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**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D.C. 20549**

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**FORM 10-Q**

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**Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**

For the quarterly period ended: **June 30, 2008**

**Transition Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**

Commission file number: **1-8443**

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**TELOS CORPORATION**

(Exact name of registrant as specified in its charter)

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**Maryland**  
(State or other jurisdiction of  
incorporation or organization)

**19886 Ashburn Road, Ashburn, Virginia**  
(Address of principal executive offices)

**52-0880974**  
(I.R.S. Employer  
Identification No.)

**20147-2358**  
(Zip Code)

**(703) 724-3800**  
(Registrant's telephone number, including area code)

**N/A**  
(Former name, former address and former fiscal year, if changed since last report)

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer or a smaller reporting company. See the definitions of "large accelerated filer," "accelerated filer," and "smaller reporting company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer  Accelerated filer   
Non-accelerated filer  (Do not check if a smaller reporting company) Smaller reporting company

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

As of February 23, 2009, the registrant had outstanding 33,554,188 shares of Class A Common Stock, no par value; and 4,037,628 shares of Class B Common Stock, no par value.

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TELOS CORPORATION AND SUBSIDIARIES

INDEX

**PART I—FINANCIAL INFORMATION**

	<u>Page</u>
Item 1. <a href="#">Financial Statements</a>	
<a href="#">Condensed Consolidated Statements of Operations for the Three and Six Months Ended June 30, 2008 and 2007 (unaudited)</a>	3
<a href="#">Condensed Consolidated Balance Sheets as of June 30, 2008 (unaudited) and December 31, 2007</a>	4-5
<a href="#">Condensed Consolidated Statements of Cash Flows for the Six Months Ended June 30, 2008 and 2007 (unaudited)</a>	6
<a href="#">Notes to Condensed Consolidated Financial Statements (unaudited)</a>	7-23
Item 2. <a href="#">Management’s Discussion and Analysis of Financial Condition and Results of Operations</a>	24-32
Item 3. <a href="#">Quantitative and Qualitative Disclosures about Market Risk</a>	32
Item 4T. <a href="#">Controls and Procedures</a>	33

**PART II—OTHER INFORMATION**

Item 1. <a href="#">Legal Proceedings</a>	34
Item 1A. <a href="#">Risk Factors</a>	34
Item 2. <a href="#">Unregistered Sales of Equity Securities and Use of Proceeds</a>	34
Item 3. <a href="#">Defaults upon Senior Securities</a>	34
Item 4. <a href="#">Submission of Matters to a Vote of Security Holders</a>	35
Item 5. <a href="#">Other Information</a>	35
Item 6. <a href="#">Exhibits</a>	35
<a href="#">SIGNATURES</a>	36

## PART I—FINANCIAL INFORMATION

## Item 1. Financial Statements

TELOS CORPORATION AND SUBSIDIARIES  
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS  
(Unaudited)  
(amounts in thousands)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2008	2007	2008	2007
Revenue				
Products	\$18,632	\$39,298	\$36,567	\$ 58,857
Services	27,855	22,097	57,525	42,753
	46,487	61,395	94,092	101,610
Costs and expenses				
Cost of sales—Products	16,457	34,065	32,241	47,965
Cost of sales—Services	21,020	15,915	42,099	29,362
Selling, general and administrative expenses	6,063	7,271	12,636	16,363
Operating income	2,947	4,144	7,116	7,920
Other income (expenses)				
Other income	100	2	128	4
Gain on sale of TIMS LLC membership interest (Note 2)	—	5,803	—	5,803
Interest expense	(1,916)	(2,058)	(3,829)	(4,124)
Income before minority interest and income taxes	1,131	7,891	3,415	9,603
Minority interest (Note 2)	(71)	(68)	(218)	(68)
Income before income taxes	1,060	7,823	3,197	9,535
Provision for income taxes (Note 8)	83	—	155	—
Net income	<u>\$ 977</u>	<u>\$ 7,823</u>	<u>\$ 3,042</u>	<u>\$ 9,535</u>

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

**TELOS CORPORATION AND SUBSIDIARIES**  
**CONDENSED CONSOLIDATED BALANCE SHEETS**  
(amounts in thousands)

	June 30, 2008 (Unaudited)	December 31, 2007
<b>ASSETS</b>		
Current assets		
Cash and cash equivalents	\$ 26	\$ 83
Marketable securities	2,399	4,005
Accounts receivable, net of reserve of \$232 and \$553, respectively	33,842	39,907
Inventories, net of obsolescence reserve of \$1,586 and \$1,482, respectively	4,535	11,918
Other current assets	3,874	3,770
Total current assets	44,676	59,683
Property and equipment, net of accumulated depreciation of \$16,584 and \$16,029, respectively	7,271	7,646
Other assets	23	127
Total assets	<u>\$ 51,970</u>	<u>\$ 67,456</u>

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

**TELOS CORPORATION AND SUBSIDIARIES**  
**CONDENSED CONSOLIDATED BALANCE SHEETS**  
(amounts in thousands)

	June 30, 2008 (Unaudited)	December 31, 2007
<b>LIABILITIES, REDEEMABLE PREFERRED STOCK AND STOCKHOLDERS' DEFICIT</b>		
Current liabilities		
Accounts payable and other accrued payables (Note 6)	\$ 26,434	\$ 40,765
Accrued compensation and benefits	7,931	8,032
Deferred revenue	5,127	5,549
Capital lease obligations – short-term	594	618
Other current liabilities	3,705	5,070
Total current liabilities	43,791	60,034
Senior credit facility (Note 6)	9,584	12,849
Senior subordinated notes (Note 6)	4,679	5,179
Capital lease obligations	7,895	8,129
Senior redeemable preferred stock (Note 7)	9,658	9,447
Public preferred stock (Note 7)	95,022	92,837
Total liabilities	170,629	188,475
Minority interest (Note 2)	(465)	217
Commitments, contingencies and subsequent events (Note 9)		
Stockholders' deficit		
Common stock	78	78
Additional paid-in capital	103	103
Accumulated deficit	(118,375)	(121,417)
Total stockholders' deficit	(118,194)	(121,236)
Total liabilities and stockholders' deficit	\$ 51,970	\$ 67,456

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

**TELOS CORPORATION AND SUBSIDIARIES**  
**CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS**  
**(Unaudited)**  
**(amounts in thousands)**

	<b>Six Months Ended June 30,</b>	
	<b>2008</b>	<b>2007</b>
<b>Operating activities:</b>		
Net income	\$ 3,042	\$ 9,535
Adjustments to reconcile net income to cash provided by (used in) operating activities:		
Gain on sale of TIMS LLC membership interest	—	(5,803)
Dividends and accretion of preferred stock as interest expense	2,396	2,657
Minority interest	218	68
Depreciation and amortization	721	882
Amortization of debt issuance costs	11	160
Other noncash items	(110)	357
Changes in other operating assets and liabilities	(3,720)	(14,198)
Cash provided by (used in) operating activities	<u>2,558</u>	<u>(6,342)</u>
<b>Investing activities:</b>		
Net proceeds from sale of TIMS LLC membership interest	—	5,803
Purchase of property and equipment	(346)	(198)
Maturity of restricted investments	1,709	—
Minority interest – TIMS LLC Class B Member	—	7
Cash provided by investing activities	<u>1,363</u>	<u>5,612</u>
<b>Financing activities:</b>		
Proceeds from senior credit facility	101,660	79,873
Repayment of senior credit facility	(104,925)	(83,548)
Increase in book overdrafts	1,095	4,629
Payments under capital leases	(258)	(285)
Payment of senior subordinated notes	(500)	—
Debt issuance costs	(150)	(160)
Distribution to Minority Investor of TIMS LLC	(900)	—
Cash (used in) provided by financing activities	<u>(3,978)</u>	<u>509</u>
Decrease in cash and cash equivalents	(57)	(221)
Cash and cash equivalents at beginning of period	83	235
Cash and cash equivalents at end of period	<u>\$ 26</u>	<u>\$ 14</u>
<b>Supplemental disclosures of cash flow information:</b>		
Cash paid during the period for:		
Interest	\$ 1,413	\$ 1,510
Income taxes	\$ 332	\$ —
Noncash:		
Interest on redeemable preferred stock	\$ 2,396	\$ 2,657

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

**TELOS CORPORATION AND SUBSIDIARIES**  
**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**  
**(Unaudited)**

**Note 1. General and Basis of Presentation**

Telos Corporation (the “Company” or “Telos”) is an information technology solutions and services company addressing the needs of U.S. Government and commercial customers worldwide. The Company’s principal offices are located at 19886 Ashburn Road, Ashburn, Virginia 20147. The Company was incorporated as a Maryland corporation in October 1971. The Company’s web site is [www.telos.com](http://www.telos.com). You can learn more about the Company by reviewing its SEC filings on the Telos web site. The SEC also maintains a web site at [www.sec.gov](http://www.sec.gov) that contains reports, proxy and information statements and other information regarding SEC registrants, including the Company.

The accompanying condensed consolidated financial statements include the accounts of Telos Corporation and its subsidiaries, including Ubiquity.com, Inc., a wholly owned subsidiary, Xacta Corporation and Telos Delaware, Inc., all of whose issued and outstanding share capital is owned by Ubiquity.com, Inc. (collectively, the “Company”). The Company has a 60% ownership interest in Telos Identity Management Solutions, LLC (“TIMS LLC”) and has consolidated its results of operations (see Note 2 – Sale of Assets). Significant intercompany transactions have been eliminated on consolidation. The Company also has a 100% ownership interest in Teloworks, Inc. (“Teloworks”), and has recorded all fundings to Teloworks as expense in its consolidated statements of operations, as the Teloworks balance sheet and operating results not already recorded were and continue to be immaterial to the Company’s consolidated financial statements. See Note 3 – Investment in Teloworks.

In the opinion of the Company, the accompanying condensed consolidated financial statements reflect all adjustments (which include normal recurring adjustments) and reclassifications necessary for their fair presentation in conformity with accounting principles generally accepted in the United States of America and pursuant to rules and regulations of the Securities and Exchange Commission (“SEC”). The presented interim results are not necessarily indicative of fiscal year performance for a variety of reasons including, but not limited to, the impact of seasonal and short-term variations. The Company has continued to follow the accounting policies (including its critical accounting policies) set forth in the consolidated financial statements included in its 2007 Annual Report on Form 10-K filed with the SEC. These condensed consolidated financial statements should be read in conjunction with the consolidated financial statements and notes thereto included in the Company’s Annual Report on Form 10-K for the fiscal year ended December 31, 2007.

The accompanying condensed consolidated financial statements have been prepared assuming that the Company will continue as a going concern. Additionally, as more fully described in Note 9 – Commitments, Contingencies and Subsequent Events, the Company is involved in an outstanding legal matter and an unfavorable outcome from this matter could result in a material adverse effect upon the Company’s financial position and results of operations. Management’s plans with respect to this matter, as well as other matters, are also disclosed in Note 9. These condensed consolidated financial statements do not include any adjustments that might result from the outcome of this uncertainty.

**Segment Reporting**

The Company previously reported two operating segments in its public filings: Managed Solutions and Xacta. Managed Solutions was primarily the Company’s traditional IT-product reselling business. Xacta comprised several business lines that together made up the Company’s security solutions brand. Beginning in late 2006, the Company undertook various cost reduction and reorganization strategies in order to address the Company’s poor operating results which were caused in part by an unsustainable revenue mix comprised of a large proportion of IT-product reselling revenue, which contributed a smaller proportion of margin to support the Company’s operations. As a result, the Company decided to focus and invest more in its higher-margin business areas. In late 2007, the Managed Solutions segment was realigned under the Secure Networks business line. While certain of the Managed Solutions products and services continue to be offered by the Company as part of its strategy of offering a broad range of IT solutions to its customers, the decision to consolidate the Managed Solutions segment with the Secure Networks business line resulted in a change in the Company’s reportable operating segments.

Accordingly, as of January 1, 2008, the Company has reflected the change in segment reporting in accordance with the criteria for segment reporting as set forth in SFAS No. 131, “Disclosures about Segments of an Enterprise and Related Information” and no longer reports multiple segments.

## Recent Accounting Pronouncements

In September 2006, the Financial Accounting Standards Board (“FASB”) issued Statement of Financial Accounting Standards (“SFAS”) No. 157, “Fair Value Measurements,” which defines fair value, establishes a framework for measuring fair value in accordance with U.S. GAAP and expands disclosures about fair value measurements. SFAS No. 157 indicates, among other things, that a fair value measurement assumes that the transaction to sell an asset or transfer a liability occurs in the principal market for the asset or liability or, in the absence of a principal market, the most advantageous market for the asset or liability. SFAS No. 157 defines fair value based upon an exit price model. SFAS No. 157 establishes a valuation hierarchy for disclosure of the inputs to valuation used to measure fair value.

A financial asset or liability’s classification within the hierarchy is determined based on the lowest level input that is significant to the fair value measurement. SFAS No. 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007, which is January 1, 2008 for the Company. In February 2008, the FASB issued Staff Position No. 157-1 and 157-2, “Effective Dates of FASB Statement No. 157,” which defers the effective date of SFAS No. 157 for one year for certain non-financial assets and liabilities and remove certain leasing transactions from its scope. In October 2008, the FASB issued FASB Staff Position No. 157-3, “Determining the Fair Value of a Financial Asset When the Market for That Asset is Not Active.” (“FSP SFAS 157-3”). FSP SFAS 157-3 clarifies the application of SFAS No. 157 in a market that is not active and provides an example to illustrate key considerations in determining the fair value of a financial asset when the market for that financial asset is not active. FSP SFAS 157-3 was effective upon issuance, including for prior periods for which financial statements have not been issued. The implementation of SFAS No. 157 for financial assets and financial liabilities, effective January 1, 2008, did not have a material impact on our financial position or results of operations and FSP SFAS 157-3 did not impact the Company’s financial position or results of operations

In February 2007, the FASB issued SFAS No. 159, “The Fair Value Option for Financial Assets and Financial Liabilities – Including an Amendment of FASB No. 115,” which permits entities to choose to measure many financial instruments and certain other items at fair value at specified election dates. A business entity is required to report unrealized gains and losses on items for which the fair value option has been elected in earnings at each subsequent reporting date. The Company adopted SFAS No. 159 on January 1, 2008 and there was no effect on the financial statements as the Company did not elect the fair value option for assets and liabilities within the scope.

