was incorporated into the Company's Infrastructure and Management Services (IMS) segment. As part of the acquisition, the Company has executed a two year marketing agreement with Parsons to give Versar the first right of refusal to certain Parsons cultural resources work from existing Parsons' clients. Thereafter, this agreement is annually renewable upon the agreement of both parties. Approximately $25,000 of the purchase price was allocated to fixed assets, with the remaining balance to be allocated to contract rights which are being amortized over a three-year period.

(I) Net Income Per Share

Basic net income per common share is computed by dividing net income by the weighted average number of common shares outstanding during the period. Diluted net income per common share also includes common stock equivalents outstanding during the period if dilutive. The Company's common stock equivalents shares consist of stock options.

	For the Three-Month Periods Ended	
	September 30, 2005	October 1, 2004
Weighted average common shares outstanding - basic	7,987,872	7,845,905
Assumed exercise of options (treasury stock method)	423,716	466,538
Weighted average common shares outstanding - diluted	8,411,588	8,312,443

(J) Common Stock

The Company issued 102,635 shares of common stock upon the exercise of stock options during the first three months of fiscal year 2006. Total proceeds from the exercise of such stock options was approximately $285,000.

Effective January 1, 2005, the Company implemented an Employee Stock Purchase Plan (ESPP) to allow eligible employees of Versar the opportunity to acquire an ownership interest in the Company's common stock. Through the Plan, employees may purchase shares of Versar common stock from the open market at 90% of its fair market value. The plan has been modified, effective September 7, 2005, to increase the purchase price of shares to 95% of fair market value as a result of the Company's adoption of the Statement of Financial Accounting Standard

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VERSAR, INC. AND SUBSIDIARIES
Notes to Consolidated Financial Statements (continued)

("SFAS") 123 (Revised 2004), "Accounting for Stock-Based Compensation" (SFAS 123 (R) requirements. The Plan qualifies as an "employee stock purchase plan" under Section 423 of the Internal Revenue Code.

(K) Stock-Based Compensation

Effective July 1, 2005, the Company adopted the Financial Accounting Standards Board (FASB) SFAS No. 123 (Revised 2004), "Accounting for Stock-Based Compensation" (SFAS 123(R)). This Statement revises SFAS No. 123 by eliminating the option to account for employee stock options under APB No. 25 and generally requires companies to recognize the cost of employee services received in exchange for awards of equity instruments based on the grant-date fair value of those awards (the "fair-value-based" method). The compensation expense of $4,000 for the first quarter of fiscal year 2006 was included in the Consolidated Statements of Operations.

On June 21, 2005, the Board of Directors of the Company accelerated the vesting of certain previously awarded unvested and "out-of-the-money" stock options that have an exercise price per share of $3.00 or more for all employees and officers of the Company. The awards accelerated were made under the Versar, Inc. 1996 Stock Option Plan and 2002 Stock Incentive Plan. As a result, options to purchase 306,010 shares of the Company's common stock became exercisable immediately. All other terms and conditions applicable to the outstanding stock option grants remain in effect. The closing price of the Company's common stock on the American Stock Exchange on June 21, 2005 was $3.00. The acceleration of the out-of-the-money stock options was done in order to avoid the impact of adopting SFAS 123(R). Non-qualified stock options were not included in the acceleration. Based on the potential for these options to have value over their expected life, the Company expects to reduce the stock option expense it otherwise would have been required to recognize in its consolidated statements of income by approximately $124,000 over the next four years on a pre-tax basis, as a result of the acceleration.

In November 2002, the stockholders approved the Versar, Inc. 2002 Stock Incentive Plan (the 2002 Plan). The 2002 Plan provides for the grant of options, restricted stock and other types of stock-based awards to any employee, service provider or director to whom a grant is approved from time to time by the Company's Compensation Committee. A "service provider" is defined for purposes of the 2002 Plan as an individual who is neither an employee nor a director of the Company or any of its affiliates but who provides the Company or one of its affiliates substantial and important services. The aggregate number of shares of the Company's Common Stock that may be issued upon exercise of options or granted as restricted stock or other stock-based awards under the 2002 Plan is 700,000. Grants of restricted stock, performance equity awards, options and stock

appreciation rights in any one fiscal year to any one participant may not exceed 250,000 shares. The maximum amount of compensation that may be received by any one employee with respect to performance unit grants in any one fiscal year may not exceed $250,000.

