VERSAR INC
Form 10-Q
November 13, 2006

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 29, 2006

[ ] Transition Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934
For the transition period from _______ to _______
Commission File Number 1-9309

VersarInc.
(Exact name of registrant as specified in its charter)

DELAWARE
(State or other jurisdiction of incorporation or organization)

54-0852979
(I.R.S. Employer Identification No.)

6850 Versar Center
Springfield, Virginia
(Address of principal executive offices)

22151
(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 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.

Large accelerated filer [ ] Accelerated filer [ ] Non-accelerated filer [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, 2006
$.01 par value	8,146,364

VERSAR, INC. AND SUBSIDIARIES

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

	September 29, 2006	June 30, 2006
ASSETS	(Unaudited)	
Current assets		
Cash and cash equivalents	$ 2,935	$ 140
Accounts receivable, net	14,853	16,227
Prepaid expenses and other current assets	1,576	1,430
Deferred income taxes	566	566
Total current assets	19,930	18,363
Property and equipment, net	1,670	1,744
Deferred income taxes	1,144	1,144
Goodwill	776	776
Other assets	770	775
Total assets	$ 24,290	$ 22,802
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities		
Accounts payable	$ 5,407	$ 4,691
Billings in excess of revenue	33	209
Accrued salaries and vacation	1,836	1,474
Other liabilities	2,677	2,585
Liabilities of discontinued operations, net	213	285
Total current liabilities	10,166	9,244
Other long-term liabilities	928	986
Total liabilities	11,094	10,230
Commitments and contingencies		
Stockholders' equity		
Common stock, $.01 par value; 30,000,000 shares authorized; 8,148,192 shares and 8,144,692 shares issued; 8,132,687 and 8,129,187 shares outstanding at September 29, 2006 and June 30, 2006, respectively	81	81
Capital in excess of par value	22,808	22,790
Accumulated deficit	(9,621)	(10,227)
Treasury stock	(72)	(72)
Total stockholders' equity	13,196	12,572
Total liabilities and stockholders' equity	$ 24,290	$ 22,802

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

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

	For the Three-Month Periods Ended	
	September 29, 2006	September 30, 2005
GROSS REVENUE	$ 22,285	$ 13,502
Purchased services and materials, at cost	13,671	5,040
NET SERVICE REVENUE	8,614	8,462
Direct costs of services and overhead	6,466	6,875
Selling, general and administrative expenses	1,497	1,451
OPERATING INCOME	651	136
OTHER EXPENSE		
Interest expense, net	11	20
Income tax expense	34	---
NET INCOME	$ 606	$ 116
NET INCOME PER SHARE - BASIC AND DILUTED	$ 0.07	$ 0.01
WEIGHTED AVERAGE NUMBER OF SHARES OUTSTANDING - BASIC	8,148	7,988
WEIGHTED AVERAGE NUMBER OF SHARES OUTSTANDING - DILUTED	8,429	8,412

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 29, 2006	September 30, 2005
Cash flows from operating activities		
Net income	$ 606	$ 116
Adjustments to reconcile net income to net cash provided by operating activities		
Depreciation and amortization	179	192
Provision for doubtful accounts receivable	25	---
Share based compensation	8	4
Changes in assets and liabilities		
Decrease in accounts receivable	1,349	2,725
(Increase) decrease in prepaids and other assets	(135)	583
Increase (decrease) in accounts payable	716	(449)
Increase in accrued salaries and vacation	362	338
Decrease in other liabilities	(142)	(1,112)
Net cash provided by continuing operating activities	2,968	2,397
Changes in net liabilities of discontinued operations	(72)	(130)
Net cash provided by operating activities	2,896	2,267
Cash flows used in investing activities		
Purchase of property and equipment	(85)	(107)
Increase in life insurance policies cash surrender value	(26)	(35)
Net cash used in investing activities	(111)	(142)
Cash flows from financing activities		
Net payments on bank line of credit	---	(777)
Proceeds from issuance of common stock	10	285
Net cash provided by (used in) financing activities	10	(492)
Net increase in cash and cash equivalents	2,795	1,633
Cash and cash equivalents at the beginning of the period	140	132
Cash and cash equivalents at the end of the period	$ 2,935	$ 1,765

Supplementary disclosure of cash flow information:

Cash paid during the period for		
Interest	$ 9	$ 23
Income taxes	7	10

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

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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 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 for the year ended June 30, 2006 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 29, 2006, and the results of operations for the three-month periods ended September 29, 2006 and September 30, 2005. 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 29, 2006, the Company had approximately $4.6 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 $2.8 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

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 of interest (8.25% as of September 29, 2006). As of September 29, 2006, there were no borrowings outstanding under the line of credit. 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 matures in November 2007. The line of credit is subject to certain covenants related to the maintenance of financial ratios. These covenants require a minimum tangible net worth of $8,500,000, 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 outstanding amounts due under the line of credit, which may impact the Company's ability to finance its working capital requirements. At September 29, 2006, the Company was in compliance with the financial covenants.

The Company believes that the borrowing capacity under the line of credit, together with anticipated cash flows from operations, is sufficient to meet the Company's liquidity needs. There can be no assurance, however, that amounts available in the future from existing sources of liquidity will be sufficient to meet future capital needs.

(F) Discontinued Operations and Restructuring Charges

In fiscal year 1998, the Company discontinued a significant portion of the operations of Science Management Corporation (SMC). Since 1998, the Company has disposed of substantially all of the remaining assets and liabilities of SMC with the exception of certain defined benefit obligations. In the second quarter of fiscal year 2006, the Company recorded an additional $205,000 liability based on a revised actuarial calculation of the remaining SMC pension plan obligation. In the fourth quarter of fiscal year 2006, an additional $85,000 accrual was deemed necessary to cover the under funding and plan termination costs. At September 29, 2006, there was an accrual of approximately $213,000 to cover the cost to terminate the SMC pension plan in accordance with the Pension Guaranty Corporation Benefit (PBGC) requirements. The Company has received Internal Revenue Service (IRS) and PBGC plan termination approval and is in the process of locating eligible participants in the pension plan and intends to make a final distribution as early as administratively practical.

(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).

(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. The carrying value of goodwill of approximately $776,000 relating to the acquisition of VGSI, is included in the Infrastructure and Management Services (IMS) reporting unit. 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, the estimated fair value of the IMS reporting unit was $25 million which exceeds the carrying value of its net assets by a substantial margin. Should the IMS reporting unit financial performance not meet estimates, then impairment of goodwill would have to be further assessed to determine whether a write down of goodwill value would be warranted. If such a write down were to occur, it would negatively impact the Company(s financial position

and results of operations. However, it would not impact the Company's cash flow or financial debt covenants.

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 expanded the Company's existing and future capabilities in cultural resources work enhancing and complimenting Versar's environmental core business. The Cultural Resources Group was incorporated into the Company's IMS segment. As part of the acquisition, the Company executed a two year marketing agreement with Parsons which gives Versar the first right of refusal to certain Parsons cultural resources work from existing Parsons' clients. Thereafter, this agreement is annually renewable should both parties agree. Substantially all of the purchase price was allocated to contract rights and is 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 and restricted stock.

	For the Three-Month Periods Ended	
	September 29, 2006	September 30, 2005
Weighted average common shares outstanding - basic	8,147,879	7,987,872
Effect of assumed exercise of options	281,251	423,716
Weighted average common shares outstanding - diluted	8,429,130	8,411,588

(J) Common Stock

The Company issued 3,500 shares of common stock upon the exercise of stock options during the first three months of fiscal year 2007. Total proceeds from the exercise of such stock options were approximately $10,000.

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. As amended, the Plan permits employees to purchase shares of Versar common stock from the open market at 95% of its fair market value. The Plan qualifies as an "employee stock purchase plan" under Section 423 of the Internal Revenue Code.

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

(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 $7,000 for the first quarter of fiscal year 2007 was included in the Consolidated Statements of Operations.

On June 21, 2005, the Board of Directors of the Company accelerated the vesting of certain unvested "out-of-the-money" employee options that had exercise prices of $3.00 or more per share. The awards subject to acceleration 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 remained in effect. The acceleration of the out-of-the-money stock options was done in order to avoid the impact of adopting SFAS 123(R). Based on the potential for these options to have value over their expected term, the Company estimated stock-based compensation of expense it otherwise would have been required to recognize in its consolidated statements of income by approximately $124,000.

