VERSAR INC
Form 10-Q
February 12, 2007

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 December 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

Versar Inc.

(Exact name of registrant as specified in its charter)

DELAWARE	54-0852979
(State or other jurisdiction of incorporation or orgnaization)	(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 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 January 31, 2007
$.01 par value	8,147,364

VERSAR, INC. AND SUBSIDIARIES

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

	December 29, 2006	June 30, 2006
	(Unaudited)	
ASSETS		
Current assets		
Cash and cash equivalents	$ 25	$ 140
Accounts receivable, net	19,943	16,227
Prepaid expenses and other current assets	868	1,430
Deferred income taxes	566	566
Total current assets	21,402	18,363
Property and equipment, net	1,689	1,744
Deferred income taxes	1,144	1,144
Goodwill	776	776
Other assets	765	775
Total assets	$ 25,776	$ 22,802
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities		
Bank line of credit	$ 608	$ ---
Accounts Payable	4,313	4,691
Billings in excess of revenue	258	209
Accrued salaries and vacation	1,435	1,474
Other liabilities	3,989	2,585
Liabilities of discontinued operations, net	199	285
Total current liabilities	10,802	9,244
Other long-term liabilities	945	986
Total liabilities	11,747	10,230
Commitments and contingencies		
Stockholders' equity		
Common stock, $.01 par value; 30,000,000 shares authorized; 8,155,192 shares and 8,144,692 shares issued; 8,139,687 and 8,129,187 shares outstanding at December 29, 2006 and June 30, 2006, respectively	82	81
Capital in excess of par value	22,891	22,790
Accumulated deficit	(8,872)	(10,227)
Treasury stock	(72)	(72)
Total stockholders' equity	14,029	12,572
Total liabilities and stockholders' equity	$ 25,776	$ 22,802

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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		For the Six-Month Periods Ended	
	December 29, 2006	December 30, 2005	December 29, 2006	December 30, 2005
GROSS REVENUE	$ 21,938	$ 16,571	$ 44,223	$ 30,073
Purchased services and materials, at cost	12,484	7,463	26,155	12,503
NET SERVICE REVENUE	9,454	9,108	18,068	17,570
Direct costs of services and overhead	6,986	7,030	13,452	13,905
Selling, general and administrative expenses	1,691	1,381	3,188	2,832
OPERATING INCOME	777	697	1,428	833
OTHER EXPENSE				
Interest expense (income)	13	(26)	24	(6)
Income tax espense	15	---	49	---
INCOME FROM CONTINUING OPERATIONS	749	723	1,355	839
LOSS FROM DISCONTINUED OPERATIONS	---	(205)	---	(205)
NET INCOME	$ 749	$ 518	$ 1,355	$ 634
INCOME PER SHARE FROM CONTINUING OPERATIONS - BASIC	$ 0.09	$ 0.09	$ 0.17	$ 0.10
INCOME PER SHARE FROM CONTINUING OPERATIONS - DILUTED	$ 0.09	$ 0.09	$ 0.16	$ 0.10

LOSS (PER SHARE) FROM DISCONTINUED OPERATIONS - DILUTED	$ ---	$ (0.02)	$ ---	$ (0.02)
NET INCOME PER SHARE - BASIC	$ 0.09	$ 0.06	$ 0.17	$ 0.08
NET INCOME PER SHARE - DILUTED	$ 0.09	$ 0.06	$ 0.16	$ 0.07
WEIGHTED AVERAGE NUMBER OF SHARES OUTSTANDING - BASIC	8,154	8,053	8,151	8,021
WEIGHTED AVERAGE NUMBER OF SHARES OUTSTANDING - DILUTED	8,392	8,456	8,412	8,515

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 Six-Month Periods Ended	
	December 29, 2006	December 30, 2005
Cash flows from operating activities		
Income from continuing operations	$ 1,355	$ 839
Loss from discontinued operations	---	(205)
Net income	1,355	634
Adjustments to reconcile net income to net cash (used in) provided by operating activities		
Depreciation and amortization	354	374
Loss on sale of property and equipment	---	9
Provision for doubtful accounts receivable	26	(11)
Share based compensation	77	21
Changes in assets and liabilities		
(Increase) decrease in accounts receivable	(3,742)	1,544
Decrease in prepaids and other assets	585	794
(Decrease) increase in accounts payable	(378)	368

