

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

FORM 10-Q

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

For the quarterly period ended: **March 31, 2005**

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

Commission file number: **1-8443**

TELOS CORPORATION

(Exact name of registrant as specified in its charter)

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)

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 an accelerated filer (as defined in Rule 12b-2 of the Exchange Act). Yes No

As of May 16, 2005, the registrant had outstanding 21,171,202 shares of Class A Common Stock, no par value; and 4,037,628 shares of Class B Common Stock, no par value.

TELOS CORPORATION AND SUBSIDIARIES

INDEX

	<u>Page</u>
PART I. FINANCIAL INFORMATION	
Item 1. Financial Statements:	
Condensed Consolidated Statements of Operations for the Three Months Ended March 31, 2005 and 2004 (unaudited)	3
Condensed Consolidated Balance Sheets as of March 31, 2005 (unaudited) and December 31, 2004	4-5
Condensed Consolidated Statements of Cash Flows for the Three Months Ended March 31, 2005 and 2004 (unaudited)	6
Notes to Condensed Consolidated Financial Statements (unaudited)	7-17
Item 2. Management’s Discussion and Analysis of Financial Condition and Results of Operations	18-26
Item 3. Quantitative and Qualitative Disclosures about Market Risk	27
Item 4. Controls and Procedures	27
PART II. OTHER INFORMATION	
Item 1. Legal Proceedings	28
Item 3. Defaults upon Senior Securities	28
Item 6. Exhibits	28
SIGNATURE	29

PART I—FINANCIAL INFORMATION
TELOS CORPORATION AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(Unaudited)
(amounts in thousands)

	Three Months Ended March 31,	
	2005	2004
Revenue	\$34,962	\$26,787
Costs and expenses		
Cost of sales	27,455	21,328
Selling, general and administrative expenses	7,030	4,694
Operating income	477	765
Other income (expenses)		
Other income	33	—
Interest expense	(2,139)	(2,192)
Loss before taxes	(1,629)	(1,427)
Provision for income taxes	—	—
Loss from continuing operations	(1,629)	(1,427)
Discontinued operations:		
Gain on sale of TCC, net of tax	1,000	—
Net loss	\$ (629)	\$ (1,427)

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

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

	March 31, 2005 (Unaudited)	December 31, 2004
ASSETS		
Current assets		
Cash and cash equivalents (includes restricted cash of \$54 at March 31, 2005 and December 31, 2004)	\$ 63	\$ 67
Accounts receivable, net of reserve of \$520 and \$540, respectively	20,569	31,672
Inventories, net of obsolescence reserve of \$76 and \$83, respectively	4,560	14,272
Other current assets	1,178	1,594
	<hr/>	<hr/>
Total current assets	26,370	47,605
Property and equipment, net of accumulated depreciation of \$13,434 and \$13,141, respectively	10,104	10,066
Other assets	866	846
	<hr/>	<hr/>
Total assets	\$ 37,340	\$ 58,517
	<hr/>	<hr/>

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

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

	March 31, 2005 (Unaudited)	December 31, 2004
LIABILITIES AND STOCKHOLDERS' DEFICIT		
Current liabilities		
Accounts payable	\$ 7,740	\$ 22,029
Accrued compensation and benefits	8,600	7,838
Deferred revenue	7,816	9,238
Capital lease obligations – short-term	530	517
Other current liabilities	1,963	2,118
	<hr/>	<hr/>
Total current liabilities	26,649	41,740
Senior credit facility	4,584	11,416
Senior subordinated notes	5,179	5,179
Capital lease obligations	9,590	9,727
Senior redeemable preferred stock (Note 4)	8,280	8,175
Public preferred stock (Note 4)	66,831	65,424
	<hr/>	<hr/>
Total	121,113	141,661
Stockholders' deficit		
Common stock	78	78
Accumulated deficit	(83,851)	(83,222)
	<hr/>	<hr/>
Total stockholders' deficit	(83,773)	(83,144)
	<hr/>	<hr/>
Total liabilities and stockholders' deficit	\$ 37,340	\$ 58,517
	<hr/>	<hr/>

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)