In November 2005, the stockholders approved the Versar, Inc. 2005 Stock Incentive Plan (the 2005 Plan). The 2005 Plan provides for grants of incentive awards, including stock options, SARS, restricted stock, restricted stock units and performance based awards, to directors, officers and employees of the Company and its affiliates as approved from time to time by the Company's Compensation Committee. Only employees may receive stock options classified as "incentive stock options", also known as "ISO's". The per share exercise price for options and SARS granted under the 2005 Plan shall not be less than the fair market value of the common stock on the date of grant. A maximum of 400,000 shares of Common Stock may be awarded under the 2005 Plan. No single director, officer, or employee may receive awards as to more than 100,000 shares of Common Stock during the term of the 2005 Plan. The ability to make awards under the 2005 Plan will terminate in November 2015.

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"). Options have been granted under these plans to purchase the Company's common stock.

Under the 1996 Plan, through September 2006, options were granted to key employees, directors and service providers at the fair market value on the date of grant. The vesting of each option was 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. The 1996 Plan has expired and no additional options may be granted under this plan. The Company will continue to maintain the plan until all previously granted options have been exercised, forfeited or expire.

Under the 1992 Plan, through November 2002, options 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 under this plan. The Company will continue to maintain the plan until all previously granted options have been exercised, forfeited or expire.

As a result of adopting SFAS 123(R) on July 1, 2005, the Company's income before income taxes for the first quarter ended September 29, 2006 and September 30, 2005 was reduced by stock-based compensation expense of $7,000 and $4,000, respectively. Basic and diluted earnings per share for the first quarter ended September 29, 2006 remained the same at $0.07.

A summary of the Company's stock option plans as of September 29, 2006, and changes during the first quarter of fiscal year 2007 is presented below:

Options	Shares (000)	Weighted-Average Exercise Price	Weighted-Average Remaining Contractual Term	Aggregate Intrinsic Value ($000)
Outstanding at July 1, 2006	1,230	$ 3.15		
Exercised	(3)	$ 2.92		
Forfeited or expired	(17)	$ 3.46		
Outstanding at September 29, 2006	1,210	$ 3.14	5.75	$ 2,120

Exercisable at

September 29, 2006	1,071	$ 3.12	5.96	$ 1,884

As of September 29, 2006, there were unvested options to purchase approximately 108,000 shares outstanding under the plans. Estimated compensation costs of $34,000 are expected to be recognized over a weighted-average period of 4.2 years. The total fair value of these unvested options is approximately $161,000 as of September 29, 2006.

(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.

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

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 29, 2006	September 30, 2005
NET SERVICE REVENUE	(In thousands)	
Infrastructure and Management Services	$ 7,367	$ 7,052
National Security	1,247	1,410
	$ 8,614	$ 8,462
OPERATING INCOME(A)		
Infrastructure and Management Services	$ 2,124	$ 1,326
National Security	24	261
	$ 2,148	$ 1,587

Selling, general and

administrative expenses	(1,497)	(1,451)
OPERATING INCOME	$ 651	$ 136

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

IDENTIFIABLE ASSETS	September 29, 2006	June 30, 2006
Infrastructure and Management Services	$ 15,215	$ 16,456
National Security	1,590	1,777
Corporate and Other	7,485	4,569
Total Assets	$ 24,290	$ 22,802

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

Financial trends

In fiscal year 2006, the Company's gross revenues continued to decline primarily due to the continuation of federal government delays in funding, which in certain instances, spanned as much as nine months and the continued diversion of funding to the war in Iraq. The Company adapted to the funding shifts by expanding its services in Iraq under existing contracts and seeking new contract work in Iraq. By the end of fiscal year 2006, the project funding began to return to normal levels and the Company's funded backlog increased by 55% to $48 million. For the first quarter of fiscal year 2007, the Company was able to further increase its funded backlog, to $65 million at September 29, 2006, an increase of 35% over that reported at June 30, 2006. The increase was primarily attributable to increased funding of construction work as a result of the U.S. government's year end funding of project work. Management continues to pursue many business opportunities to continue such growth.

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;
- Loss of key personnel;
- The ability to compete in a highly competitive environment;
- Federal funding delays due to war in Iraq, and funding of Iraq support; and
- Changes in political parties and the impact to funding of priorities.

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

Results of Operations

First Quarter Comparison of Fiscal Year 2007 and 2006

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 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 2007 was $22,285,000, an $8,783,000 (65%) increase over that reported in the first quarter of fiscal year 2006. Approximately sixty-six percent of the increase is due to growth in construction work in support of the Air Force and the State Department. The remaining amount of the increase is due to additional work in Iraq to provide personnel services for the Army, which was awarded to the Company in fiscal year 2006.