In November 1996, the stockholders approved the Versar 1996 Stock Option Plan (the 1996 Plan) to provide employees and directors of the Company and certain other persons an incentive to remain as employees of the Company and to encourage superior performance. The Company also maintains the Versar 1992 Stock Option Plan (the "1992 Plan") and the Versar 1987 Stock Option Plan (the "1987 Plan"). Options have been granted from these plans to purchase the Company's common stock.

Under the 1996 Stock Option Plan, options may be granted to key employees, directors and service providers at the fair market value on the date of grant. The vesting of each option will be determined by the Administrator of the Plan. Each option expires on the earlier of the last day of the tenth year after the date of grant or after expiration of a period designated in the option agreement.

Under the 1992 Plan, options through November 2002, were generally granted to key employees at the fair market value on the date of grant and became exercisable during the five-year period from the date of the grant at 20% per year. Options were granted with a ten year term and expire if not exercised by the tenth anniversary of the grant date. The 1992 plan has expired and no additional options may be granted. The Company will continue to maintain the plan until all previously granted options have been exercised, forfeited or expire.

VERSAR, INC. AND SUBSIDIARIES
Notes to Consolidated Financial Statements (continued)

As a result of adopting SFAS 123(R) on July 1, 2005, the Company's income before income taxes and net income for the first quarter ended September 30, 2005 is $4,000 lower than if it had continued to account for share-based compensation under Opinion 25. Basic and diluted earnings per share for the first quarter ended September 30, 2005 remained the same at $0.01 and $0.01, respectively.

A summary of option activity under the Company's employee stock option plans as of September 30, 2005, and changes during the thirteen weeks then ended is presented below:

Options	Shares (000)	Weighted-Average Exercise Price	Weighted-Average Remaining Contractual Term	Aggregate Intrinsic Value ($000)
Outstanding at July 1, 2005	1,690	$ 3.10		

Granted	5	$ 3.20		
Exercised	(104)	$ 2.77		
Forfeited or expired	(40)	$ 3.30		
Outstanding at September 30, 2005	1,551	$ 3.16	6.3	$ 2,730
Exercisable at September 30, 2005	1,238	$ 3.26	6.3	$ 2,248

As of September 30, 2005, there was approximately 313,000 shares of unvested option under the plans. The estimated compensation costs of $112,000 is expected to be recognized over a weighted-average period of 6.4 years. The total fair value of these unvested shares is approximately $482,000 as of September 30, 2005.

(L) Business Segments

The Company's business segments are Infrastructure and Management Services and National Security. The Infrastructure and Management Services segment provides a full range of services including remediation/corrective actions, site investigations, remedial designs, and construction, operation and maintenance of remedial systems, engineering, design and construction management to industrial, commercial and government facilities. The National Security segment provides expertise in developing, testing and providing personal protection equipment.

In fiscal year 2005, Versar combined the Infrastructure and Management Services and the former Engineering and Construction business segment because many of the services provided were similar to the Company's remediation business, and the two segments shared similar customers and business opportunities, and were duplicative in nature. Such a combination provided a more efficient use of resources and more effective management of the business operations, given the cyclical nature of the former Engineering and Construction business segment. The Company now evaluates the business along these two business lines. The prior year segment information has been restated to conform to the new presentation.

The Company evaluates and measures the performance of its business segments based on net service revenue and operating income. As such, selling, general and administrative expenses, interest and income taxes have not been allocated to the Company's business segments.

Summary financial information for each of the Company's

segments follows:

	For the Three-Month Periods Ended	
	September 30, 2005	October 1, 2004
NET SERVICE REVENUE	(In thousands)	
Infrastructure and Management Services	$ 7,052	$ 7,533
National Security	1,410	1,511
	$ 8,462	$ 9,044
OPERATING INCOME(A)		
Infrastructure and Management Services	$ 1,326	$ 1,706
National Security	261	300
	$ 1,587	$ 2,006
Selling, general and administrative expenses	(1,451)	(1,490)
OPERATING INCOME	$ 136	$ 516

(A) Operating income is defined as net service revenue less direct costs of services and overhead.