In December 2007, SEC issued Staff Accounting Bulletin (“SAB”) No. 110 which expresses the views of the staff regarding the use of the “simplified” method in developing an estimate of expected term of “plain vanilla” share options in accordance with FASB 123(R), “Share-Based Payments.” The use of the “simplified” method was scheduled to expire on December 31, 2007. SAB 110 extends the use of the “simplified” method for “plain vanilla” awards in certain situations. The Company currently uses the “simplified” method to estimate the expected term for share option grants as it does not have enough historical experience to provide a reasonable estimate due to the limited period stock options have been available. The Company will continue to use the “simplified” method until enough historical experience exists to provide a reasonable estimate of expected term in accordance with SAB 110. SAB 110 is effective for options granted after December 31, 2007.



## Revenue Recognition

Revenues are recognized in accordance with SEC Staff Accounting Bulletin (“SAB”) No. 104, “Revenue Recognition.” The Company considers amounts earned upon evidence that an arrangement has been obtained, services are delivered, fees are fixed or determinable, and collectability is reasonably assured. Additionally, revenues on arrangements requiring the delivery of more than one product or service are recognized in accordance with EITF 00-21, “Accounting for Revenue Arrangements with Multiple Deliverables” except as the pronouncement states, on contracts where higher-level GAAP (such as Statement of Position (“SOP”) 97-2 as described below) prevails.

The Company recognizes revenues for software arrangements upon persuasive evidence of an arrangement, delivery of the software, and determination that collection of a fixed or determinable license fee is probable. Revenues for software licenses sold on a subscription basis are recognized ratably over the related license terms. For arrangements where the sale of software licenses are bundled with other products, including software products, upgrades and enhancements, post-contract customer support (“PCS”), and installation, the relative fair value of each element is determined based on vendor-specific objective evidence (“VSOE”). VSOE is defined by SOP 97-2, “Software Revenue Recognition” (“SOP 97-2”), and SOP 98-9, “Modification of SOP 97-2, Software Revenue Recognition With Respect to Certain Transactions” (“SOP 98-9”), and is limited to the price charged when the element is sold separately or, if the element is not yet sold separately, the fair value assigned under the residual method or the price set by management having the relevant authority. If VSOE does not exist for the allocation of revenue to the various elements of the arrangement, all revenue from the arrangement is deferred until the earlier of the point at which (1) such VSOE does exist or (2) all elements of the arrangement are delivered. PCS revenues, upon being unbundled from a software license fee, are recognized ratably over the PCS period.

Substantially all of the Company’s contracts are contracts with the U.S. Government involving the complex delivery of technology products and services. Accordingly, these contracts are within the scope of the American Institute of Certified Public Accountant’s Audit and Accounting Guide for Audits of Federal Government Contractors. To the extent contracts are incomplete at the end of an accounting period; revenue is recognized on the percentage-of-completion method, on a proportional performance basis, using costs incurred in relation to total estimated costs.

The Company may use subcontractors in the course of performing on services contracts. Some such arrangements may fall within the scope of EITF 99-19 “Reporting Revenue Gross as a Principal versus Net as an Agent”. The Company presumes that revenues on services contracts are recognized on a gross basis, in accordance with EITF 99-19, as the Company generally provides significant value-added services, assumes credit risk, and reserves the right to select subcontractors, but the Company evaluates the various criteria specified in the guidance in making the determination of whether revenue should be recognized on a gross or net basis. The revenue recognized on a net basis for the current and prior years has been insignificant.

## Investments

The Company accounts for its investments under SFAS No. 115, “Accounting for Certain Investments in Debt and Equity Securities.” The Company considers its holdings of short-term and long-term securities, consisting primarily of fixed income securities to be available-for-sale securities. The difference between cost or amortized cost (cost adjusted for amortization of premiums and accretion of discounts that are recognized as adjustments to interest income) and fair value, representing unrealized holdings gains or losses, net of the related tax effect, if any, is recorded, until realized, as a separate component of stockholders’ equity. Gains and losses on the sale of debt securities are determined on a specific identification basis. Realized gains and losses are included in other income (expense) in the accompanying condensed consolidated statements of operations.

## Income Taxes

The Company accounts for income taxes in accordance with SFAS No. 109, “Accounting for Income Taxes.” Under SFAS No. 109, deferred tax assets and liabilities are computed based on the difference between the financial statement and income tax bases of assets and liabilities using the enacted marginal tax rate. SFAS No. 109 requires that the net deferred tax asset be reduced by a valuation allowance if, based on the weight of available evidence, it is more likely than not that some portion or all of the net deferred tax asset will not be realized.

## [Table of Contents](#)

This process requires assessments regarding the timing and probability of the ultimate tax impact. The Company records valuation allowances on deferred tax assets if it determines it is more likely than not that the asset will not be realized. Additionally, the Company establishes reserves for uncertain tax positions based upon its judgment regarding potential future challenges to those positions. Actual income taxes could vary from these estimates due to future changes in income tax law, significant changes in the jurisdictions in which the Company operates, the inability to generate sufficient future taxable income or unpredicted results from the final determination of each year's tax liability by taxing authorities. These changes could have a significant impact on the Company's financial position.

The accounting estimate related to the tax valuation allowance requires the Company to make assumptions regarding the timing of future events, including the probability of expected future taxable income and available tax planning opportunities. These assumptions require significant judgment because actual performance has fluctuated in the past and may do so in the future. The impact that changes in actual performance versus these estimates could have on the realization of tax benefits as reported in the results of operations could be material.

The Company adopted FASB Interpretation No. 48, "Accounting for Uncertainty in Income Taxes" ("FIN 48"), on January 1, 2007. The accounting estimates related to liabilities for uncertain tax positions requires judgments regarding the sustainability of each uncertain tax position based on its technical merits. If it is determined to be more likely than not that a tax position will be sustained based on its technical merits, the Company records the impact of the position in its consolidated financial statements at the largest amount that is greater than fifty percent likely of being realized upon ultimate settlement. These estimates are updated at each reporting date based on the facts, circumstances and information available. The Company is also required to assess at each reporting date whether it is reasonably possible that any significant increases or decreases to its unrecognized tax benefits will occur during the next twelve months. See Note 8 – Income Taxes.

### **Stock-Based Compensation**

The Company adopted SFAS No. 123(R), "Share-Based Payments," using the modified prospective transition method as of January 1, 2006. Under this method, compensation cost is recognized based on the requirements of SFAS No. 123(R) for all share-based awards granted subsequent to January 1, 2006 and for all awards granted, but not vested, prior to January 1, 2006. There were no options granted on or after December 31, 2005. Results for prior periods have not been restated.

#### *Restricted Stock Grants*

In June 2008, the Company issued 4,774,273 shares of restricted stock (Class A common) in exchange for the majority of stock options outstanding under the Telos Corporation, Xacta Corporation and Telos Delaware, Inc. stock option plans. In addition, the Company granted 7,141,501 shares of restricted stock to its executive officers and employees. Such stock is subject to a vesting schedule as follows: 25% of the restricted stock vests immediately on the date of grant, thereafter, an additional 25% will vest annually on the anniversary of the date of grant subject to continued employment or services. In accordance with SFAS No. 123(R), the Company reported no compensation expense as the common stock was valued at zero.

### **Reclassifications**

Certain reclassifications have been made to the 2007 financial statements to conform to the current period presentation.

**Note 2. Sale of Assets**

On April 11, 2007, Telos Identity Management Solutions, LLC (“TIMS LLC”) was formed as a limited liability company under the Delaware Limited Liability Company Act. The Company contributed substantially all of the assets of its Identity Management business line and assigned its rights to perform under its U.S. Government contract with the Defense Manpower Data Center (“DMDC”) to TIMS LLC at their stated book values. The net book value of assets contributed by the Company totaled \$17,000. Until April 19, 2007, the Company owned 99.999% of the membership interests of TIMS LLC and certain private equity investors (“Investors”) owned 0.001% of the membership interests of TIMS LLC. On April 20, 2007, the Company sold an additional 39.999% of the membership interests to the Investors in exchange for \$6 million in cash consideration. In accordance with SAB 51, “Accounting for Sales of Stock by a Subsidiary,” the Company recognized a gain of \$5.8 million. Legal and investment banking expenses directly associated with the transaction amounted to approximately \$190,000. The brother of John B. Wood, the Company’s Chairman and Chief Executive Officer, indirectly held a 2% effective ownership interest in TIMS LLC as a result of the transaction. Such ownership interest was sold in the fourth quarter of 2008.

The parties signed an Amended and Restated Operating Agreement (“Operating Agreement”) which provides for a Board of Directors comprised of five members. The Operating Agreement also provides for two subclasses of membership units: Class A, consisting of the Company and Class B, consisting of the Investors. The Class A membership unit owns 60% of TIMS LLC, and as such is allocated 60% of the profits, which was \$107,000 and \$327,000 for the three and six months ended June 30, 2008, and \$102,000 for the three and six months ended June 30, 2007, respectively, and to appoint three members of the Board of Directors. The Class B membership unit owns 40% of TIMS LLC, and as such is allocated 40% of the profits, which was \$71,000 and \$218,000 for the three and six months ended June 30, 2008, and \$68,000 for the three and six months ended June 30, 2007, respectively, and to appoint two members of the Board of Directors.

Pursuant to the Operating Agreement, John B. Wood, Chairman and CEO of the Company, has been designated as the Chairman of the Board of TIMS LLC. In addition, in April 2007, the Company entered into a corporate services agreement with TIMS LLC whereby the Company provides certain administrative support services to TIMS LLC, including finance, accounting and human resources services.

In accordance with the Operating Agreement, quarterly distributions of \$450,000 were required to be made to the Class B member for the first 18 months after the sale of the TIMS LLC membership interests. During the three and six months ended June 30, 2008, the Class B member received a total of \$450,000 and \$900,000, respectively, of such distributions. The negative minority interest as presented on the balance sheet reflects such cash distributions to the Class B member in excess of the actual cumulative earnings allocated to the Class B member. No distribution was made to the Class A Member.

As indicated above, the Company owns 60% of TIMS LLC, and therefore continues to account for the investment in TIMS LLC using the consolidation method.

**Note 3. Investment in Teloworks**

As previously reported, the Company has recorded all fundings to Teloworks as expense in its consolidated statement of operations since 2004, as the Teloworks balance sheet and operating results not already recorded were and continue to be immaterial to the Company's consolidated financial statements.

In 2007, Enterworks was unable to fund its entire share of the scheduled funding. The Company funded \$250,000 on Enterworks' behalf for which it received a note from Enterworks. The Company has provided Enterworks with a notice of default in accordance with the Agreements due to its default on its funding obligations. Enterworks has waived its rights under the Agreements to cure such default. Accordingly, effective January 1, 2008 Telos owns 100% of Teloworks.

The Company incurred expenses related to Teloworks in the amounts of approximately \$0.4 million and \$1.0 million for the three and six months ended June 30, 2008, respectively, and \$0.4 million and \$0.6 million for the three and six months ended June 30, 2007, respectively.

**Note 4. Investment in Enterworks**

As of June 30, 2008, the Company owns 671,301 shares of common stock, 729,732 shares of Series A-1 Preferred Stock, 1,793,903 shares of Series B-1 Preferred Stock, 8,571,429 shares of Series D Preferred Stock of Enterworks, and warrants to purchase 1,785,714 underlying common stock shares, representing a fully diluted ownership percentage of 10.6%. Since its initial investment in Enterworks, the Company has accounted for such investment as prescribed by APB Opinion No. 18, "The Equity Method of Accounting for Investments in Common Stock," and continued to do so due to the Company's significant influence on Enterworks operations through its representation on the Board of Directors of Enterworks. Effective January 1, 2008, the Company discontinued the equity method of accounting for its investment in Enterworks due to its significantly diminished role in Enterworks operations. The Company previously reduced the carrying value of its investment in Enterworks to zero.

In March 2008, the Company and Enterworks amended their Agreement for Services and Sublease ("Agreement") effective as of January 1, 2008. Pursuant to the Agreement, Telos shall continue to sublease office space in its Ashburn facility and provide certain general, administrative and support services to Enterworks, for an amount of \$180,000 for a period of one year, payable in 12 equal installments of \$15,000 per month.

In 2007, Enterworks was unable to fund its entire share of its scheduled Teloworks funding. The Company funded \$250,000 on Enterworks' behalf for which it received a note from Enterworks, and warrants to purchase 1,785,714 underlying common stock shares. The Company recorded this note as a note receivable, however, due to uncertainty regarding the timing and amount of repayment of the note, the Company recorded a full reserve against the note. In May 2008, the principal amount of the note was amended to approximately \$272,000 to reflect interest accrued up to May 28, 2008. Enterworks has paid all interest due subsequent to this amendment.

**Note 5. Fair Value Measurements**

The Company adopted SFAS No. 157, "Fair Value Measurements," which defines fair value, establishes a framework for measuring fair value and expands disclosures about fair value measurements for financial instruments effective January 1, 2008. The framework requires the valuation of investments using a three-tiered approach. The statement requires fair value measurement to be classified and disclosed in one of the following categories:

- Level 1: Unadjusted quoted prices in active markets that are accessible at the measurement date for identical, unrestricted assets and liabilities;
- Level 2: Quoted prices in the markets that are not active, or inputs which are observable, either directly or indirectly, for substantially the full term of the asset or liability;
- Level 3: Prices or valuation techniques that require inputs that are both significant to the fair value measurement and unobservable (i.e. supported by little or no market activity).

The following table represents the assets on the Company's financial statements as of June 30, 2008 subject to SFAS No. 157, and indicates the fair value hierarchy of the valuation techniques the Company used to determine the fair value (in thousands):

Description	Balance at June 30, 2008	Fair Value Measurements at Reporting Date Using		
		Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
U.S. government securities	\$ 2,399	\$ 2,399	\$ —	\$ —

**Note 6. Current Liabilities and Debt Obligations***Accounts Payable and Other Accrued Payables*

As of June 30, 2008 and December 31, 2007, the accounts payable and other accrued payables consisted of \$18.7 million and \$32.6 million, respectively, in trade account payables and \$7.7 million and \$8.2 million, respectively, in accrued trade payables.