Purchased services and materials increased by $8,631,000 (171%) in the first quarter of fiscal year 2007 compared to that reported in the first quarter of fiscal year 2006. The increase was the result of the increased gross revenues as mentioned above.

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 increased by 2% in the first quarter of fiscal year 2007 compared to that reported in the first quarter of fiscal year 2006. The increase was primarily due to the markup on the increased purchased services and materials.

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 decreased to 75.1% in the first quarter of fiscal year 2007 compared to 81.2% in the first quarter of fiscal year 2006. The decrease was primarily due to increased labor utilization and reduced facility costs over that reported in the prior fiscal year reporting period.

Selling, general and administrative expenses approximated 17.4% of net service revenue in the first quarter of fiscal year 2007, compared to 17.1% in the first quarter of fiscal year 2006. The slight increase is primarily due to costs associated with the Company's reinstitution of its in-house corporate proposal development capacity in the first quarter of fiscal year 2007 to address the Company's business growth and future business opportunities.

Operating income for the first quarter of fiscal year 2007 was $651,000, a $515,000 increase over that reported in the prior fiscal year. The increase is primarily due to the increased gross revenues and the decreased direct costs of services and overhead as discussed above.

Interest expense for the first quarter of fiscal year 2007 was $11,000, a decrease of $9,000 (45%) over that reported in the prior fiscal year. The decrease was due to reduced usage of the Company's line of credit and the effect of interest income earned during the quarter on cash balances invested with the United Bank.

In the first quarter of fiscal year 2007, the company recorded $34,000 of tax expenses associated with the various annual minimum tax filing requirements for the Company.

Versar's net income for the first quarter of fiscal year 2007 was $606,000 compared to $116,000 in the first quarter of fiscal year 2006. The increased earnings were primarily due to increased gross revenues and reduced direct costs of services and overhead as discussed above.

Liquidity and Capital Resources

The Company's working capital as of September 29, 2006 approximated $9,764,000, an increase of $645,000 (7%). In addition, the Company's current ratio was 1.96, which was slightly less than June 30, 2006. The reduction was primarily due to the increased business growth of the Company increasing both accounts receivables and accounts payables in the first quarter of fiscal year 2007.

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 of interest (8.25% as of September 29, 2006). As of September 29, 2006, there were no borrowings outstanding under the line of credit. 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 matures in November 2007. The line of credit is subject to certain covenants related to the maintenance of financial ratios. These covenants require a minimum tangible net worth of $8,500,000, 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 outstanding amounts due under the line of credit, which may impact the Company's ability to finance its working capital requirements. At September 29, 2006, the Company was in compliance with the financial covenants.

We believe that with our current cash position along with anticipated cash flows will be sufficient to meet the Company?s liquidity needs within the next year. Expected capital requirements for fiscal year 2007 are approximately $400,000 primarily to maintain our existing information technology systems. Such capital requirements will either be funded through existing working capital or will be financed through third party sources.

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 elsewhere in this report on Form 10-Q and our annual report on Form 10-K filed for our 2006 fiscal year.

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 affect the revenue recognition on a project. Losses on contracts are recognized in the period when they become known.

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 likely that such adjustments could occur with our larger fixed priced projects. 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 statements 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 $4.6 million in deferred tax assets of which a $2.8 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. The carrying value of goodwill of approximately $776,000 relating to the acquisition of VGSI, is included in the Infrastructure and Management Services (IMS) reporting unit. 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, the estimated fair value of the IMS reporting unit was $25 million which exceeds the carrying value of its net assets by a substantial margin. Should the IMS reporting unit financial performance not meet estimates, then impairment of goodwill would have to be further assessed to determine whether a write down of goodwill value would be warranted. If such a write down were to occur, it would negatively impact the Company's financial position and results of operations. However, it would not impact the Company's cash flow or financial debt covenants.

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 expanded the Company's existing and future capabilities in cultural resources work enhancing and complimenting Versar's environmental core business. The Cultural Resources Group was incorporated into the Company's IMS segment.