IDENTIFIABLE ASSETS	September 30, 2005	July 1, 2004
Infrastructure and Management Services	$ 12,280	$ 14,817
National Security	1,536	1,738
Corporate and Other	5,371	4,357
Total Assets	$ 19,187	$ 20,912

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

Financial trends

From fiscal year 2002 to 2004, the Company's net service revenue declined as the Company wound down the Army STEPO suit

production contract in its National Security business segment. With increased funded contract backlog in the fourth quarter of fiscal year 2004 and the first quarter of fiscal year 2005, the Company began to reverse this trend. Multi-million dollar contracts were awarded in the IMS business segment; including roofing projects in San Diego in support of the Defense Logistic Agency and hurricane emergency response projects in various locations in Florida. The Company achieved significant gross revenue growth in the first half of fiscal year 2005 as a result of increased IMS work.

However, during the third and fourth quarters of fiscal year 2005, gross revenues on the major construction projects declined compared to the first half of the fiscal year, due to delays in obtaining follow-on and new projects. The resulting reduction in gross revenues along with the delay in resolution of several construction change orders had a negative effect on the Company's operating results for the second half of fiscal year 2005. Additionally, during 2005, there were delays in contract funding for the Environmental Protection Agency and certain delays with civilian agencies because of diversion of funds for the war effort, and the announcement of additional military base closings by the BRAC commission, which impacted funding by approximately $5 million.

During much of the first quarter of 2006, the Company continued to experience reduced gross revenues as a result of continuing effects of the delays and other factors that impacted the last half of fiscal 2005. However, late in the first quarter of 2006, the Company increased its funded contract backlog from $31 million as reported at July 1, 2005 to $40 million for the end of the first quarter of fiscal 2006, primarily due to the release of several construction projects, recently awarded an additional $3 million contract for construction oversight in Iraq and increased activity at the government fiscal year end. Further, the Company has over $11 million of pending large construction projects that as of yet have not been funded. We anticipate that with the increased funded backlog, that gross revenues will increase during the remainder of the fiscal year as compared to that reported for the first quarter of fiscal 2006. However, for the Company to foster and sustain growth, it must win additional follow-on projects and additional new contracts to keep funded contract backlog at levels that will support continued growth. There can be no assurance that the Company's efforts to grow the business base will be successful or that the Company will receive sufficient contract awards to replace work as contracts are completed.

In fiscal year 2005, the Company discontinued the operations of its biological laboratory primarily due to the continued poor operating performance, market saturation and poor future business outlook. Such results are presented as discontinued operations for financial statement purposes and the liabilities of such operations have been segregated as the Company winds down the business affairs of the laboratory.

There are a number of risk factors or uncertainties that could significantly impact our financial performance including the following:

* General economic or political conditions;
* Threatened or pending litigation;

* The timing of expenses incurred for corporate initiatives;
* Employee hiring, utilization, and turnover rates;
* The seasonality of spending in the federal government and for commercial clients;
* Delays in project contracted engagements;
* Unanticipated contract changes impacting profitability;
* Reductions in prices by our competitors;
* The ability to obtain follow on project work;
* Failure to properly manage projects resulting in additional costs;
* The cost of compliance for the Company's laboratories;
* The impact of a negative government audit potentially impacting our costs, reputation and ability to work with the federal government;

ITEM 2 Management's Discussion and Analysis of Financial Condition and Results of Operations (continued)

* Loss of key personnel;
* The ability to compete in a highly competitive environment; and
* Federal funding delays due to war in Iraq.

Results of Operations

First Quarter Comparison of Fiscal Year 2006 and 2005

This report contains certain forward-looking statements which are based on current expectations. Actual results may differ materially. The forward-looking statements include those regarding the continued award of future work or task orders from government and private clients, cost controls and reductions, the expected resolution of delays in billing of certain projects, and the possible impact of current and future claims against the Company based upon negligence and other theories of liability. Forward-looking statements involve numerous risks and uncertainties that could cause actual results to differ materially, including, but not limited to, the possibilities that the demand for the Company's services may decline as a result of possible changes in general and industry specific economic conditions and the effects of competitive services and pricing; the possibility the Company will not be able to perform work within budget or contractual limitations; one or more current or future claims made against the Company may result in substantial liabilities; the possibility the Company will not be able to attract and retain key professional employees; changes to or failure of the Federal government to fund certain programs in which the Company participates; and such other risks and uncertainties as are described in reports and other documents filed by the Company from time to time with the Securities and Exchange Commission.