*Senior Revolving Credit Facility*

Effective January 31, 2008, the Company amended its \$15 million revolving credit facility (the "Facility") with Wells Fargo Foothill, Inc. ("Wells Fargo Foothill") to increase the limit on the Facility to \$20 million through March 31, 2008, and to accommodate increased operational needs. The fees associated with this amendment amounted to \$10,000. In March 2008, the Company renewed the Facility and amended its terms. Under the amended terms, the maturity on the Facility was extended to September 30, 2011 and the limit on the Facility was increased to \$25 million to accommodate current and projected financing needs. Borrowings under the Facility are collateralized by substantially all of the Company's assets including inventory, equipment, and accounts receivable. The amount of available borrowings fluctuates based on the underlying asset-borrowing base, as defined in the Facility agreement.

Pursuant to the terms of the Facility, the interest rate is established as the Wells Fargo "prime rate" plus 1%, the Federal Funds rate plus 1.5%, or 7.00%, whichever is higher. In lieu of having interest charged at the rate based on the Wells Fargo prime rate, the Company has the option to have interest on all or a portion of the advances on such Facility charged at a rate of interest based on the LIBOR Rate (the greater of the LIBOR rate three business days prior to the commencement of the requested interest period or 3%), plus 4.00%. The fees associated with this renewal and amendment amounted to \$150,000, which was capitalized.

Effective January 1, 2007, the Company and Wells Fargo Foothill amended the Facility to provide additional availability through the relief of certain reserves against available collateral through April 30, 2007, to establish Earnings Before Interest, Taxes, Depreciation and Amortization ("EBITDA") covenants for 2007, to give consent to the formation of TIMS LLC and subsequent sale of a portion of the membership interests in TIMS LLC (disclosed in Note 2—Sale of Assets), and to provide various waivers in accordance with the Facility. The fees associated with such amendments amounted to \$160,000.

## Table of Contents

As of June 30, 2008, the interest rate on the Facility was 7.00%. Pursuant to the terms of the Facility, the interest rate was the Wells Fargo “prime rate” plus 1% (as of June 30, 2008 the Wells Fargo “prime rate” was 6.00%). As of June 30, 2008, the Company had not elected the LIBOR rate option. The Company incurred interest expense in the amount of \$195,000 and \$428,000 for the three and six months ended June 30, 2008, respectively, and \$231,000 and \$465,000, for the three and six months ended June 30, 2007, respectively, on the Facility.

The Facility has various covenants that may, among other things, affect the ability of the Company to merge with another entity, sell or transfer certain assets, pay dividends and make other distributions beyond certain limitations. As of June 30, 2008, the Company was in compliance with the Facility’s financial covenants, including EBITDA covenants. Based on the Company’s current projection of EBITDA, the Company expects that it will remain in compliance with its EBITDA covenants, and accordingly, the Facility is classified as a noncurrent liability as of June 30, 2008.

At June 30, 2008 and December 31, 2007, the Company had outstanding borrowings of \$9.6 million and \$12.8 million, respectively, and unused borrowing availability of \$2.6 million and \$2.2 million, respectively, on the Facility. As of February 18, 2009, the Company has availability under its current arrangement of approximately \$2.2 million. The effective weighted average interest rates (including various fees charged pursuant to the Facility agreement and related amendments) on the outstanding borrowings under the Facility were 12.3% for the six months ended June 30, 2008 and 13.3% for the year ended December 31, 2007.

### *Senior Subordinated Notes*

In 1995, the Company issued Senior Subordinated Notes (“Notes”) to certain shareholders. Such Notes are classified as either Series B or Series C. The Series B Notes are secured by the Company’s property and equipment, but subordinate to the security interests of Wells Fargo Foothill. The Series C Notes are unsecured. The maturity date of such Notes has been extended to December 31, 2011, with interest rates ranging from 14% to 17%, and paid quarterly on January 1, April 1, July 1, and October 1 of each year. The Notes can be prepaid at the Company’s option; however, the Notes contain a cumulative prepayment premium of 13.5% per annum payable upon certain circumstances, which include, but are not limited to, an initial public offering of the Company’s common stock or a significant refinancing (“qualifying triggering event”), to the extent that sufficient net proceeds from either of the above events are received to pay such cumulative prepayment premium. Due to the contingent nature of the cumulative prepayment premium, any associated premium expense can only be quantified and recorded subsequent to the occurrence of such a qualifying triggering event. At June 30, 2008, if such a qualifying triggering event had occurred, the cumulative prepayment premium would have been approximately \$20.1 million.

The balances of the Series B Notes were \$2.0 million and \$2.5 million at June 30, 2008 and December 31, 2007, respectively. The balances of the Series C Notes were \$2.7 million at June 30, 2008 and December 31, 2007.

In June and July of 2008, the Company repaid \$0.5 million, respectively, of the outstanding Series B Notes. The prepayment penalties on the repayment of such Notes were waived by the note holders. Additionally, Wells Fargo Foothill granted a waiver and amendment to the Facility to allow the repayment on such Notes.

The Company incurred interest expense in the amount of \$183,000 and \$371,000 for the three and six months ended June 30, 2008, respectively, and \$189,000 and \$375,000 for the three and six months ended June 30, 2007, respectively, on the Notes.

The following are maturities of obligations presented by year (in thousands):

	<u>Year</u>	<u>Obligation Due</u>
Senior Subordinated Notes	2011	\$ 4,679 <sup>1</sup>
Senior Credit Facility	2011	\$ 9,584 <sup>2</sup>

<sup>1</sup> Pursuant to Section 17 of the Amended and Restated Subordination Agreement entered into in conjunction with the Facility, the senior subordinated note holders and the Company have extended the maturity date of the Notes to December 31, 2011.

<sup>2</sup> Balance due represents balance as of June 30, 2008, however, the Senior Credit Facility is a revolving credit facility with fluctuating balances based on working capital requirements of the Company.

*Warranty Liability*

As discussed more fully in Note 1, under ‘Segment Reporting’, in late 2007 the Managed Solutions segment, through which warranty service is provided, was realigned under the Secure Networks business line as part of an ongoing cost reduction and reorganization strategy to address the Company’s prior poor operating results through increased focus of its efforts on growth of higher-margin business. The series of decisions related to this change resulted in a shift in focus by the Company to an increased proportion of contracts with the Original Equipment Manufacturer (“OEM”) warranty requirements, which primarily involve referrals to the OEM for service calls. While certain contracts and programs continue to require an enhanced level of Company-provided warranty coverage, this shift to OEM-coverage contracts, and additionally, current reduced Company call center demand trends by certain large customers, resulted in a reduction of the estimates related to its warranty liabilities. Accordingly, the Company adjusted its accrued warranty liability down by approximately \$1.1 million in the first quarter of 2008. Accordingly, the balance as of June 30, 2008 and December 31, 2007 was \$1.4 million and \$2.4 million, respectively.

**Note 7. Redeemable Preferred Stock**

*Senior Redeemable Preferred Stock*

The components of the authorized, issued and outstanding senior redeemable preferred stock (“Senior Redeemable Preferred Stock”) are 1,250 Series A-1 and 1,750 Series A-2 senior redeemable preferred shares, respectively, each with \$.01 par value. The Senior Redeemable Preferred Stock carries a cumulative per annum dividend rate of 14.125% of its liquidation value of \$1,000 per share. The dividends are payable semiannually on June 30 and December 31 of each year. The liquidation preference of the Senior Redeemable Preferred Stock is the face amount of the Series A-1 and A-2 (\$1,000 per share), plus all accrued and unpaid dividends. The Company was required to redeem all shares and accrued dividends outstanding on October 31, 2005. However, on April 14, 2005, Toxford Corporation, the holder of 72.6% of the Senior Redeemable Preferred Stock, extended the maturity of its instruments to October 31, 2008. Subsequently, on March 17, 2008, Toxford Corporation further extended the maturity of its instruments to December 31, 2011. Additionally, on June 4, 2008, North Atlantic Smaller Companies Investment Trust PLC and North Atlantic Value LLP A/C B, the holder of 7.9% and .06%, respectively, of the Senior Redeemable Preferred Stock, also extended the maturity of their instruments to December 31, 2011. Subject to limitations set forth below, the Company was scheduled to redeem 18.9% of the outstanding shares and accrued dividends outstanding on October 31, 2005. Among the limitations with regard to the mandatory redemptions of the Senior Redeemable Public Preferred Stock is the legal availability of funds, pursuant to Maryland law. Accordingly, due to the Company’s current financial position and the terms of the Wells Fargo Foothill agreement, it is precluded by Maryland law from making the scheduled payment. As the Senior Redeemable Preferred Stock is not due on demand, or callable, within twelve months from June 30, 2008, the remaining 18.9% is also classified as noncurrent.

The Senior Redeemable Preferred Stock is senior to all other present equity of the Company, including the 12% Cumulative Exchangeable Redeemable Preferred Stock. The Series A-1 ranks on a parity with the Series A-2. The Company has not declared dividends on its Senior Redeemable Preferred Stock since its issuance. At June 30, 2008 and December 31, 2007, cumulative undeclared, unpaid dividends relating to Senior Redeemable Preferred stock totaled \$6.7 million and \$6.4 million, respectively.

The Company accrued senior redeemable preferred stock dividends of \$105,000 and \$210,000 for the three and six months ended June 30, 2008, respectively, and \$106,000 and \$211,000 for the three and six months ended June 30, 2007, respectively, which were reported as interest expense. Prior to the effective date of SFAS No. 150 on July 1, 2003, such dividends were charged to stockholders’ deficit.

*12% Cumulative Exchangeable Redeemable Preferred Stock*

A maximum of 6,000,000 shares of 12% Cumulative Exchangeable Redeemable Preferred Stock (the “Public Preferred Stock”), par value \$.01 per share, has been authorized for issuance. The Company initially issued 2,858,723 shares of the Public Preferred Stock pursuant to the acquisition of the Company during fiscal year 1990. The Public Preferred Stock was recorded at fair value on the date of original issue, November 21, 1989, and the Company makes periodic accretions under the interest method of the excess of the redemption value over the recorded value. The Company adjusted its estimate of accrued accretion in the amount of \$1.5 million in the second quarter of 2006. Such accretion for the three and six months ended June 30, 2008 was \$136,000 and \$273,000, respectively, and \$268,000 and \$535,000 for the three and six months ended June 30, 2007, respectively. The Company declared stock dividends totaling 736,863 shares in 1990 and 1991. Since 1991, no other dividends, in stock or cash, have been declared. In November 1998, the Company retired 410,000 shares of the Public Preferred Stock. The total number of shares issued and outstanding at June 30, 2008 was 3,185,586. The stock is now quoted as TLSRP in the Pink Sheets.

## Table of Contents

Since 1991, the Company has not declared or paid any dividends on its Public Preferred Stock, based upon its interpretation of restrictions in its Articles of Amendment and Restatement, limitations in the terms of the Public Preferred Stock instrument, specific dividend payment restrictions in the Facility entered into with Wells Fargo Foothill, to which the Public Preferred Stock is subject, and other senior obligations, and limitations pursuant to Maryland law. Pursuant to their terms, the Company is scheduled, but not required, to redeem the Public Preferred Stock in five annual tranches during the period 2005 through 2009. However, due to its substantial senior obligations, limitations set forth in the covenants in the Facility, foreseeable capital and operational requirements, restrictions and prohibitions of its Articles of Amendment and Restatement, and provisions of Maryland law, and assuming insufficient liquidity to undertake any stock redemption (which is presently unquantifiable), the Company believes that the likelihood is that it will continue to be unable to meet the redemption schedule set forth in the terms of the Public Preferred Stock. Moreover, the Public Preferred Stock is not payable on demand, nor callable, for failure to redeem the Public Preferred Stock in accordance with the redemption schedule set forth in the instrument. Therefore, the Company has classified these securities as noncurrent liabilities in the consolidated balance sheets as of June 30, 2008 and December 31, 2007.

The Company and certain of its subsidiaries are parties to the Facility agreement with Wells Fargo Foothill, whose term expires on September 30, 2011. Under the Facility, the Company agreed that, so long as any credit under the Facility is available and until full and final payment of the obligations under the Facility, it would not make any distribution or declare or pay any dividends (other than common stock) on its stock, or purchase, acquire, or redeem any stock, or exchange any stock for indebtedness, or retire any stock. The Company continues to actively rely upon the Facility and expects to continue to do so until the Facility agreement expires on September 30, 2011.

Accordingly, as stated above, the Company will continue to classify the entirety of its obligation to redeem the Public Preferred Stock as a long-term obligation. The Facility prohibits, among other things, the redemption of any stock, common or preferred, until September 30, 2011. The Public Preferred Stock by its terms cannot be redeemed if doing so would violate the terms of an agreement regarding the borrowing of funds or the extension of credit which is binding upon the Company or any subsidiary of the Company, and it does not include any other provisions that would otherwise require any acceleration of the redemption of or amortization payments with respect to the Public Preferred Stock. Thus, the Public Preferred Stock is not and will not be due on demand, nor callable, within twelve months from June 30, 2008. This classification is consistent with ARB No. 43 and SFAS No. 78, "Classification of Obligations that are Callable by the Creditor".

Paragraph 7 of Chapter 3A of ARB No. 43 defines a current liability, as follows:

"The term current liabilities is used principally to designate obligations whose liquidation is reasonably expected to require the use of existing resources properly classifiable as current assets, or the creation of other current liabilities. As a balance sheet category, the classification is intended to include obligations for items that have entered into the operating cycle, such as payables incurred in the acquisition of materials and supplies to be used in the production of goods or in providing services to be offered for sale; collections received in advance of the delivery of goods or performance of services; and debts that arise from operations directly related to the operating cycle, such as accruals for wages, salaries, commissions, rentals, royalties, and income and other taxes. Other liabilities whose regular and ordinary liquidation is expected to occur within a relatively short period of time, usually 12 months, are also intended for inclusion, such as short-term debts arising from the acquisition of capital assets, serial maturities of long-term obligations, amounts required to be expended within 1 year under sinking fund provisions, and agency obligations arising from the collection or acceptance of cash or other assets for the account of third persons."