Decrease in accrued salaries and vacation	(39)	(84)
Increase (decrease) in other liabilities	1,413	(364)
Net cash (used in) provided by continuing operating activities	(349)	3,285
Changes in net liabilities of discontinued operations	(86)	(27)
Net cash (used in) provided by operating activities	(435)	3,258
Cash flows used in investing activities		
Purchase of property and equipment	(261)	(336)
Increase in life insurance policies cash surrender value	(51)	(52)
Net cash used in investing activities	(312)	(388)
Cash flows from financing activities		
Net borrowings (payments) on bank line of credit	608	(777)
Proceeds from issuance of common stock	24	376
Net cash provided by (used in) financing activities	632	(401)
Net (decrease) increase in cash and cash equivalents	(115)	2,469
Cash and cash equivalents at the beginning of the period	140	132
Cash and cash equivalents at the end of the period	$ 25	$ 2,601
Supplementary disclosure of cash flow information:		
Cash paid during the period for		
Interest	$ 25	$ 18
Income taxes	21	17

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 accounting principles generally accepted in the United States of America 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 December 29, 2006, and the results of operations for the six-month periods ended December 29, 2006 and December 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 December 29, 2006, the Company had approximately $4.1 million in deferred tax assets which primarily relate to net operating loss and tax credit carryforwards. The Company has an accumulated deficit and has experienced losses in previous years, as such, management recorded a valuation allowance of approximately $2.4 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 December 29, 2006). During October 2006, the Company obtained a letter of credit of approximately $1,570,000 which serves as collateral for surety bond coverage provided by the Company's insurance carrier. The letter of credit reduces the Company's borrowing base on the line of credit. As of December 29, 2006, there were $608,000 borrowings under the line of credit. The remaining line of credit capacity at December 29, 2006 was $4,392,000. 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 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 December 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 December 29, 2006, there was an accrual of approximately $199,000 remaining 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. Final distribution to eligible participants of the pension plan was substantially completed as of January 2007.

(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 part of Infrastructure and Management Services (IMS) reporting unit. 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 compliance with 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 consist of stock options and restricted stock.

	For the Three-Month Periods Ended		For the Six-Month Periods Ended	
	December 29, 2006	December 30, 2005	December 29, 2006	December 30, 2005
Weighted average common shares outstanding - basic	8,153,522	8,053,449	8,150,810	8,020,987
Assumed exercise of options and restricted stock (treasury stock method)	238,771	402,436	261,301	493,815
Weighted average common shares outstanding - basic/diluted	8,392,293	8,455,885	8,412,111	8,514,802

For the six months periods ended December 29, 2006 and December 30, 2005, options to purchase approximately 194,000 and 341,000 shares, respectively, were not included in the computation of diluted earnings per share because the effect would be anti-dilutive.

(J) Common Stock

The Company issued 10,500 shares of common stock upon the exercise of stock options during the first six months of fiscal year 2007. Total proceeds from the exercise of such stock options was approximately $24,000.

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.

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

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.

(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). In the first six months of fiscal year 2007, the Company has awarded 34,800 shares of restricted stock to employees and the Board of Directors. Compensation expense of $77,000 and $21,000 for the first six months of fiscal year 2007 and 2006, respectively, was included in the Consolidated Statements of Operations.

As a result of adopting SFAS 123(R) on July 1, 2005, the Company's income before income taxes for the six months ended December 29, 2006 and December 30, 2005 was reduced by stock-based compensation expense of $77,000 and $21,000, respectively.

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 acceleration of vesting of such avoided approximately $124,000 of compensation expense that otherwise would have been required to be recognized.

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 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 six months ended December 29, 2006 and December 30, 2005 was reduced by stock-based compensation expense of $77,000 and $21,000, respectively.

A summary of activity under the Company?s stock option plans as of December 29, 2006, and changes during the first six months of fiscal year 2007 are presented below:

Options	Shares (000)	Weighted-Average Exercise Price	Weighted-Average Remaining Contractual Term	Aggregate Intrinsic Value ($000)
Outstanding at July 1, 2006	1,229	$ 3.15		
Exercised	(10)	$ 2.30		
Forfeited or expired	(24)	$ 3.66		
Outstanding at December 29, 2006	1,195	$ 3.14	5.50	$ 2,096
Exercisable at December 29, 2006	1,125	$ 3.08	5.74	$ 1,954

As of December 29, 2006, there were unvested options to purchase approximately 70,000 shares outstanding under the plans. Estimated compensation costs of $16,000 is expected to be recognized over a weighted-average period of 3 years. The total fair value of these unvested options is approximately $141,000 as of December 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.