Gross revenue for the first quarter of fiscal year 2006 was

$13,502,000, a $5,456,000 (29%) decrease over that reported in the first quarter of fiscal year 2005, which had significant growth due to several large construction projects. The decrease in gross revenue is primarily attributable to decreased revenue in the Company's Infrastructure and Management Services segment due to reduced new construction work and delayed project funding of pending construction work. A portion of that funding was received late in the first quarter of fiscal year 2006. Such revenue was primarily generated from purchased services and materials, which is further discussed below.

Purchased Services and materials decreased by $4,874,000 (49%) in the first quarter of fiscal year 2006 compared to that reported in the first quarter of fiscal year 2005. The decrease was primarily the result of reduced subcontracted construction work and delayed project funding of pending construction work. A portion of that funding was not received until late in the first quarter of fiscal year 2006.

Net service revenue is derived by deducting the costs of purchased services and materials from gross revenue. Versar considers it appropriate to analyze operating margins and other ratios in relation to net service revenue, because such revenues reflect the actual work performed by the Company's labor force. Net service revenues decreased by 6% in the first quarter of fiscal year 2006 compared to that reported in the first quarter of fiscal year 2005. This was primarily due to the lower markup on purchased services and materials as a result of the reduced subcontracted work in the first quarter of fiscal year 2006.

Direct costs of services and overhead include the cost to Versar of direct and overhead staff, including recoverable and unallowable costs that are directly attributable to contracts. The percentage of these costs to net service revenue increased to 81.2% in the first quarter of fiscal year 2006 compared to 77.8% in the first quarter of fiscal year 2005. The increase was primarily due to lower labor utilization over that reported in the prior fiscal reporting period and significant proposal activity during the first quarter of fiscal year 2006.

Selling, general and administrative expenses approximated 17.1% of net service revenue in the first quarter of fiscal year 2006, compared to 16.5% in the first quarter of fiscal year 2005. The increase is primarily due to the decrease in business volume in the first quarter of fiscal year 2006 as compared to the first quarter of fiscal year 2005.

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ITEM 2 Management's Discussion and Analysis of Financial Condition and Results of Operations (continued)

Operating income from continuing operations for the first quarter of fiscal year 2006 was $136,000, a 74% decrease over that reported in the prior fiscal year. The decrease is primarily due to the decreased gross revenues and the increased direct costs of services and overhead as discussed above.

Interest expense for the first quarter of fiscal year 2006

was $20,000, an increase of $7,000 (59%) over that reported in the first quarter of fiscal year 2005. The increase was due to the Company's temporary utilization of the line of credit as well as interest rate increases as the line of credit is tied to the prime rate. During the first quarter of fiscal year 2006, the Company repaid outstanding borrowings on the line of credit and reduced the Company's reliance on such credit facility to manage the Company's working capital requirements.

Income from continuing operations was $116,000, a decrease of $387,000 over that reported in the prior fiscal year. The decrease is primarily due to the decreased gross revenues and increased direct costs of services and overhead as discussed above.

In the fourth quarter of fiscal year 2005, management approved a plan to discontinue the operations of its biological laboratory facilities due to the lack of business volume, market concentration, and poor operating performance. The loss from discontinued operations for the biological laboratory for the first quarter of fiscal year 2005 was $96,000. No further losses were incurred in the first quarter of fiscal year 2006.

Versar's net income for the first quarter of fiscal year 2006 was $116,000 compared to $407,000 in the first quarter of fiscal year 2005. The lower earnings were primarily attributable to the decrease in gross revenues and higher direct costs of services as discussed above.

Liquidity and Capital Resources

The Company's working capital as of September 30, 2005 approximated $8,699,000, an increase of $812,000 (10%). In addition, the Company's current ration was 2.23 which improved over the 1.86 reported on July 1, 2005. The improvement was primarily due to the decrease in accounts receivables, which improved the Company's cash position and allowed it to repay its line of credit.