Paragraph 5 of SFAS No. 78, provides the following:

"The current liability classification is also intended to include obligations that, by their terms, are due on demand or will be due on demand within one year (or operating cycle, if longer) from the balance sheet date, even though liquidation may not be expected within that period. It is also intended to include long-term obligations that are or will be callable by the creditor either because the debtor's violation of a provision of the debt agreement at the balance sheet date makes the obligation callable or because the violation, if not cured within a specified grace period, will make the obligation callable..."

If, pursuant to the terms of the Public Preferred Stock, the Company does not redeem the Public Preferred Stock in accordance with the scheduled redemptions described above, the terms of the Public Preferred Stock require the Company to discharge its obligation to redeem the Public Preferred Stock as soon as the Company is financially capable and legally permitted to do so. Therefore, by its very terms, the Public Preferred Stock is not due on demand or callable for failure to make a scheduled payment pursuant to its redemption provisions and is properly classified as a noncurrent liability.



## [Table of Contents](#)

On any dividend payment date after November 21, 1991, the Company may exchange the Public Preferred Stock, in whole or in part, for 12% Junior Subordinated Debentures that are redeemable upon terms substantially similar to the Public Preferred Stock and subordinated to all indebtedness for borrowed money and like obligations of the Company.

Dividends on the Public Preferred Stock are paid by the Company, when and if declared by the Board of Directors, and are required to be paid out of legally available funds in accordance with Maryland law. The Public Preferred Stock accrues a semi-annual dividend at the annual rate of 12% (\$1.20) per share, based on the liquidation preference of \$10 per share and is fully cumulative. Dividends in additional shares of the Public Preferred Stock for 1990 and 1991 were paid at the rate of 6% of a share for each \$.60 of such dividends not paid in cash. For the cash dividends payable since December 1, 1995, the Company has accrued \$63.4 million and \$61.5 million as of June 30, 2008 and December 31, 2007, respectively.

In accordance with SFAS No. 150, both the Senior Redeemable Preferred Stock and the Public Preferred Stock have been reclassified from equity to liability. Consequently, accretion and dividends totaling \$1.2 million and \$2.4 million for the three and six months ended June 30, 2008, respectively, and \$1.2 million and \$2.7 million for the three and six months ended June 30, 2007, respectively, were accrued and reported as interest expense. Prior to the effective date of SFAS No. 150 on July 1, 2003, such dividends were charged to stockholders' accumulated deficit.

The carrying value of the accrued Paid-in-Kind ("PIK") dividends on the Public Preferred Stock for the period 1992 through June 1995 was \$4.0 million. Had the Company accrued such dividends on a cash basis for this time period, the total amount accrued would have been \$15.1 million. However, as a result of the redemption of the 410,000 shares of the Public Preferred Stock in November 1998, such amounts were reduced and adjusted to \$3.5 million and \$13.4 million, respectively. The Company's Articles of Amendment and Restatement, Section 2(a) states, "Any dividends payable with respect to the Exchangeable Preferred Stock ("Public Preferred Stock") during the first six years after the Effective Date (November 20, 1989) may be paid (subject to restrictions under applicable state law), in the sole discretion of the Board of Directors, in cash or by issuing additional fully paid and nonassessable shares of Exchangeable Preferred Stock ..." Accordingly, the Board had the discretion to pay the dividends for the referenced period in cash or by the issuance of additional shares of Public Preferred Stock. During the period in which the Company stated its intent to pay PIK dividends, the Company stated its intention to amend its Charter to permit such payment by the issuance of additional shares of Public Preferred Stock. In consequence, as required by applicable accounting requirements, the accrual for these dividends was recorded at the estimated fair value (as the average of the ask and bid prices) on the dividend date of the shares of Public Preferred Stock that would have been (but were not) issued. This accrual was \$9.9 million lower than the accrual would be if the intent was only to pay the dividend in cash, at that date or any later date.

In May 2006, the Board concluded that the accrual of PIK dividends for the period 1992 through June 1995 was no longer appropriate. Since 1995, the Company has disclosed in the footnotes to its audited financial statements the carrying value of the accrued PIK dividends on the Public Preferred Stock for the period 1992 through June 1995 as \$4.0 million, and that had the Company accrued cash dividends during this time period, the total amount accrued would have been \$15.1 million. As stated above, such amounts were reduced and adjusted to \$3.5 million and \$13.4 million, respectively, due to the redemption of 410,000 shares of the Public Preferred Stock in November 1998. On May 12, 2006, the Board voted to confirm that the Company's intent with respect to the payment of dividends on the Public Preferred Stock for this period changed from its previously stated intent to pay PIK dividends to that of an intent to pay cash dividends. The Company therefore changed the accrual from \$3.5 million to \$13.4 million, the result of which was to increase the Company's negative shareholder equity by the \$9.9 million difference between those two amounts, by recording an additional \$9.9 million charge to interest expense for the second quarter of 2006, resulting in a balance of \$95.0 million and \$90.4 million for the principal amount and all accrued dividends on the Public Preferred Stock as of June 30, 2008 and 2007, respectively. This action is considered a change in assumption that results in a change in accounting estimate as defined in SFAS No. 154, "Accounting Changes and Error Corrections" which replaces APB No. 20, "Accounting Changes" and SFAS No. 3, "Reporting Accounting Changes in Interim Financial Statements."

**Note 8. Income Taxes**

The income tax provision for interim periods is determined using an estimated annual effective tax rate adjusted for discrete items, if any, which are taken into account in the quarterly period in which they occur. The Company reviews and updates its estimated annual effective tax rate each quarter. The income tax expense totaled approximately \$83,000 and \$155,000 for the three and six months ended June 30, 2008, respectively. No income tax expense was recorded for the three and six months ended June 30, 2007. This amount represented the federal alternative minimum tax and certain state income tax liabilities.

In accordance with SFAS 109, "Accounting for Income Taxes," a full valuation allowance has been provided at June 30, 2008 and December 31, 2007, due principally to the evidence that it is more likely than not that the deferred tax assets will not be realized.

The Company implemented the provisions of FIN 48 on January 1, 2007. There has been no material change to the amount of unrecognized tax benefits reported as of June 30, 2008. The Company believes that the total amounts of unrecognized tax benefits will not significantly increase or decrease within the next 12 months. The period for which tax years are open, 2006 to 2008, has not been extended beyond applicable statute of limitations.

**Note 9. Commitments, Contingencies and Subsequent Events**

*Financial Condition and Liquidity*

The Company's working capital was \$0.9 million as of June 30, 2008. The Company's working capital deficit was \$0.4 million as of December 31, 2007. Although no assurances can be given, the Company expects that it will be in compliance throughout the term of the amended Facility with respect to the financial and other covenants.

As described in Note 6 – Current Liabilities and Debt Obligations, the Company maintains a revolving credit facility ("the Facility") with Wells Fargo Foothill, Inc. ("Wells Fargo Foothill"). Borrowings under the Facility are collateralized by substantially all of the Company's assets including inventory, equipment, and accounts receivable. The amount of available borrowings fluctuates based on the underlying asset-borrowing base, in general 85% of the Company's trade accounts receivable, as adjusted by certain reserves (as further defined in the Facility agreement). The Facility provides the Company with virtually all of the liquidity it requires to meet its operating, investing and financing needs. Therefore maintaining sufficient availability on the Facility is the most critical factor in the Company's liquidity. While a variety of factors related to sources and uses of cash, such as timeliness of accounts receivable collections, vendor credit terms, or significant collateral requirements, ultimately impact the Company's liquidity, such factors may or may not have a direct impact on the Company's liquidity, based on how the transactions associated with such circumstances impact the Company's availability under the Facility. For example, a contractual requirement to post collateral for a duration of several months, depending on the materiality of the amount, could have an immediate negative effect on the Company's liquidity, as such a circumstance would utilize availability on the Facility without an near-term cash inflow back to the Company. Likewise, the release of such collateral could have a corresponding positive effect on the Company's liquidity, as it would represent an addition to the Company's availability without any corresponding near-term cash outflow. Similarly, a slow-down of payments from a customer, group of customers or government payment office would not have an immediate and direct effect on the Company's availability on the Facility unless the slowdown was material in amount and over an extended period of time. The Company discusses any significant unusual circumstances, such as these the examples described above, that could have an impact on the Facility, and therefore its liquidity.

The Company believes that available cash and borrowings under the amended Facility will be sufficient to generate adequate amounts of cash to meet the Company's needs for operating expenses, debt service requirements, and projected capital expenditures for 2009. The Company anticipates the continued need for a credit facility upon terms and conditions substantially similar to the amended Facility in order to meet the Company's long term needs for operating expenses, debt service requirements, and projected capital expenditures.

## [Table of Contents](#)

### *Restricted stock grants*

In September 2008, the Company granted 480,000 shares of restricted stock to certain of its directors. Such stock is subject to a vesting schedule as follows: 25% of the restricted stock vests immediately on the date of grant, thereafter, an additional 25% will vest annually on the anniversary of the date of grant subject to continued employment or services.

### *Legal Proceedings*

#### *Costa Brava Partnership III, L.P., et al. v. Telos Corporation, et al.*

As previously reported, Costa Brava Partnership III, L.P. (“Costa Brava”), a holder of the Company’s 12% Cumulative Exchangeable Redeemable Preferred Stock (“ERPS” or “Public Preferred Stock”), filed a lawsuit (hereinafter the “Complaint”) on October 17, 2005 in the Circuit Court for the City of Baltimore in the State of Maryland (“the Court”) against the Company, its directors, and certain of its officers. As of June 30, 2008, Costa Brava owns 16.4% of the outstanding Public Preferred Stock.

The Complaint alleged that the Company and its officers and directors had engaged in tactics to avoid paying mandatory dividends on the Public Preferred Stock, and asserted that the Public Preferred Stock had characteristics of debt instruments even though it was issued by the Company in the form of stock. Costa Brava alleged, among other things, that the Company and an independent committee of the Board of Directors had done nothing to improve what they claimed to be the Company’s insolvency, or its ability to redeem the Public Preferred Stock and pay accrued dividends. They also challenged the bonus payments to the Company’s officers and directors, and consulting fees paid to the holder of a majority of the Company’s common stock.

On December 22, 2005, the Company’s Board of Directors established a special litigation committee (“Special Litigation Committee”) composed of independent directors to review and evaluate the matters raised in the derivative suit filed against the Company by Costa Brava.

On January 9, 2006, the Company filed a motion to dismiss the Complaint or, in the alternative, to stay the action until the Special Litigation Committee had sufficient time to properly investigate and respond to Costa Brava’s demands. On March 30, 2006, the Court granted the motion to dismiss in part and denied it in part, and denied the alternative request for a stay.

On February 8, 2006, Wynnefield Small Cap Value, L.P. (“Wynnefield”) filed a motion to intervene. An order was entered on May 25, 2006 by the Court, designating Wynnefield Partners as the plaintiff with Costa Brava in the lawsuit. On May 31, 2006, an Amended Complaint was filed in which Wynnefield joined as a Plaintiff. Costa Brava and Wynnefield are hereinafter referred to as “Plaintiffs.”

On May 26, 2006, Plaintiffs filed a motion for a preliminary injunction to prevent the sale or disposal of Xacta Corporation, a subsidiary of the Company, or any of its assets until the lawsuit is resolved on the merits. Subsequently, an order was issued dismissing the motion without prejudice on October 26, 2006, and then reissued on January 26, 2007.

On August 30, 2006, Plaintiffs filed a motion for receivership following the resignations of six of the nine members of the Board of Directors on August 16, 2006. Within a week of the resignations, three new independent board members were added and then two more were added in October 2006, bringing the total board membership to eight. Thus, the board and all board committees, including the Special Litigation Committee and the Transaction Committee, were fully reconstituted. The Plaintiffs’ motion for receivership was denied on November 29, 2006. In its Memorandum Opinion denying the motion for receivership, the Court concluded that the Plaintiffs’ holdings in the Public Preferred Stock represented a minority equity interest, (not a fixed liability), and that their minority equity interest did not provide a guarantee to payment of dividends or redemption of their shares. The Court further stated that it could not find that the Plaintiffs’ expectations were objectively reasonable, and concluded that the Plaintiffs had not been denied any rights as defined by the proxy statement and prospectus forming the terms of the Public Preferred Stock.

On February 15, 2007, the Plaintiffs filed their second Motion for Preliminary Injunction to prevent the sale or disposal of any corporate assets outside the ordinary course of business until such time that two new Class D directors could be elected. On April 19, 2007, the Court denied the Plaintiffs’ motion. Two new Class D Directors, Messrs. Seth W. Hamot and Andrew R. Siegel, were elected at the June 18, 2007 special meeting of the holders of Public Preferred Stock.

## [Table of Contents](#)

On February 27, 2007, the Plaintiffs filed a Second Amended Complaint and added Mr. John R. C. Porter, then majority shareholder, as a defendant. The Company filed its motion to strike/dismiss and motion for summary judgment on March 28, 2007. On June 6, 2007, the Court granted the motion to dismiss in part and denied it in part. The following counts were dismissed: allegations of fraudulent conveyance (Count I); request for permanent and preliminary injunction related to the fraudulent conveyance allegations (Count II); and allegations of shareholder oppression against Mr. John Porter (Count V). The following counts were not dismissed: request for appointment of a receiver (Count III); request to dissolve the corporation (Count IV); breach of fiduciary duty by directors (Count VI); and breach of fiduciary duty by officers (Count VII).

On May 29, 2007, Telos filed a Counterclaim ("Telos Counterclaim") against the Plaintiffs alleging interference with its relationship with Wells Fargo Foothill, and a related motion for a preliminary injunction. On June 4, 2007, the Court entered a consent order in which the Plaintiffs agreed to cease and desist communications with Wells Fargo Foothill. On August 28, 2007, the Court issued a ruling granting Telos' motion for a preliminary injunction.

On July 20, 2007, counsel for the Special Litigation Committee issued its final report, which found that the available evidence did not support the derivative claims, and there was no instance of bad faith, breach of fiduciary duty or self-interested action or inaction that would make it in the Company's best interests to support the derivative claims. Further, Special Litigation Committee counsel recommended that the Company take all action necessary, appropriate and consistent with such findings.