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		For the Six-Month Periods Ended	
	December 29, 2006	December 30, 2005	December 29, 2006	December 30, 2005
NET SERVICE REVENUE				

Infrastructure and Management Services	$ 8,274	$ 7,747	$ 15,642	$ 14,799
National Security	1,180	1,361	2,426	2,771
	$ 9,454	$ 9,108	$ 18,068	$ 17,570
OPERATING INCOME (A)				
Infrastructure and Management Services	$ 2,573	$ 1,785	$ 4,697	$ 3,111
National Security	(105)	293	(81)	554
	2,468	2,078	4,616	3,665
Selling, general and administrative expenses	(1,691)	(1,381)	(3,188)	(2,832)
OPERATING INCOME	$ 777	$ 697	$ 1,428	$ 833

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

IDENTIFIABLE ASSETS	December 29, 2006	June 30, 2006
Infrastructure and Management Services	$ 20,291	$ 16,456
National Security	1,659	1,777
Corporate and Other	3,826	4,569
Total Assets	$ 25,776	$ 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 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, government project funding began to return to normal levels and the Company's funded backlog increased by 55% to $48 million at June 30, 2006. For the first six months of fiscal year 2007, the Company was able to further increase its funded backlog to $53 million

at December 29, 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 such project work and the award of additional work in Iraq. 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 or investigation 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

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 that 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 that 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; delays on project funding; and such other risks and uncertainties as are described under Item 1A Risk Factors of this report and in other reports and other documents filed by the Company from time to time with the Securities and Exchange Commission.

Second Quarter Comparison of Fiscal Year 2007 and 2006

Gross revenue for the second quarter of fiscal year 2007 was $21,938,000, an increase of $5,367,000 (32%) over that reported in the second quarter of fiscal year 2006. The increase is attributable to the Company's work on supporting of both the Air Force and the Army in Iraq as part of the reconstruction efforts.

Purchased services and materials increased by $5,021,000 (67%) in the second quarter of fiscal year 2007 compared to that reported in the second quarter of fiscal year 2006. The increase was the result of the additional subcontract work as part of the Iraq projects 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 4% in the second quarter of fiscal year 2007 compared to that reported in the second quarter of fiscal year 2006. The increase was primarily due to the markup on the increased purchased services and materials. The increase in such markup was reduced by lower revenue generated by the Company's labor force as such labor was 12% lower than the prior fiscal year as the Company adjusted to the changes in business mix and reduced business volume from the prior fiscal year.

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 73.9% in the second quarter of fiscal year 2007 compared to 77.2% in the second quarter of fiscal year 2006. The decreased was primarily due to lower direct labor and facility costs compared to that reported in the second quarter of fiscal year 2006.

Selling, general and administrative expenses approximated 17.9% of net service revenue in the second quarter of fiscal year 2007, compared to 15.2% in the second quarter of fiscal year 2006. The increase is primarily due to the Company's reinstitution of its corporate proposal development group in the first quarter of fiscal year 2007 to enhance the Company's business growth and future business opportunities.

Operating income for the second quarter of fiscal year 2007 was $777,000, an $80,000 increase over that reported in the prior fiscal year. The increase is primarily attributable to the increased gross revenues, and reduced labor and facility costs. Operating income was decreased by various incentive plan accruals of $323,000 as part of the Company's approved incentive plans during the second quarter of fiscal year 2007.

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

Interest expense (income) for the second quarter of fiscal year 2007 was $13,000, an increase of $39,000 (150%) over that reported in the prior fiscal year. Fiscal year 2006 included interest income that was received in connection with the settlement of a lawsuit. The Company has used its line of credit to a limited extent during the second quarter of fiscal year 2007. The interest expense is primarily associated with capital leases and the financing of insurance programs for the Company.

In the second quarter of fiscal year 2007, the Company recorded $15,000 of tax expenses associated with the various annual minimum tax filing requirements for the Company.

In the second quarter of fiscal year 2006, the Company accrued an additional $205,000 for discontinued operations associated with changes in actuarial estimates in the dissolution of the former SMC pension plan.

Versar's net income for the second quarter of fiscal year 2007 was $749,000 compared to $518,000 in the second quarter of fiscal year 2006.

Six Months Comparison of Fiscal Years 2007 and 2006

Gross revenue for the first six months of fiscal year 2007 was $44,223,000, an increase of $14,150,000 (47%) over that reported in the first six months of fiscal year 2006. Seventy percent of the increase is attributable to the Company's efforts to support both the Air Force and the Army in Iraq as part of the reconstruction support efforts. The balance is from increased construction work in the United States in support of the Air Force and the Department of State.

Purchased services and materials increased by $13,652,000 (109%) in the first six months of fiscal year 2007 compared to that reported in the first six months of fiscal year 2006. The increase was the result of the increased Iraq, domestic and subcontract work as mentioned above.

Net service revenue is derived by deducting the costs of purchased services and materials from gross revenue. Net service revenues increased by 3% in the first six months of fiscal year 2007 compared to that reported in the first six months of fiscal year 2006. The increase was primarily due to the markup on the increased purchased services and materials. The increase in such markup was reduced by lower revenue generated by the Company's labor force which was 9% lower than the prior fiscal year as the Company resulting from the changes in business mix and reduced business volume from the prior fiscal year.