The Company has a line of credit facility with United Bank (the Bank) that provides for advances up to $5,000,000 based upon qualifying receivables. Interest on borrowings is based on the prime rate plus one and half percent (7.75% as of September 30, 2005). As of September 30, 2005, Versar had no balance outstanding on the line of credit. Borrowing capacity available under the line of credit was $5,000,000. Obligations under the credit facility are guaranteed by the Company and each subsidiary individually and collectively secured by accounts receivable, equipment and intangibles, plus all insurance policies on property constituting collateral. The credit facility is scheduled for renewal in November 2005, and is subject to certain covenants related to the maintenance of financial ratios. These covenants require a minimum tangible net worth of $6,500,000, a maximum total liabilities to tangible net worth ratio not exceed 2.5 to 1; and a minimum current ratio of at least 1.25 to 1. Failure to met the covenant requirements gives the Bank the right to demand the amount due under the line of credit, which may impact the Company's ability to finance its working capital requirements. At September 30, 2005, the Company was in compliance with the financial covenants.

We believe that with our current cash position, together

with anticipated cash flows and the renewal of the line of credit, will be sufficient to meet the Company's liquidity needs within the next year. Expected capital requirements for fiscal year 2006 are approximately $500,000 primarily to maintain and upgrade our chemical laboratory and the Company's computer systems. Such capital requirements will either be funded through the existing working capital or will be financed through third party financing sources. However, third party financing services may not be available on terms acceptable to us, or at all.

ITEM 2 Management's Discussion and Analysis of Financial Condition and Results of Operations (continued)

Critical Accounting Policies and Related Estimates That Have a Material Effect on Versar's Consolidated Financial Statements

Below is a discussion of the accounting policies and related estimates that we believe are the most critical to understanding the Company's consolidated, financial position, and results of operations which require management judgments and estimates, or involve uncertainties. Information regarding our other accounting policies is included in the notes to our consolidated financial statements included in our annual report filed on Form 10-K.

Revenue recognition: Contracts in process are stated at the lower of actual costs incurred plus accrued profits or net estimated realizable value of costs, reduced by progress billings. On cost-plus fee contracts, revenue is recognized to the extent of costs incurred plus a proportionate amount of fee earned, and on time-and material contracts, revenue is recognized to the extent of billable rates times hours delivered plus material and other reimbursable costs incurred. The Company records income from major fixed-price contracts, extending over more than one accounting period, using the percentage-of-completion method. During the performance of such contracts, estimated final contract prices and costs are periodically reviewed and revisions are made as required. Fixed price contracts can be significantly impacted by changes in contract performance, contract delays, liquidated damages and penalty provisions, and contract change orders, which may effect the revenue recognition on a project. Losses on contracts are recognized in the period when they become known.

From time to time we may proceed with work based on customer direction pending finalizing and signing of contract funding documents. We have an internal process for approving any such work. The Company recognizes revenue based on actual costs incurred to the extent that the funding is assessed as probable. In evaluating the probability of funding being received, we consider our previous experiences with the customer, communications with the customer regarding funding status, and our knowledge of available funding for the contract or program. If funding is not assessed as probable, costs are expensed as they are incurred.

There is the possibility that there will be future and currently unforeseeable significant adjustments to our estimated contract revenues, costs and margins for fixed price contracts, particularly in the later stages of these contracts. It is most likely that such adjustments could occur in our Engineering and Construction business segment. Such adjustments are common in the construction industry given the nature of the contracts. These adjustments could either positively or negatively impact our estimates due to the circumstances surrounding the negotiations of change orders, the impact of schedule slippage, subcontractor claims and contract disputes which are normally resolved at the end of the contract. Adjustments to the financial statement are made when they are known.

Allowance for doubtful accounts: Disputes arise in the normal course of the Company's business on projects where the Company is contesting with customers for collection of funds because of events such as delays, changes in contract specifications and questions of cost allowability or collectibility. Such disputes, whether claims or unapproved change orders in process of negotiation, are recorded at the lesser of their estimated net realizable value or actual costs incurred and only when realization is probable and can be reliably estimated. Claims against the Company are recognized where loss is considered probable and reasonably determinable in amount. Management reviews outstanding receivables on a regular basis and assesses the need for reserves, taking into consideration past collection history and other events that bear on the collectibility of such receivables.