Thus, on August 24, 2007, the Company filed a motion to dismiss the derivative claims as recommended by the Special Litigation Committee and its report. On January 7, 2008, the Court granted the Company's motion to dismiss the derivative claims and dismissed Counts VI and VII of the Second Amended Complaint, leaving only Counts III and IV remaining. Accordingly, all counts against the individual defendants were dismissed. Subsequently, the Company filed a motion for Summary Judgment on February 1, 2008 to dismiss the remaining counts.

On February 12, 2008, the Plaintiffs filed a Third Amended Complaint which included all the previous counts from the original Complaint and the Second Amended Complaint as well as additional counts. The additional counts are as follows: breach of contract against Telos (Count VIII); preliminary and permanent injunction to prevent the Company from entering into a transaction to dispose of assets that allegedly would unjustly enrich the officers and directors (Count IX); and a request for an accounting alleging that the Company failed to prepare financial statements as required under Maryland law (Count X). The Company filed a Motion to Dismiss or to Strike the Third Amended Complaint or for Summary Judgment on February 19, 2008.

On March 3, 2008, the Plaintiffs and all the Defendants to the litigation entered into a Stipulation regarding the Third Amended Complaint. All parties stipulated that the Third Amended Complaint alleges causes of action against the Company only and not against the individual defendants. The parties stipulated that, for purposes of appellate preservation only, the Third Amended Complaint contained allegations concerning parties who, and causes of action which, had been dismissed by prior orders of the Court. The parties further stipulated that all causes of action asserted against the individual defendants in the Third Amended Complaint, and Counts I, II, V, VI and VII of the Third Amended Complaint, were dismissed with prejudice in accordance with the Court's prior rulings. The parties stipulated that the Plaintiffs were not seeking reconsideration of the Court's previous rulings concerning parties or causes of action that had been dismissed.

On April 15, 2008, the Court issued an order dismissing with prejudice the remaining counts (Counts III, IV, VIII, IX, and X) of the Plaintiff's Third Amended Complaint against the Company.

On June 19, 2008, the Plaintiffs filed a Motion for Leave to Serve Discovery on Wells Fargo Foothill, Inc. in the matter of the Telos Counterclaim. The Company filed its opposition to the motion on July 8, 2008. On December 2, 2008, the Company filed a motion for voluntary dismissal of the counterclaim without prejudice, and the Plaintiffs filed their opposition to the motion on December 19, 2008. A hearing was held on January 23, 2009 before Judge W. Michele Pierson. On the same day, Judge Pierson issued an order granting the Company's motion to dismiss the counterclaim without prejudice and denied the Plaintiffs' motion for leave to service discovery as moot.

On February 23, 2009, the Plaintiffs filed a Notice of Appeal to the Court of Special Appeals of Maryland.

At this stage of the litigation, it is impossible to reasonably determine the degree of probability related to Plaintiffs' success in any of their assertions. Although there can be no assurance as to the ultimate outcome of this litigation, the Company and its officers and directors strenuously deny Plaintiffs' claims, will continue to vigorously defend the matter, and oppose the relief sought.

## [Table of Contents](#)

### *Hamot et al. v. Telos Corporation*

On August 2, 2007, Messrs. Seth W. Hamot and Mr. Andrew R. Siegel, principals of Costa Brava Partnership III L.P. (“Costa Brava”) and Class D Directors of Telos (“Class D Directors”), filed a complaint against the Company and a motion for a temporary restraining order in the Circuit Court for the City of Baltimore, Maryland (“the Court” or “Circuit Court”). The complaint alleged that certain company documents and records had not been promptly provided to them as requested, and that these documents were necessary to fulfill their fiduciary duty as directors.

On August 22, 2007 the Class D Directors filed an amended complaint which alleged that the Company was denying them the ability to effectively review, examine, consider and question future regulatory filings and all other important actions and undertakings of the Company.

On August 28, 2007, the Court converted the motion for temporary restraining order into a request for a preliminary injunction and stated that the Class D Directors were entitled to documents in response to reasonable requests for information pertinent and necessary to perform their duties as members of the Board. In addition, the Court noted that during the pendency of the shareholder litigation, it was not inclined to permit the Class D Directors, through the guise of their newly acquired director status, to avoid their currently binding commitments under the stipulation and protective order entered on July 7, 2006. Pursuant to the terms of such order the Company is entitled to designate documents produced in discovery or submitted to the Court as “confidential” or “highly confidential” and to withhold from the Class D Directors information protected by the work product doctrine or attorney-client privilege.

On September 24, 2007, the Class D Directors filed a new motion for temporary restraining order as well as a second amended verified complaint in which they requested that the Court “compel Telos to adhere to the Telos Amended and Restated Bylaws” and alleged that provisions concerning the noticing of Board committee meetings and the recording of Board meeting minutes had been violated and that Mr. Wood’s service as both CEO and Chairman of the Board was improper and impermissible under the Company’s Bylaws. The Court denied the Class D Directors’ motion on October 12, 2007. On the same day, the Court issued an amended preliminary injunction stating that the Class D Directors are entitled to receive written responses to requests for Board of Directors or Board committee minutes within seven (7) days of any such requests and copies of such minutes within fifteen (15) days of any such requests, as well as written responses to all other requests for information and/or documents related to their duties as directors within seven (7) days of such requests, and all Board of Directors appropriate information and/or documents within thirty (30) days of any such requests. The Court further stated that in all other respects, the preliminary injunction order of August 28, 2007 shall remain in full force and effect.

On April 16, 2008, the Company’s independent auditor, Reznick Group, P.C. (“Reznick”), resigned. In its resignation letter addressed to the Chairman of the Audit Committee, Reznick stated that it believed that its independence had been impaired due to communications from the Class D Directors that it perceived as threats of litigation and attempts to influence its opinion on certain accounting issues. The communications included a March 28, 2008 letter that was sent on the letterhead of Roark, Rearden & Hamot Capital Management, LLC (“RRHCM”), which is the general partner of Costa Brava, and of which Seth Hamot, Class D Director, is the managing member, to Goodman & Company, LLP (“Goodman”), which had served as the Company’s independent auditor prior to the engagement of Reznick. The letter also was blind-copied to Reznick. The letter demanded that Goodman withdraw its audit opinion for the years 2006, 2005, and 2004, and threatened further legal action against Goodman, stating “Costa Brava reserves its right to bring claims against Goodman for any damages resulting from clean audit opinions relating to past or future financial statements.”

After Reznick resigned citing impairment to its independence as a result of communications from the Class D Directors, the Company filed a Counterclaim on April 23, 2008, in an effort to prevent the Class D Directors from engaging in any further acts of misrepresentation, interference and improper influence upon the Company’s independent auditors regarding, among other things, a specific accounting treatment (from that of a non-current liability to that of a current liability) for their holdings in the Company’s 12% Cumulative Exchangeable Redeemable Preferred Stock (“ERPS” or “Public Preferred Stock”). The Counterclaim states claims against the Class D Directors for Tortious Interference with Contractual Relationship with Goodman (Count I); Tortious Interference with Contractual Relationship with Reznick (Count II); Tortious Inference with Economic or Business Relations with Goodman (Count III); Tortious Inference with Economic or Business Relations with Reznick (Count IV); Breach of Fiduciary Duty by Hamot (Count V); and Breach of Fiduciary Duty by Siegel (Count VI).

On May 1, 2008, the Court issued an order “to preserve the status quo until a hearing may be conducted.” The Status Quo Order, among other things, stated that the Class D Directors must “cease, desist and refrain from any and all direct or indirect, verbal or written, contact or communication with the Company’s past, current and future auditors, including without limitation Goodman & Company, LLP, (“Goodman”) and Reznick Group (“Reznick”), acting either singly or in concert with others, and either directly with any such auditors and/or with their agents or employees.”

On June 20, 2008, the Company filed its First Amended Counterclaim supplementing and updating its allegations.

## [Table of Contents](#)

On June 27, 2008, the Court granted the Company's motion for Preliminary Injunction against the Class D Directors regarding their interference with the Company's relationship with its current and former auditors. The Court ordered Hamot and Siegel to:

... cease, desist and refrain from any and all direct and indirect contact or communications (whether verbal, written, or otherwise) with Goodman, Reznick, or any other former, current or future auditors of Telos Corporation, or with any agents or representatives of any such auditors, regarding the conduct herein prohibited, during the pendency of this litigation or until such time as Telos obtains audited financial statements for 2007 and files its 10-K with the SEC.

The Court further prohibited Hamot and Siegel from:

... engaging in contacts, communications or other conduct prohibited by this Order acting either singly or in concert with others, including any entities that they control or through which they operate, including, but not limited to, Costa Brava, RRHCM and RRH [Roark, Rearden, & Hamot Capital Management, LLC and Roark, Rearden & Hamot entities, respectively]. It also specifically prohibits any such actions or conduct undertaken through or in concert or collusion with other persons or entities, including, but not limited to, Wynnefield Partners Small Cap Value, L.P. ("Wynnefield"), Paul Berger or any other ERPS holders.

The Order further states:

In this case, Telos has contractual relationships with both Reznick and Goodman, which are reflected in their engagement letters with Telos, and Hamot and Siegel had knowledge of these relationships. The record further indicates that Hamot and Siegel intentionally interfered with these relationships, and that their interference caused the non-performance by Reznick and Goodman of the services they were engaged to perform, as well as Reznick's termination of the engagement. Thus, Telos has raised a substantial claim for tortious interference with contract under the facts presented.

... As discussed above, the record indicates that Telos is likely to demonstrate that Hamot and Siegel intentionally sought to interfere with Reznick's audit through questionable and potentially misleading communications and barely-veiled threats of litigation, and that their interference caused Reznick to resign. Telos, therefore, has also raised claims going to the merits of its count for tortious interference with business or economic relations.

The Order also states that "Telos is likely to demonstrate that their conduct was not just wrongful, but unlawful." It further states that "Telos is likely to show that Hamot and Siegel used potentially misleading communications and threats of litigation in an effort to dictate the accounting treatment that Reznick should adopt, thereby running afoul of Sarbanes-Oxley section 303 and SEC Rule 13b2-2 and providing another basis for liability for tortious interference with business or economic relations."

In addition, the Order states:

Here, the conduct by Hamot and Siegel indicates that they put their interests ahead of the corporation they were supposed to be serving and sought to disrupt the company's essential relationships to serve their own ends. Indeed, even after being advised at Telos' April 2, 2008, board meeting that their conduct was jeopardizing the company's relationship with its auditor, they continued to send more communications to Reznick attempting to influence its opinions. ... Given the record before the Court, it appears that Telos likely will be able to demonstrate that Hamot and Siegel breached their fiduciary duties to the company.

Lastly, the Order states that "the public interest favors Telos." It states:

When directors with conflicted interests are allowed to interfere with [the audit] process, the public's interest in the integrity of the process – and its interest in the integrity of the financial information that ultimately will be provided to the investing public – suffers. Moreover, it also is in the public interest to protect the operational status quo of an ongoing viable business, which employs over 500 people and provides essential services to the United States military.

The Class D Directors filed a Motion to Dismiss the Counterclaim on May 21, 2008 and it was denied on July 24, 2008.

On July 16, 2008, the Class D Directors filed a Motion for Stay of Enforcement of Interlocutory Order in the Circuit Court seeking a stay of enforcement of the June 27, 2008 preliminary injunction. The Circuit Court denied the Class D Directors' motion on August 15, 2008.

On July 25, 2008, the Class D Directors filed a Notice of Appeal of the June 27, 2008 Preliminary Injunction with the Court of Special Appeals of Maryland.

On July 30, 2008, the Class D Directors filed in the Court of Special Appeals of Maryland a motion to stay enforcement of the June 27, 2008 preliminary injunction pending appeal of the preliminary injunction. The motion was denied without prejudice on August 5, 2008. The Class D Directors filed a renewed motion to stay the preliminary injunction in the Court of Special Appeals on August 20, 2008 and that motion was denied on September 15, 2008.

## [Table of Contents](#)

On October 2, 2008, the Company filed a Second Amended Counterclaim which added a Count VII, requesting that the Court issue a declaratory judgment that the Class D Directors are not entitled to indemnification or the advancement of expenses under Maryland law.

The oral argument on the Class D Directors' appeal of the June 27, 2008 preliminary injunction took place before the Court of Special Appeals of Maryland on November 3, 2008. The Court of Special Appeals took the matter under advisement and, to date, has not issued a decision on the appeal.

Through a letter dated December 17, 2008, the Company informed the Court of Special Appeals that the Company's audited annual financial statement Form 10-K had been filed with the SEC. In their response letter of December 19, 2008 to the Court, the Plaintiffs argued that the "controversy between the parties is capable of repetition, yet evading appellate review" and therefore required a full review by this court. The Company responded on December 23, 2008 that it would be amenable to additional briefing. Thus, on December 30, 2008, the Court of Special Appeals issued an order to both parties asking for briefs on whether the filing of the Form 10-K by the Company moots the June 27, 2008 preliminary injunction or whether the matter needed to be resolved definitively by this court. The Company and the Plaintiffs filed their respective Supplemental Memoranda on January 14, 2009. On January 21, 2008, the Company and the Plaintiffs filed their respective Supplemental Reply Briefs. To date, the Court of Special Appeals has not ruled on this pending matter.

At this stage of the litigation, it is impossible to reasonably determine the degree of probability related to the Class D Directors' success in any of their assertions. Although there can be no assurance as to the ultimate outcome of this litigation, the Company and its officers and directors strenuously deny the Class D Directors' claims, will vigorously defend the matter, and continue to oppose the relief sought.

### *Other Litigation*

In addition, the Company is a party to litigation arising in the ordinary course of business. In the opinion of management, while the results of such litigation cannot be predicted with any reasonable degree of certainty, the final outcome of such known matters will not, based upon all available information, have a material adverse effect on the Company's consolidated financial position, results of operations or cash flows.