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 74.5% in the first six months of fiscal year 2007 compared to 79.1% in the first six months of fiscal year 2006. The decrease was primarily due to lower direct labor and facility costs compared to that reported in the first six months of fiscal year 2006.

Selling, general and administrative expenses approximated 17.6% of net service revenue in the first six months of fiscal year 2007, compared to 16.1% in the first six months of fiscal year 2006.

The increase is primarily due to the Company's reinstitution of its corporate proposal development group in fiscal year 2007 to enhance the Company's business growth and future business opportunities.

Operating income for the first six months of fiscal year 2007 was $1,428,000, a $595,000 increase over that reported in the prior fiscal year. The increase is primarily attributable to the increased gross revenues, and reduced labor and facility costs. Operating income was decreased by various incentive plan accruals of $511,000 as part of the Company's incentive plans during the first six months of fiscal year 2007.

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

Interest expense (income) for the first six months of fiscal year 2007 was $24,000, an increase of $30,000 over that reported in the prior fiscal year. Fiscal year 2006 included interest income that was reported in connection with the settlement of a lawsuit. The Company currently has had very limited use of the Company's line of credit during the first six months of fiscal year 2007. The interest expense is primarily associated with capital leases and the financing of insurance programs for the Company.

In the first six months of fiscal year 2007, the Company recorded $49,000 of tax expenses associated with the various annual minimum tax filing requirements for the Company.

In the second quarter of fiscal year 2006, the Company accrued an additional $205,000 for discontinued operations associated with changes in actuarial estimates in the dissolution of the former SMC pension plan.

Versar's net income for the first six months of fiscal year 2007 was $1,355,000 compared to $634,000 in the first six months of fiscal year 2006.

Liquidity and Capital Resources

The Company's working capital as of December 29, 2006 approximated $10,600,000, an increase of $1,481,000 (16%) from June 30, 2006. In addition, at December 29, 2006, the Company's current ratio was 1.98, which was slightly less than at June 30, 2006. The reduction was primarily due to the increased business growth of the Company resulting in increased accounts receivables, offset by increased current liabilities and accruals, causing a slight decrease in the first six months 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 December 29, 2006). During October 2006, the Company obtained a letter of credit of approximately $1,570,000 which serves as collateral for surety bond

coverage provided by the Company?s insurance carrier. The letter of credit reduces the Company's borrowing base on the line of credit. As of December 29, 2006, there were $608,000 borrowings under the line of credit. The remaining line of credit capacity at December 29, 2006 was $4,392,000. 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 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 December 29, 2006, the Company was in compliance with the financial covenants.

We believe that our current cash position along with anticipated cash flows will be sufficient to meet the Company's liquidity needs for the next year. Expected capital requirements for fiscal year 2007 are approximately $250,000 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.

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 the receipt of funding, 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 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. The Company currently has approximately $370,000 reserved as of December 29, 2006. 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: At December 29, 2006, the Company had approximately $4.3 million in deferred tax assets which primarily relate to net operating loss and tax credit carryforwards. The Company has an accumulated deficit and has experienced losses in previous years, as such, management recorded a valuation allowance of approximately $2.6 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.

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 part of the Infrastructure and Management Services (IMS) reporting unit. 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 compliance with 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 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 the stock-based compensation of expense it otherwise would have been required to recognize in its consolidated statements of income would have been 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 effect 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. The Company anticipates that the adoption of SAB 108, would have minimal impact to the Company.

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.

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. On April 20, 2001, the Trustees 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. IP01-0531 C H/G.

The parties have agreed to settle their various claims against each other and are in the process of executing a settlement agreement. The settlement is not expected to 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 4 - Submission of Matters to a Vote of Stockholders

The Company's Annual Meeting of Stockholders (the "Annual Meeting") was held on November 15, 2006. The matters voted on at the Annual Meeting were as follows:

(1) The Election of Directors
The election of nine nominees to serve as directors of the Company was approved as indicated below:

	For	Withheld
Robert L. Durfee	6,857,267	150,020
Fernando V. Galaviz	6,827,803	179,484
James L. Gallagher	6,775,114	232,173
James V. Hansen	6,857,910	149,377
Amoretta M. Hoeber	6,857,076	150,211
Paul J. Hoeper	6,857,910	149,377
Michael Markels, Jr.	6,790,351	216,936
Amir A. Metry	6,841,510	165,777
Theodore M. Prociv	6,853,192	154,095

(2) To ratify the appointment of Grant Thornton LLP as independent accountants for fiscal year 2007:

For Against Abstain

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6,952,871	47,887	6,529

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)

/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: February 12, 2007