Deferred tax valuation allowance: The Company has approximately $4.3 million in deferred tax assets of which a $3.5 million valuation allowance has been established against such assets. Management provides for a valuation allowance until such time as it can conclude more likely than not that the Company will derive a benefit from such assets. The valuation allowance is adjusted as necessary based upon the Company's ability to generate taxable income, including management's ability to implement tax strategies that will enable the Company to benefit from such deferred tax assets.

Goodwill and other intangible assets:

On January 30, 1998, Versar completed the acquisition of The Greenwood Partnership, P.C. subsequently renamed Versar Global Solutions, Inc. or VGSI. The transaction was accounted for as a purchase. Goodwill resulting from this transaction was approximately $1.1 million. In fiscal year 2003, the Company adopted the Statement of Financial Accounting Standards (SFAS) No. 142, "Goodwill and Other Intangible Assets" which eliminated the amortization of goodwill, but requires the Company to test such goodwill for impairment annually. Currently, the carrying

value of goodwill is approximately $776,000 relating to the acquisition of VGSI, which is now part of the Infrastructure and Management Services (IMS) reporting unit. The IMS business segment was combined with the Engineering and Construction business segment during fiscal year 2005 and continues to operate under the IMS segment name, because many of the services provided were similar to the Company's remediation business, and the two segments shared similar customers and business opportunities, and were duplicative in nature. Such a combination provided a more efficient use of resources and more effective management of the business operations. In performing its goodwill impairment analysis, management has utilized a market-based valuation approach to determine the estimated fair value of the IMS reporting unit. Management engages outside professionals and valuation experts, as necessary, to assist in performing this analysis. An analysis was performed on public companies and company transactions to prepare a market-based valuation. Based upon the analysis, as of July 1, 2005, the estimated fair value of the IMS reporting unit was $23 million which is in excess of the carrying amount of the net assets of the reporting unit by a substantial margin. As such, management concluded goodwill was not impaired.

On April 15, 2005, the Company acquired the Cultural Resources Group from Parsons Infrastructure & Technology Group, Inc., a subsidiary of Parsons Corporation for a purchase price of approximately $260,000 in cash. The Cultural Resources Group, based in Fairfax County, Virginia provides archaeological, cultural and historical services to federal, state and municipal clients across the country. The acquisition will expand the Company's existing and future capabilities in cultural resources work. Their expertise will enhance and compliment Versar's environmental core business. The Cultural Resources Group was incorporated into the Company's Infrastructure and Management Services (IMS) segment. As part of the acquisition, the Company has executed a two year marketing agreement with Parsons to give Versar the first right of refusal to certain Parsons cultural resources work from existing Parsons' clients. Thereafter, this agreement is annually renewable upon agreement of both parties. Approximately $25,000 of the purchase price was allocated to fixed assets, with the remaining balance to be allocated to contract rights which are being amortized over a three-year period.

Impact of Inflation

Versar seeks to protect itself from the effects of inflation. The majority of contracts the Company performs are for a period of a year or less or are cost plus fixed-fee type contracts and, accordingly, are less susceptible to the effects of inflation. Multi-year contracts provide for projected increases in labor and other costs.

Commitments and Contingencies

In September 2002, the Company recorded a non-recurring charge of $800,000 to reduce the Company's overall cost structure and to reduce costs in non-performing divisions. The costs included $450,000 for severance payments to terminated employees and $350,000 for costs to restructure certain leased facilities.

At September 2005, all of the severance obligations were satisfied. As of September 30, 2005, there is an accrual of approximately $137,000 to be utilized to reduce the facility costs for vacant space at the Company's headquarters in Springfield, Virginia.

Item 3 - Quantitative and Qualitative Disclosures About Market Risk

There have been no material changes regarding the Company's market risk position from the information provided on Form 10-K for the fiscal year end July 1, 2005.