### **Note 10. Related Party Transactions**

Mr. John R.C. Porter, the owner of less than 2% of the Company's Class A Common Stock, has a consulting agreement with the Company whereby he is compensated for consulting services provided to the Company in the areas of marketing, product development, strategic planning and finance as requested by the Company. The Company incurred \$65,000 and \$130,000 in expenses for the first three and six months of 2008 and 2007, respectively, for Mr. Porter's consulting services. Effectively January 1, 2009, the consulting agreement with Mr. Porter has been terminated.

The brother of the Company's Chairman and CEO, Emmett Wood, has been an employee of the Company since 1996. The amounts paid to this individual as compensation for the three and six months ended June 30, 2008 were \$38,000 and \$90,000, respectively. The amounts paid to this individual as compensation for the three and six months ended June 30, 2007 were \$67,000 and \$103,000, respectively.

As reported in Note 2 – Sale of Assets, as a member of certain private equity investors, the brother of the Company's Chairman and CEO, Nicholas Wood, indirectly held a 2% effective ownership interest in TIMS LLC. Such ownership interest was sold in the fourth quarter of 2008.

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

### Forward-Looking Statements

This Quarterly Report on Form 10-Q contains forward-looking statements. For this purpose, any statements contained herein that are not statements of historical fact may be deemed to be forward-looking statements. Without limiting the foregoing, the words "believes," "anticipates," "plans," "expects" and similar expressions are intended to identify forward-looking statements. There are a number of important factors that could cause the Company's actual results to differ materially from those indicated by such forward-looking statements. These factors include, without limitation, those set forth in the risk factors section included in the Company's Form 10-K for the year ended December 31, 2007, as filed with the SEC.

### General

The Company previously reported two operating segments in its public filings: Managed Solutions and Xacta. Managed Solutions was primarily the Company's traditional IT-product reselling business. Xacta comprised several business lines that together made up the Company's security solutions brand. Beginning in late 2006, the Company undertook various cost reduction and reorganization strategies in order to address the Company's poor operating results which were caused in part by an unsustainable revenue mix comprised of a large proportion of IT-product reselling revenue, which contributed a smaller proportion of margin to support the Company's operations. As a result, the Company decided to focus and invest more in its higher-margin business areas. In late 2007, the Managed Solutions segment was realigned under the Secure Networks business line. While certain of the Managed Solutions products and services continue to be offered by the Company as part of its strategy of offering a broad range of IT solutions to its customers, the decision to consolidate the Managed Solutions segment with the Secure Networks business line resulted in a change in the Company's reportable operating segments.

Accordingly, as of January 1, 2008, the Company has reflected the change in segment reporting in accordance with the criteria for segment reporting as set forth in SFAS No. 131, "Disclosures about Segments of an Enterprise and Related Information" and no longer reports multiple segments.

The Company's goal is to deliver superior IT solutions that meet or exceed its customers' expectations. The Company focuses on secure enterprise solutions that address the unique requirements of the federal government, the military, and the intelligence community, as well as commercial enterprises that require secure solutions. The Company's solutions consist of the following:

- **Secure Networks**—Secure wired and wireless network solutions for DoD and federal agencies. Telos provides an extensive range of wired and wireless voice, data, and video secure network solutions and services to support defense and civilian missions.
- **Information Assurance**—Automate, streamline, and enforce IT security and risk management processes across your enterprise. Telos offers information assurance consulting services and Xacta GRC (governance, risk, and compliance) solutions to protect and defend IT systems, ensuring their availability, integrity, authentication, and confidentiality.
- **Secure Messaging**—Deploy the next-generation messaging solution supporting warfighters throughout the world. Telos' Automated Message Handling System (AMHS) offers secure, automated, web-based solutions for distributing and managing enterprise messages formatted for DMS (Defense Messaging System).
- **Identity Management**—Establish end-to-end logical and physical security from the gate to the network. Telos identity management solutions provides control of physical access to bases, offices, workstations, and other facilities, as well as control of logical access to databases, host systems, and other IT resources.



## [Table of Contents](#)

### Backlog

The Company's total backlog was \$610.0 million and \$118.4 million at June 30, 2008 and 2007, respectively. Backlog was \$118.5 million at December 31, 2007.

Such backlog amounts include both funded backlog (unfilled firm orders for the Company's products for which funding has been both authorized and appropriated), and unfunded backlog (firm orders for which funding has not been appropriated). Funded backlog as of June 30, 2008 and 2007 was \$85.5 million and \$101.4 million, respectively.

### Consolidated Results of Operations (Unaudited)

The accompanying condensed consolidated financial statements include the accounts of Telos Corporation and its subsidiaries, including Ubiquity.com, Inc., a wholly owned subsidiary, Xacta Corporation and Telos Delaware, Inc., all of whose issued and outstanding share capital is owned by Ubiquity.com, Inc. (collectively, the "Company"). The Company has a 60% ownership interest in Telos Identity Management Solutions, LLC and has consolidated its results of operations (see Note 2 – Sale of Assets). Significant intercompany transactions have been eliminated. The Company also has a 100% ownership interest in Teloworks, Inc. ("Teloworks"), and has recorded all fundings to Teloworks as expense in its consolidated statements of operations, as the Teloworks balance sheet and operating results not already recorded were and continue to be immaterial to the Company's consolidated financial statements. See Note 3 – Investment in Teloworks.

The Company's operating cycle involves many types of solutions, product and service contracts with varying delivery schedules. Accordingly, results of a particular quarter, or quarter-to-quarter comparisons of recorded sales and operating profits, may not be indicative of future operating results and the following comparative analysis should therefore be viewed in such context.

The principal element of the Company's operating expenses as a percentage of sales for the three and six months ended June 30, 2008 and 2007 are as follows:

	(unaudited)			
	Three Months Ended		Six Months Ended	
	June 30,	June 30,	June 30,	June 30,
	2008	2007	2008	2007
Sales	100.0%	100.0%	100.0%	100.0%
Cost of sales	80.7	81.4	79.0	76.1
Selling, general, and administrative expenses	13.0	11.8	13.4	16.1
Operating income	6.3	6.8	7.6	7.8
Other income	0.2	—	0.1	—
Gain on sale of TIMS LLC membership interest	—	9.4	—	5.7
Interest expense	(4.1)	(3.4)	(4.1)	(4.1)
Income before minority interest and income taxes	2.4	12.8	3.6	9.4
Minority interest	(0.1)	(0.1)	(0.2)	—
Income before income taxes	2.3	12.7	3.4	9.4
Provision for income taxes	(0.2)	—	(0.2)	—
Net income	<u>2.1%</u>	<u>12.7%</u>	<u>3.2%</u>	<u>9.4%</u>

## [Table of Contents](#)

### *Three Months Ended June 30, 2008 Compared with Three Months Ended June 30, 2007*

Revenue decreased by 24.3% to \$46.5 million for the second quarter of 2008, from \$61.4 million for the same period in 2007. Such decrease primarily consists of a decrease in sales of \$10.4 million from the ARISS (Army Recruiting Information Support System) program which are not regularly recurring sales of Secure Networks solutions. Product revenue decreased from \$39.3 million for the second quarter in 2007 to \$18.6 million for the same period in 2008, primarily attributable to a decrease in sales of product reselling activities of Secure Networks solutions due to the Company's decision to focus on higher margin solutions. Services revenue increased from \$22.1 million for the second quarter in 2007 to \$27.9 million for the same period in 2008, primarily attributable to increase in revenue of \$2.2 million of Secure Networks solutions and \$1.2 million of Identity Management solutions due to the DMDC contract awarded in May 2008.

Cost of sales decreased by 25.0% to \$37.5 million for the second quarter of 2008 from \$50.0 million for the same period in 2007, due primarily to the decrease in resold product revenue of Secure Network solutions.

Gross profit decreased by 21.1% to \$9.0 million for the second quarter of 2008 from \$11.4 million for the same period in 2007. Gross margin increased to 19.4% in the second quarter of 2008, from 18.6% for the same period in 2007, primarily attributable to an increase in sales of higher margin Information Assurance and Secure Messaging services/solutions.

Selling, general, and administrative expense ("SG&A") decreased by 16.6% to \$6.1 million for the second quarter of 2008, from \$7.3 million for the same period in 2007, primarily attributable to a decrease of \$1.3 million of net litigation-related expenses due to the timing of the receipts of insurance reimbursements.

Operating income decreased by 28.9% to \$2.9 million for the second quarter of 2008, from \$4.1 million for the same period in 2007, due primarily to a decrease in gross profit noted above.

Interest expense decreased 6.9% to \$1.9 million for the second quarter of 2008, from \$2.1 million for the same period in 2007, primarily due to a decrease in the accrual of accretion of the public preferred stock.

The Company recorded a provision for income taxes of \$83,000 for the second quarter of 2008, which represents primarily the federal alternative minimum tax and certain state income tax liabilities. The Company recorded a full valuation allowance against its deferred tax assets as of June 30, 2008 and December 31, 2007. No tax provision was recorded for the second quarter of 2008 due to the lack of sufficient taxable income history following several years of net operating losses.

The Company's net income decreased by 87.5% to \$1.0 million for the second quarter of 2008, from \$7.8 million for the same period in 2007, primarily attributable to the sale of TIMS LLC membership interest in April 2007.

### *Six Months Ended June 30, 2008 Compared with Six Months Ended June 30, 2007*

Revenue decreased by 7.4% to \$94.1 million for the six months ended June 30, 2008 from \$101.6 million in the same period in 2007. Such decrease consists of decreased sales of \$10.4 million from the ARISS contract, which are not regularly recurring sales, offset by an increase in sales from the U.S. Air Force NETCENTS (Network-Centric Solutions) contract of \$7.5 million. Product revenue decreased to \$36.6 million for the six months ended June 30, 2008 from \$58.9 million for the same period in 2007, primarily attributable to a decrease in sales of product reselling activities of Secure Networks solutions due to the Company's decision to focus on higher margin solutions. Services revenue increased to \$57.5 million for the same period in 2008 from \$42.8 million for the same period in 2007, primarily attributable to an increase in revenue of \$6.4 million of Secure Network solutions and \$4.1 million of Information Assurance solutions.

Cost of sales decreased by 3.9% to \$74.3 million for the six months ended June 30, 2008 from \$77.3 million for the same period in 2007, due primarily to the decrease in resold product in the Secure Networks solutions as discussed above, and the \$1.1 million warranty adjustment in the first quarter of 2008.

Gross profit decreased 18.7% to \$19.8 million for the six months ended June 30, 2008 from \$24.3 million compared to the same period in 2007. Gross margin decreased 2.9% to 21.0% for the six months ended June 30, 2008, from 23.9% in the same period in 2007. The decrease in gross margin is attributable to the decrease in sales of higher margin proprietary software.

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## [Table of Contents](#)

Selling, general, and administrative expense (“SG&A”) decreased 22.8% to \$12.6 million for the six months ended June 30, 2008 from \$16.4 for the same period in 2007, primarily due to reduction of \$4.4 million of net litigation-related expenses due to the timing of the receipts of insurance reimbursements.

Operating income decreased 10.1% to \$7.1 million for the six months ended June 30, 2008, from \$7.9 million for the same period in 2007, due primarily to decrease in gross profit, offset by a reduction in net litigation-related expenses as noted above.

Interest expense decreased 7.2% to \$3.8 million for the six months ended June 30, 2008, from \$4.1 million for the same period in 2007, primarily due to a decrease in the accrual of accretion of the public preferred stock.

The Company recorded a provision for income taxes of \$155,000 for the six months ended June 30, 2008, which represents primarily the federal alternative minimum tax and certain state income tax liabilities. The Company recorded a full valuation allowance against its deferred tax assets as of June 30, 2008 and December 31, 2007. No tax provision was recorded for the six months ended June 30, 2007 due to the lack of sufficient taxable income history following several years of net operating losses.

The Company’s net income decreased 68.1% to \$3.0 million for the six months ended June 30, 2008, from \$9.5 million for the same period in 2007, primarily attributable to the sale of TIMS LLC membership interest in April 2007.

## Liquidity and Capital Resources

As described in more detail below, the Company maintains a revolving credit facility (“the Facility”) with Wells Fargo Foothill, Inc. (“Wells Fargo Foothill”). Borrowings under the Facility are collateralized by substantially all of the Company’s assets including inventory, equipment, and accounts receivable. The amount of available borrowings fluctuates based on the underlying asset-borrowing base, in general 85% of the Company’s trade accounts receivable, as adjusted by certain reserves (as further defined in the Facility agreement). The Facility provides the Company with virtually all of the liquidity it requires to meet its operating, investing and financing needs. Therefore maintaining sufficient availability on the Facility is the most critical factor in the Company’s liquidity. While a variety of factors related to sources and uses of cash, such as timeliness of accounts receivable collections, vendor credit terms, or significant collateral requirements, ultimately impact the Company’s liquidity, such factors may or may not have a direct impact on the Company’s liquidity, based on how the transactions associated with such circumstances impact the Company’s availability under the Facility. For example, a contractual requirement to post collateral for a duration of several months, depending on the materiality of the amount, could have an immediate negative effect on the Company’s liquidity, as such a circumstance would utilize availability on the Facility without a near-term cash inflow back to the Company. Likewise, the release of such collateral could have a corresponding positive effect on the Company’s liquidity, as it would represent an addition to the Company’s availability without any corresponding near-term cash outflow. Similarly, a slow-down of payments from a customer, group of customers or government payment office would not have an immediate and direct effect on the Company’s availability on the Facility unless the slowdown was material in amount and over an extended period of time. The Company discusses any significant unusual circumstances, such as these the examples described above, that could have an impact on the Facility, and therefore its liquidity. However, management believes that the Company’s borrowing capacity is sufficient to fund its capital and liquidity needs for the foreseeable future.

Cash provided by or used in operating activities is primarily driven by the Company’s operating income, the timing of receipt of customer payments, and the timing of its payments to vendors and employees. For the six months ended June 30, 2008, cash provided by operating activities was \$2.6 million. For the six months ended June 30, 2007, cash used by operating activities was \$6.3 million. Cash provided by investing activities for the six months ended June 30, 2008 was approximately \$1.4 million, due to the maturity of \$1.7 million of certain restricted investments, offset by the purchase of property and equipment of \$0.3 million. Cash provided by investing activities for the six months ended June 30, 2007 was approximately \$5.6 million, primarily due to the net proceeds from sale of TIMS LLC membership interest, offset by the purchase of property and equipment. Cash used in financing activities for the six months ended June 30, 2008 was \$4.0 million, primarily due to net repayments of \$2.2 million of the Facility, repayment of \$0.5 million of senior subordinated notes, and distribution of \$0.9 million to the Class B Member of TIMS LLC. Cash provided by financing activities for the six months ended June 30, 2007 was \$0.5 million, due primarily to net borrowings of \$1.0 million from the Facility.