As part of the acquisition, the Company executed a two year marketing agreement with Parsons which gives Versar the first right of refusal to certain Parsons cultural resources work from existing Parsons' clients. Thereafter, this agreement is annually renewable should both parties agree. Substantially all of the purchase price was allocated to contract rights and is being amortized over a three-year period.

Stock-based compensation: Effective July 1, 2005, the Company adopted the Financial Accounting Standards Board (FASB) SFAS No. 123 (Revised 2004), "Share-Based Payment" (SFAS 123(R)). This Statement revised SFAS No. 123 by eliminating the option to account for employee stock options under APB No. 25 and related interpretations 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).

On June 21, 2005, the Board of Directors of the Company accelerated the vesting of certain unvested "out-of-the-money" employee options that had exercise prices of $3.00 or more per share. The awards acceleration 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 remained in effect. The acceleration of the out-of-the-money stock options was done in order to avoid the impact of adopting SFAS 123(R). Based on the potential for these options to have value over their expected term, the Company estimated stock-based compensation of expense it otherwise would have been required to recognize in its consolidated statements of income by approximately $124,000.

New accounting pronouncements: On July 13, 2006, the Financial Accounting Standards Board (FASB) issued FIN No. 48, Accounting for Uncertainty of Income Taxes, which is an interpretation of FAS 109, Accounting for Income Taxes. The FASB issued FIN No. 48 to address concerns about the diversity in financial reporting of tax positions with uncertainty. The regulation prevents the recording of tax benefits of a transaction unless it is more-likely-than-not that the benefits from a tax position will be realized in the financial statements. FIN No. 48 becomes effective as of July 1, 2007. The Company is currently evaluating the impact of the adoption of this standard to determine any potential impact to the consolidated financial results of the Company.

In September 2006, the Financial Accounting Standard Board issued a Statement of Financial Accounting Standards (SFAS) No. 157. The Statement defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles (GAAP), and expands disclosures about fair value measurements. This Statement is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. Management believes that the adoption of SFAS 157 will not have a material impact on the consolidated financial results of the Company.

In September 2006, the Securities and Exchange Commission (SEC) released Staff Accounting Bulletin No. 108 (SAB 108). SAB 108 expresses the SEC staff's views regarding the process of quantifying financial statement misstatements. These interpretations were issued to address diversity in practice and the potential under current practice for the build up of improper amounts on the balance sheet. SAB 108 expresses the SEC staff's view that a registrant's materiality evaluation of an identified unadjusted error should quantify the effects of the error on each financial statement and related financial statement disclosures and that prior year misstatements should be considered in quantifying misstatements in current year financial statements. SAB 108 also states that correcting prior year financial statements for immaterial errors would not require previously filed reports to be amended. Such correction may be made the next time the registrant files the prior year financial statements. Registrants electing not to restate prior periods should reflect the effects of initially applying the guidance in SAB 108 in their annual financial statements covering the first fiscal year ending after November 15, 2006. The cumulative effect of the initial application should be reported in the carrying amounts of assets and liabilities as of the beginning of that fiscal year and the offsetting adjustment should be made to the opening balance of retained earnings for that year. Registrants should disclose the nature and amount of each individual error being corrected in the cumulative adjustment. The disclosure should also include when and how each error arose and the fact that the errors had

previously been considered immaterial. The SEC staff encourages early application of the guidance in SAB 108 for interim periods of the first fiscal year ending after November 15, 2006.

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.

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).

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 June 30, 2006.

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 which has continued for several years is now completed. The court granted Versar's demand that the Trustees supply requested information and documents. Versar continues to seek additional discovery compliance by the Trustees. Motions for summary judgment were filed by both parties. On September 5, 2006, the court granted, in part and denied in part, the Trustees' claim that Versar was obligated to achieve certain clean up criteria and eliminated certain, but not all, defenses raised by Versar in its counterclaims. The court also granted Versar summary judgement on one of the Trustees' breach of contract claims. The court also denied both parties motions to exclude certain expert testimony. Preliminary settlement discussions have taken place under the Court's auspices. Trial is presently scheduled for February 26, 2007. The Company continues to evaluate the impact of the Trustees' claim and Versar's defenses and other avenues of potential recoveries. Based upon discussions with outside counsel and assuming expected defenses and recoveries are available, 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.

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)

By: /S/ Theodore M. Prociv

Theodore M. Prociv
Chief Executive Officer,
President, and Director

By: /S/ Lawrence W. Sinnott

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

Date: November 13, 2006