Item 4 - Procedures and Controls

As of the last day of the period covered by this report, the Company carried out an evaluation, under the supervision of the Company's Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of the Company's disclosure controls and procedures pursuant to Exchange Act Rule 13a-15. Based upon that evaluation, the Chief Executive Officer and Chief Financial Officer concluded that the Company's disclosure controls and procedures are effective, as of such date, to ensure that required information will be disclosed on a timely basis in its reports under the Exchange Act.

Further, our Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures have been designed to ensure that information required to be disclosed in reports filed by us under the Exchange Act is accumulated and communicated to our management, including the Chief Executive Officer and Chief Financial Officer, in a manner to allow timely decisions regarding the required disclosure.

There were no changes in the Company's internal control over financial reporting during the last quarter that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

PART II - OTHER INFORMATION

Item 1 - Legal Proceedings

In August 1997, Versar entered into a contract with the Trustees for the Enviro-Chem Superfund Site, which provided that, based upon an existing performance specification, Versar would refine the design of, and construct and operate a soil vapor extraction system. During the performance of the contract, disputes arose between Versar and the Trustees regarding the scope of work. Eventually, Versar was terminated by the Trustees for convenience. The Trustees then failed to pay certain invoices and retainages due Versar.

On March 19, 2001, Versar instituted a lawsuit against the Trustees and three environmental consulting companies in the U.S. District Court of the Eastern District of Pennsylvania, entitled Versar, Inc. v. Roy O. Ball, Trustee, URS Corporation,

Environmental Resources Management and Environ Corp., No. 01CV1302. Versar, in seeking to recover amounts due under the remediation contract from the Trustees of the Superfund Site, claimed breach of contract, interference with contractual relationships, negligent misrepresentations, breach of good faith and fair dealing, unjust enrichment and implied contract. Mr. Ball and several defendants moved to dismiss the action or, in the alternative, transfer the action to the U.S. District Court for the Southern District of Indiana, where, on April 20, 2001, the two Trustees had filed suit against Versar in the U.S. District Court for the Southern District of Indiana, entitled, Roy O. Ball and Norman W. Bernstein, Trustees v. Versar, Inc., Case No. IPO1-0531 C H/G. The Trustees alleged breach of contract and breach of warranty with respect to the remediation contract and asked for a declaratory judgment on a number of the previously stated claims.

On July 12, 2001, the Federal District Court in Pennsylvania granted defendants' motion to transfer the Pennsylvania lawsuit and consolidate the two legal actions in Indiana. The Company filed an answer and counterclaim to the Indiana lawsuit. The plaintiffs and third-party defendants filed Motions to Dismiss the Company's counterclaim. The court granted the motions in part and denied them in part. Versar amended its answer and counterclaim. In the meantime, plaintiffs filed a Motion for Partial Summary Judgment which the Judge granted in part and denied in part. The Judge held that certain agreements entered into by the parties prevented Versar from recovering certain amounts under its counterclaim but that Versar could pursue its claim for fraud in other areas. Written and oral discovery has continued for several years. The court granted Versar's demand that the Trustees supply requested information and documents, including electronic documents. Versar continues to seek additional discovery compliance by the Trustees. Motions for Partial Summary Judgement have been filed by both parties. No trial date is presently scheduled. Based upon discussions with outside counsel, management does not believe that the ultimate resolution under the Trustees' lawsuit will have a materially adverse effect on the Company's consolidated financial condition and results of operations.

Versar and its subsidiaries are parties from time to time to various other legal actions arising in the normal course of business. The Company believes that any ultimate unfavorable resolution of these legal actions will not have a material adverse effect on its consolidated financial condition and results of operations.

Item 6 - Exhibits

(a) Exhibits

31.1 and 31.2 - Certification pursuant to Securities Exchange Act Section 13a-14.

32.1 and 32.2 - Certification under Section 906 of the Sarbanes-Oxley Act of 2002.

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SIGNATURES

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.

VERSAR, INC.
(Registrant)

/S/ Theodore M. Prociv

By:______________________
Theodore M. Prociv
Chief Executive Officer,
President, and Director

/S/ Lawrence W. Sinnott

By:______________________
Lawrence W. Sinnott
Executive Vice President,
Chief Operating Officer,
Chief Financial Officer,
Treasurer, and Principal
Accounting Officer

Date: November 10, 2005

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