Additionally, the Company’s capital structure consists of subordinated notes, redeemable preferred stock, and common stock. The capital structure is complex and requires an understanding of the terms of the instruments, certain restrictions on scheduled payments and redemptions of the various instruments, and the interrelationship of the instruments especially as it relates to the subordination hierarchy. Therefore a thorough understanding of how the Company’s capital structure impacts its liquidity is necessary and accordingly the Company has disclosed the relevant information about each instrument as follows:

### *Senior Revolving Credit Facility*

As of December 31, 2007, the Company had a \$15 million Facility with Wells Fargo Foothill that was scheduled to mature on October 21, 2008. The Company amended the Facility, effective January 31, 2008, to increase the limit on the Facility to \$20 million through March 31, 2008, and to accommodate increased operational needs, supported by sufficient collateral. The fees associated with this amendment amounted to \$10,000. In March 2008, the Company renewed the Facility and amended its terms. Under the amended terms, the maturity on the Facility was extended to September 30, 2011, and the limit on the Facility was increased to \$25 million to accommodate current and projected financing needs going forward. Pursuant to the terms of the Facility, the interest rate is established as the Wells Fargo “prime rate” plus 1%, the Federal Funds rate plus 1.5%, or 7.00%, whichever is higher. In lieu of having interest charged at the rate based on the Wells Fargo prime rate, the Company has the option to have interest on all or a portion of the advances on such Facility be charged at a rate of interest based on the LIBOR Rate (the greater of the LIBOR rate three business days prior to the commencement of the requested interest period or 3%), plus 4.00%.

## [Table of Contents](#)

Effective January 1, 2007, the Company and Wells Fargo Foothill amended the Facility to provide additional availability through the relief of certain reserves against available collateral through April 30, 2007, to establish Earnings Before Interest, Taxes, Depreciation and Amortization (“EBITDA”) covenants for 2007, to give consent to the formation of TIMS LLC and subsequent sale of a portion of the membership interests in TIMS LLC (disclosed in Note 2—Sale of Assets), and to provide various waivers in accordance with the Facility.

The Facility has various covenants that may, among other things, affect the ability of the Company to merge with another entity, sell or transfer certain assets, pay dividends and make other distributions beyond certain limitations. The Facility also requires the Company to meet certain financial covenants, including, EBITDA as defined in the Facility. As of June 30, 2008, the Company was in compliance with the Facility’s financial and EBITDA covenants. Based on the Company’s current projection of EBITDA, the Company expects that it will remain in compliance with its EBITDA covenants, and accordingly, the Facility is classified as a noncurrent liability as of June 30, 2008.

At June 30, 2008 and December 31, 2007, the Company had outstanding borrowings of \$9.6 million and \$12.8 million, respectively, and unused borrowing availability of \$2.6 million and \$2.2 million, respectively, on the Facility. As of February 18, 2009, the Company has availability under its current arrangement of approximately \$2.2 million. The effective weighted average interest rates (including various fees charged pursuant to the Facility agreement and related amendments) on the outstanding borrowings under the Facility were 12.3% for the six months ended June 30, 2008 and 13.3 % for the year ended December 31, 2007.

### *Senior Subordinated Notes*

In 1995, the Company issued Senior Subordinated Notes (“Notes”) to certain shareholders. Such Notes are classified as either Series B or Series C. The Series B Notes are secured by the Company’s property and equipment, but are subordinate to the security interests of Wells Fargo Foothill. The Series C Notes are unsecured. The Company’s Notes are held principally by common shareholders and totaled \$4.7 million and \$5.2 million at June 30, 2008 and December 31, 2007, respectively. These subordinated notes bear interest at rates between 14% and 17%, due and payable on December 31, 2011. During the first six months of 2008 and 2007, the Company paid \$371,000 and \$375,000, respectively, in interest to subordinated note holders. In addition, these notes have a cumulative prepayment premium of 13.5% per annum payable only upon certain circumstances, which if in effect, would be approximately \$20.1 million at June 30, 2008. See Note 6 – Current Liabilities and Debt Obligations.

In June and July of 2008, the Company repaid \$0.5 million, respectively, of the outstanding Series B Notes. The prepayment penalties on the repayment of such Notes were waived by the note holders. Additionally, Wells Fargo Foothill granted a waiver and amendment to the Facility to allow the repayment of such Notes.

### *Redeemable Preferred Stock*

The Company currently has two primary classes of redeemable preferred stock—Senior Redeemable Preferred Stock and Public Preferred Stock. Each class carries cumulative dividend rates of 12% to 14.125%. The Company accrues dividends and provides for accretion related to the redeemable preferred stock. The total carrying amount of redeemable preferred stock, including accumulated and unpaid dividends was \$104.7 million and \$102.3 million at September 30, 2008 and December 31, 2007, respectively. During the first six months of 2008 and 2007, the Company recorded \$2.4 million and \$2.7 million, respectively, of dividends on the two classes of redeemable preferred stock, and such amounts have been included in interest expense.

### *Senior Redeemable Preferred Stock*

Redemption for all shares of the Senior Redeemable Preferred Stock plus all accrued dividends on those shares was scheduled, subject to limitations detailed below, on October 31, 2005. However, on April 14, 2005, Toxford Corporation, the holder of 72.6% of the Senior Redeemable Preferred Stock, extended the maturity of its instruments to October 31, 2008. Subsequently, on March 17, 2008, Toxford Corporation further extended the maturity of its instruments to December 31, 2011. Additionally, on June 4, 2008, North Atlantic Smaller Companies Investment Trust PLC and North Atlantic Value LLP A/C B, the holders of 7.9% and .06%, respectively, of the Senior Redeemable Preferred Stock, also extended the maturity of their instruments to December 31, 2011. Among the limitations with regard to the scheduled redemptions of the Senior Redeemable Public Preferred Stock is the legal availability of funds, pursuant to Maryland law. Accordingly, due to the Company’s current financial position and the terms of the Facility agreement, it is precluded by Maryland law from making the scheduled payment. As the Senior Redeemable Preferred Stock is not due on demand, or callable, within twelve months from June 30, 2008, the remaining 18.9% is also classified as noncurrent.

## [Table of Contents](#)

### *Public Preferred Stock*

#### *Redemption Provisions*

Redemption for the Public Preferred Stock is contractually scheduled from 2005 through 2009. Since 1991, the Company has not declared or paid any dividends on its Public Preferred Stock, based upon its interpretation of restrictions in its Articles of Amendment and Restatement, filed with the State of Maryland on January 5, 1992, as amended on April 14, 1995 ("Charter"), limitations in the terms of the Public Preferred Stock instrument, specific dividend payment restrictions in the Facility entered into with Wells Fargo Foothill, and other senior obligations and limitations pursuant to Maryland law. Pursuant to their terms, the Company is scheduled, but not required, to redeem the Public Preferred Stock in five annual tranches during the period 2005 through 2009. However, due to its substantial senior obligations, limitations set forth in the covenants in the Facility, foreseeable capital and operational requirements, restrictions and prohibitions of its Charter, and provisions of Maryland law, and assuming sufficient liquidity to undertake any stock redemption (which is presently unquantifiable), the Company believes that it will continue to be unable to meet the redemption schedule set forth in the terms of the Public Preferred Stock instrument. Moreover, the Public Preferred Stock is not payable on demand, nor callable, for failure to redeem the Public Preferred Stock in accordance with the redemption schedule set forth in the instrument. Therefore, the Company has classified these securities as noncurrent liabilities in the balance sheet as of June 30, 2008 and December 31, 2007.

The Company and certain of its subsidiaries are parties to the Facility agreement with Wells Fargo Foothill, whose term expires on September 30, 2011. Under the Facility, the Company agreed that, so long as any credit under the Facility is available and until full and final payment of the obligations under the Facility, it would not make any distribution or declare or pay any dividends (other than common stock) on its stock, or purchase, acquire, or redeem any stock, or exchange any stock for indebtedness, or retire any stock. The Company continues to actively rely upon the Facility and expects to continue to do so until the Facility expires on September 30, 2011.

Accordingly, as stated above, the Company will continue to classify the entirety of its obligation to redeem the Public Preferred Stock as a long-term obligation. The Facility prohibits, among other things, the redemption of any stock, common or preferred, until September 30, 2011. The Public Preferred Stock by its terms cannot be redeemed if doing so would violate the terms of an agreement regarding the borrowing of funds or the extension of credit which is binding upon the Company or any subsidiary of the Company, and it does not include any other provisions that would otherwise require any acceleration of the redemption of or amortization payments with respect to the Public Preferred Stock. Thus, the Public Preferred Stock is not and will not be due on demand, nor callable, within twelve months from June 30, 2008. This classification is consistent with ARB No. 43 and Statement of Financial Accounting Standard ("SFAS") No. 78, "Classification of Obligations that are Callable by the Creditor."

Paragraph 7 of Chapter 3A of ARB No. 43 defines a current liability, as follows:

"The term current liabilities is used principally to designate obligations whose liquidation is reasonably expected to require the use of existing resources properly classifiable as current assets, or the creation of other current liabilities. As a balance sheet category, the classification is intended to include obligations for items that have entered into the operating cycle, such as payables incurred in the acquisition of materials and supplies to be used in the production of goods or in providing services to be offered for sale; collections received in advance of the delivery of goods or performance of services; and debts that arise from operations directly related to the operating cycle, such as accruals for wages, salaries, commissions, rentals, royalties, and income and other taxes. Other liabilities whose regular and ordinary liquidation is expected to occur within a relatively short period of time, usually 12 months, are also intended for inclusion, such as short-term debts arising from the acquisition of capital assets, serial maturities of long-term obligations, amounts required to be expended within 1 year under sinking fund provisions, and agency obligations arising from the collection or acceptance of cash or other assets for the account of third persons."

Paragraph 5 of SFAS No. 78, provides the following:

"The current liability classification is also intended to include obligations that, by their terms, are due on demand or will be due on demand within one year (or operating cycle, if longer) from the balance sheet date, even though liquidation may not be expected within that period. It is also intended to include long-term obligations that are or will be callable by the creditor either because the debtor's violation of a provision of the debt agreement at the balance sheet date makes the obligation callable or because the violation, if not cured within a specified grace period, will make the obligation callable..."

## [Table of Contents](#)

If, pursuant to the terms of the Public Preferred Stock, the Company does not redeem the Public Preferred Stock in accordance with the scheduled redemptions described above, the terms of the Public Preferred Stock require the Company to discharge its obligation to redeem the Public Preferred Stock as soon as the Company is financially capable and legally permitted to do so. Therefore, by its very terms, the Public Preferred Stock is not due on demand or callable for failure to make a scheduled payment pursuant to its redemption provisions and is properly classified as a noncurrent liability.

### *Dividend Provisions*

Dividends on the Public Preferred Stock are paid by the Company, when and if declared by the Board of Directors and are required to be paid out of legally available funds in accordance with Maryland law. The Public Preferred Stock accrues a semiannual dividend at the annual rate of 12% (\$1.20) per share, based on the liquidation preference of \$10 per share and is fully cumulative. Dividends in additional shares of the Public Preferred Stock for 1990 and 1991 were paid at the rate of 6% of a share for each \$.60 of such dividends not paid in cash. For the cash dividends payable since December 1, 1995, the Company has accrued \$63.4 million and \$61.5 million as of June 30, 2008 and December 31, 2007, respectively. During the first six months of 2008 and 2007, the Company accrued cumulative Public Preferred Stock dividends of \$1.9 million, respectively, which was recorded as interest expense.

In accordance with SFAS No. 150, both the Senior Redeemable Preferred Stock and the Public Preferred Stock have been reclassified from equity to liability. Consequently, for the six months ended June 30, 2008 and 2007, dividends totaling \$2.4 million and \$2.7 million, respectively, were accrued and reported as interest expense in the respective periods. Prior to the effective date of SFAS No. 150 on July 1, 2003, such dividends were charged to stockholders' accumulated deficit.

The carrying value of the accrued Paid-in-Kind ("PIK") dividends on the Public Preferred Stock for the period 1992 through June 1995 was \$4.0 million. Had the Company accrued such dividends on a cash basis for this time period, the total amount accrued would have been \$15.1 million. However, as a result of the redemption of the 410,000 shares of the Public Preferred Stock in November 1998, such amounts were reduced and adjusted to \$3.5 million and \$13.4 million, respectively. The Company's Charter, Section 2(a) states, "Any dividends payable with respect to the Exchangeable Preferred Stock ("Public Preferred Stock") during the first six years after the Effective Date (November 20, 1989) may be paid (subject to restrictions under applicable state law), in the sole discretion of the Board of Directors, in cash or by issuing additional fully paid and nonassessable shares of Exchangeable Preferred Stock ...". Accordingly, the Board had the discretion to pay the dividends for the referenced period in cash or by the issuance of additional shares of Public Preferred Stock. During the period in which the Company stated its intent to pay PIK dividends, the Company stated its intention to amend its Charter to permit such payment by the issuance of additional shares of Public Preferred Stock. In consequence, as required by applicable accounting requirements, the accrual for these dividends was recorded at the estimated fair value (as the average of the ask and bid prices) on the dividend date of the shares of Public Preferred Stock that would have been (but were not) issued. This accrual was \$9.9 million lower than the accrual would be if the intent was only to pay the dividend in cash, at that date or any later date.

In May 2006, the Board concluded that the accrual of PIK dividends for the period 1992 through June 1995 was no longer appropriate. Since 1995, the Company has disclosed in the footnotes to its audited financial statements the carrying value of the accrued PIK dividends on the Public Preferred Stock for the period 1992 through June 1995 was \$4.0 million, and that had the Company accrued cash dividends during this time period, the total amount accrued would have been \$15.1 million. As stated above, such amounts were reduced and adjusted to \$3.5 million and \$13.4 million, respectively, due to the redemption of 410,000 shares of the Public Preferred Stock in November 1998. On May 12, 2006, the Board voted to confirm that the Company's intent with respect to the payment of dividends on the Public Preferred Stock for this period changed from its previously stated intent to pay PIK dividends to that of an intent to pay cash dividends. The Company therefore changed the accrual from \$3.5 million to \$13.4 million, the result of which was to increase the Company's negative shareholder equity by the \$9.9 million difference between those two amounts, by recording an additional \$9.9 million charge to interest expense for the second quarter of 2006, resulting in a balance of \$95.0 million and \$92.8 million for the principal amount and all accrued dividends on the Public Preferred Stock as of June 30, 2008 and December 31, 2007, respectively. This action is considered a change in assumption that results in a change in accounting estimate as defined in SFAS 154, "Accounting Changes and Error Corrections" which replaces APB No. 20, "Accounting Changes" and SFAS No. 3, "Reporting Accounting Changes in Interim Financial Statements."

## [Table of Contents](#)

### *Borrowing Capacity*

At June 30, 2008, the Company had outstanding debt and long-term obligations of \$126.8 million, consisting of \$9.6 million under the Facility, \$4.7 million in subordinated debt, \$7.9 million in capital lease obligations and \$104.6 million in redeemable preferred stock classified as liability in accordance with SFAS No. 150.

The Company's working capital was \$0.9 million as of June 30, 2008. The Company's working capital deficit \$0.4 million as of December 31, 2007. Although no assurances can be given, the Company expects that it will be in compliance throughout the term of the amended Facility with respect to the financial and other covenants.

The Company believes that available cash and borrowings under the amended Facility will be sufficient to generate adequate amounts of cash to meet the Company's needs for operating expenses, debt service requirements, and projected capital expenditures for 2008. The Company anticipates the continued need for a credit facility upon terms and conditions substantially similar to the amended Facility in order to meet the Company's long term needs for operating expenses, debt service requirements, and projected capital expenditures.

In April 2007, as a result of the sale of a membership interest in TIMS LLC, the Company received \$6 million in cash consideration which was used to address working capital requirements. See Note 2 – Sale of Assets.

Additionally, in late 2007, the Company experienced delayed payments from one of the Company's significant government payment offices due to complications arising from that office's payment system conversion. As a result, anticipated payments from this government payment office have been received significantly later than the payment due dates. The Company has been able to utilize its Facility to mitigate the effect of these payment delays. This slow down in payment has since been resolved.

In accordance with the terms of one the Company's government contracts for services, the Company was also required to provide a performance bond and a payment bond for a system installation at a customer site. The amount of such bond is approximately \$4.1 million and the Company has been required to collateralize the entire amount of the bond. The Company provided such collateral on or about October 31, 2007. The terms of the bond requirement allow for a release of a significant amount of the collateral subject to satisfactory performance. Consequently, \$1.7 million, \$1.7 million, and \$0.6 million in collateral were released in accordance with such satisfactory performance in May, July and November 2008, respectively. As of February 23, 2009, the remaining collateral balance is approximately \$103,000, which is expected to be released in December of 2009, which is one year after anticipated satisfactory completion of the contract.

### **Recent Accounting Pronouncements**

See Note 1 of the Consolidated Financial Statements for a discussion of recently issued accounting pronouncements.

### **Critical Accounting Policies**

There have been no changes to the Company's critical accounting policies as disclosed its Annual Report on Form 10-K for the year ended December 31, 2007 as filed with the SEC on December 17, 2008.

### **Item 3. Quantitative and Qualitative Disclosures about Market Risk**

The Company is exposed to interest rate volatility with regard to its variable rate debt obligations under its Facility. Interest on the Facility is charged at 1% over the Wells Fargo "prime rate" (as of June 30, 2008 the Wells Fargo "prime rate" was 5.25%), or 5.75%, whichever is higher. The effective average interest rates, including all bank fees, for June 30, 2008 and December 31, 2007 were 12.3% and 13.3%, respectively. The Facility had an outstanding balance of \$9.6 million at June 30, 2008.

The Company's restricted investments are reported at amortized cost, in accordance with SFAS No. 115. The restricted investments consist of one treasury note with fixed interest rate of 3.849% due June 30, 2009, which the Company intends to hold to the maturity date. At June 30, 2008, the restricted investments also consisted of a treasury bill and a treasury note with fixed interest rate of 1.298%, and 4.019%, respectively, which the Company held to the maturity dates. The balance at June 30, 2008 was pledged as collateral on a performance bond and payment bond for one of the Company's government contracts for services, a significant amount of which was released upon satisfactory performance in the May, July and November 2008 time periods.



**Item 4T. Controls and Procedures**

*Evaluation of Disclosure Controls and Procedures*

The Company has established controls and procedures to ensure that material information relating to the Company is made known to the officers who certify the financial statements and to other members of senior management and to the audit committee and board of directors. As of June 30, 2008, an evaluation of the effectiveness of the Company's disclosure controls and procedures (as defined in Rule 13a-15(e) and 15d-15(e) promulgated under the Exchange Act, was performed under the supervision and with the participation of the Company's management, including the Chief Executive Officer and Chief Financial Officer. Based on that evaluation, the Company's Chief Executive Officer and Chief Financial Officer have concluded that the Company's disclosure controls and procedures are effective to ensure that information required to be disclosed by the Company in its reports that it files or submits under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission rules and forms, and that information required to be disclosed by the Company in the reports the Company files or submits under the Exchange Act is accumulated and communicated to the Company's management, including its Chief Executive Officer and Chief Financial Officer, as appropriate to allow timely decisions regarding required disclosure.

*Internal Control over Financial Reporting*

There has been no change in the Company's internal control over financial reporting during the quarter ended June 30, 2008 that has materially affected, or is reasonably likely to materially affect, the Company's internal controls over financial reporting.

## PART II—OTHER INFORMATION

### Item 1. Legal Proceedings

Information regarding legal proceedings may be found in Note 9 to the Condensed Consolidated Financial Statements.

### Item 1A. Risk Factors

There were no material changes in the second quarter of 2008 in the Company's risk factors as disclosed in the Company's Annual Report on Form 10-K for the year ended December 31, 2007.

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

None.

### Item 3. Defaults upon Senior Securities

#### *Senior Redeemable Preferred Stock*

The Company has not declared dividends on its Senior Redeemable Preferred Stock, Series A-1 and A-2, since issuance. At June 30, 2008, total undeclared unpaid dividends accrued for financial reporting purposes are \$6.7 million for the Series A-1 and A-2 Preferred Stock. The Company was required to redeem all shares and accrued dividends outstanding on October 31, 2005. However, on April 14, 2005, Toxford Corporation, the holder of 72.6% of the Senior Redeemable Preferred Stock, extended the maturity of its instruments to October 31, 2008. Subsequently, on March 17, 2008, Toxford Corporation further extended the maturity of its instruments to December 31, 2011. Additionally, on June 4, 2008, North Atlantic Smaller Companies Investment Trust PLC and North Atlantic Value LLP A/C B, the holder of 7.9% and .06%, respectively, of the Senior Redeemable Preferred Stock, also extended the maturity of their instruments to December 31, 2011. Subject to limitations set forth below, the Company was scheduled to redeem 18.9% of the outstanding shares and accrued dividends outstanding on October 31, 2005. Among the limitations with regard to the mandatory redemptions of the Senior Redeemable Public Preferred Stock is the legal availability of funds, pursuant to Maryland law. Accordingly, due to the Company's current financial position and the terms of the Wells Fargo Foothill agreement, it is precluded by Maryland law from making the scheduled payment.

#### *12% Cumulative Exchangeable Redeemable Preferred Stock*

Through November 21, 1995, the Company had the option to pay dividends in additional shares of Preferred Stock in lieu of cash (provided there were no restrictions on payment as further discussed below). As more fully explained in the next paragraph, dividends are payable by the Company, provided that the Company has legally available funds under Maryland law (as discussed above) and is able to pay dividends under its charter and other senior financing documents, when and if declared by the Board of Directors, commencing June 1, 1990, and on each six month anniversary thereof. Dividends in additional shares of the Preferred Stock for 1990 and 1991 were paid at the rate of 6% of a share for each \$.60 of such dividends not paid in cash. Dividends for the years 1992 through 1994, and for the dividend payable June 1, 1995, were accrued under the assumption that such dividends would be paid in additional shares of preferred stock and were valued at \$4.0 million. Had the Company accrued these dividends on a cash basis, the total amount accrued would have been \$15.1 million. However, as a result of the redemption of the 410,000 shares of the Public Preferred Stock in November 1998, such amounts were reduced and adjusted to \$3.5 million and \$13.4 million, respectively. As more fully disclosed in Note 6 – Redeemable Preferred Stock, in the second quarter of 2006, the Company accrued an additional \$9.9 million in interest expense to reflect its intent to pay cash dividends in lieu of stock dividends, for the years 1992 through 1994, and for the dividend payable June 1, 1995. The Company has accrued \$63.4 million in cash dividends as of June 30, 2008 and \$61.5 million as of December 31, 2007.

Since 1991, the Company has not declared or paid any dividends on its Public Preferred Stock, based upon its interpretation of restrictions in its Articles of Amendment and Restatement, limitations in the terms of the Public Preferred Stock instrument, specific dividend payment restrictions in the Facility entered into with Wells Fargo Foothill, to which the Public Preferred Stock is subject, and other senior obligations, and limitations pursuant to Maryland law (as discussed above). Pursuant to their terms, the Company is scheduled, but not required, to redeem the Public Preferred Stock in five annual tranches during the period 2005 through 2009. However, due to its substantial senior obligations, limitations set forth in the covenants in the Facility, foreseeable capital and operational requirements, restrictions and prohibitions of its Articles of Amendment and Restatement, and provisions

## Table of Contents

of Maryland law (as discussed above), the Company did not make the first three scheduled redemption payments, and assuming insufficient liquidity to undertake any stock redemption (which is presently unquantifiable), the Company believes that it will not be able to make the remaining two scheduled redemption payments as set forth in the terms of the Public Preferred Stock. Accordingly, the Public Preferred Stock is not payable on demand, nor callable, for failure to redeem the Public Preferred Stock in accordance with the redemption schedule set forth in the instrument. The Company has therefore classified these securities as noncurrent liabilities on the presented balance sheet as of June 30, 2008 and December 31, 2007.

### **Item 4. Submission of Matters to a Vote of Security Holders**

None.

### **Item 5. Other Information**

#### *Notice of Delisting*

As previously disclosed, effective July 13, 2007, the Company's Public Preferred Stock is no longer quoted on the OTCBB, and is now quoted as TLSRP in the Pink Sheets.

### **Item 6. Exhibits**

<u>Exhibit Number</u>	<u>Description of Exhibit</u>
3.1	Articles of Amendment and Restatement of the Company, dated January 14, 1992. (Incorporated by reference to Exhibit 4 to the Company's Form 8-K filed on January 29, 1992)
3.2	Amended and Restated Bylaws of the Company, as amended on October 3, 2007. (Incorporated by reference to Exhibit 3.1 to the Company's Form 8-K filed on October 5, 2007)
4.1	Form of Indenture between the Registrant and Bankers Trust Company, as Trustee, relating to the 12% Junior Subordinated Debentures Due 2009. (Incorporated by reference to C3's Registration Statement on Form S-4 filed October 20, 1989)
4.2	Form of the terms of the 12% Cumulative Exchangeable Redeemable Preferred Stock of the Registrant (Incorporated by reference to C3's Registration Statement on Form S-4 filed October 20, 1989)
10.1	Telos Corporation 2008 Omnibus Long-Term Incentive Plan. (Incorporated by reference to Exhibit 10.21 to the Company's Form 10-K report for the year ended December 31, 2007)
10.2	Fifteenth Amendment to Loan and Security Agreement between Telos Corporation, a Maryland corporation, and Wells Fargo Foothill, Inc. (Incorporated by reference to Exhibit 10.2 to the Company's Form 10-Q report for the quarter ended March 31, 2008)
10.3	Amended and Restated Loan and Security Agreement between Telos Corporation, a Maryland corporation, and Wells Fargo Foothill, Inc. (Incorporated by reference to Exhibit 10.22 to the Company's Form 10-K report for the year ended December 31, 2007)
31.1*	Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
31.2*	Certification of Chief Financial Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
32*	Certification Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

\* filed herewith

**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.

Date: March 4, 2009

TELOS CORPORATION

/s/ John B. Wood

John B. Wood  
Chief Executive Officer

/s/ Michele Nakazawa

Michele Nakazawa  
Chief Financial Officer

## CERTIFICATION

I, John B. Wood, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Telos Corporation;

2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;

3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;

4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:

a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;

b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;

c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and

d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and

5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and to the audit committee of registrant's board of directors:

a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and

b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: March 4, 2009

/s/ John B. Wood

John B. Wood

Chief Executive Officer

## CERTIFICATION

I, Michele Nakazawa, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Telos Corporation;

2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;

3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;

4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:

a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;

b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;

c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and

d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and

5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and to the audit committee of registrant's board of directors:

a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and

b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: March 4, 2009

/s/ Michele Nakazawa

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Michele Nakazawa  
Chief Financial Officer

**CERTIFICATION PURSUANT TO  
18 U.S.C. SECTION 1350,  
AS ADOPTED PURSUANT TO  
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002**

In connection with the Quarterly Report of Telos Corporation (the "Company") on Form 10-Q for the period ending June 30, 2008 as filed with the Securities and Exchange Commission on the date hereof (the "Report"), we, John B. Wood and Michele Nakazawa, certify, pursuant to 18 U.S.C. § 1350, as adopted pursuant to § 906 of the Sarbanes-Oxley Act of 2002, that to our knowledge:

- (1) The Report fully complies with the requirements of section 13(a) or 15(d) of the Securities Exchange Act of 1934, as amended; and
- (2) The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

Date: March 4, 2009

/s/ John B. Wood

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John B. Wood  
Chief Executive Officer

Date: March 4, 2009

/s/ Michele Nakazawa

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Michele Nakazawa  
Chief Financial Officer