	Three Months Ended March 31,	
	2005	2004
Operating activities:		
Loss from continuing operations	\$ (1,629)	\$ (1,427)
Adjustments to reconcile loss from continuing operations to cash provided by operating activities:		
Dividends and accretion of preferred stock as interest expense	1,510	1,615
Depreciation and amortization	473	373
Other noncash items	(21)	(39)
Changes in other operating assets and liabilities	5,737	3,694
	<u>6,070</u>	<u>4,216</u>
Cash provided by continuing operating activities	6,070	4,216
Investing activities:		
Net proceeds from sale of TCC	1,000	—
Purchase of property and equipment	(427)	(85)
	<u>573</u>	<u>(85)</u>
Cash provided by (used in) investing activities	573	(85)
Financing activities:		
Repayment of borrowings under senior credit facility, net	(6,832)	(3,854)
Increase (decrease) in book overdrafts	308	(166)
Payments under capital leases	(123)	(109)
	<u>(6,647)</u>	<u>(4,129)</u>
Cash used in financing activities	(6,647)	(4,129)
(Decrease) increase in cash and cash equivalents	(4)	2
Cash and cash equivalents at beginning of period	67	64
	<u>\$ 63</u>	<u>\$ 66</u>
Cash and cash equivalents at end of period	\$ 63	\$ 66

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

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

Note 1. General

The accompanying condensed consolidated financial statements are unaudited and include the accounts of Telos Corporation (“Telos”) and its wholly owned subsidiaries Xacta Corporation and Telos Delaware, Inc. (collectively, the “Company”). The accounts of the Company’s investment in Enterworks, Inc. (“Enterworks”) have been deconsolidated as of December 30, 1999, and therefore have been removed from the consolidated balance sheet and statement of changes in stockholders equity. The Company has applied the equity method of accounting for the remaining Enterworks investment. In December 2003, the Company purchased a 50% interest in Enterworks International, Inc. which, at the time of the transaction, was a wholly-owned subsidiary of Enterworks. Enterworks International is considered a variable interest entity of Telos and, therefore, is required to be consolidated. Significant intercompany transactions have been eliminated.

In the opinion of the Company, the accompanying financial statements reflect all adjustments (which include only normal recurring adjustments) and reclassifications necessary for their fair presentation in conformity with accounting principles generally accepted in the United States of America. 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 2004 Annual Report on Form 10-K filed with the Securities and Exchange Commission. These 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, 2004.

Reclassifications

Certain reclassifications have been made to prior year financial statements to conform to the classifications used in the current period.

Recent Accounting Pronouncements

In January 2003, the Financial Accounting Standards Board (“FASB”) issued Interpretation (“FIN”) No. 46, “Consolidation of Variable Interest Entities” and in December 2003, a revised interpretation was issued (FIN No. 46(R)). In general, a variable interest entity (“VIE”) is a corporation, partnership, trust, or any other legal structure used for business purposes that does not have equity investors with voting rights or equity investors providing sufficient financial resources for the entity to support its activities. FIN No. 46 requires a VIE to be consolidated by a company if that company is designated as the primary beneficiary. Generally, the interpretation applies to VIEs created after January 31, 2003, and for all financial statements issued after December 15, 2003, for VIEs in which an enterprise held a variable interest that it acquired before February 1, 2003. As a result of the adoption of this standard, Enterworks International, Inc. is required to be consolidated. See Note 2 – Investment in Enterworks.

Stock-Based Compensation and New Accounting Announcement

In December 2004, the FASB issued Statement of Financial Accounting Standards No. 123(R), "Share Based Payment" ("SFAS No. 123(R)"), a revision of SFAS No. 123, "Accounting for Stock-Based Compensation." SFAS No. 123(R) supersedes APB Opinion No. 25, "Accounting for Stock Issued to Employees." SFAS No. 123(R) requires all share-based payments to employees, including grants of employee stock options, to be recognized in the income statement based on their fair values. SFAS No. 123(R) must be adopted by the Company by the third quarter of 2005. In April 2005, the effective date was amended for calendar year companies until the beginning of 2006. The Company currently accounts for share-based compensation using APB No. 25's intrinsic value method and, accordingly, recognizes no compensation cost for employee stock options. The Company is in the process of determining which transitional method it will elect upon the adoption of SFAS No. 123(R).

The Company has applied the provisions of SFAS No. 123, as amended by SFAS No. 148, "Accounting for Stock-Based Compensation and Disclosure, an amendment of FASB Statement No. 123." Under those provisions, the Company has provided pro forma disclosures as if the fair value measurement provisions of SFAS No. 123 had been used in determining compensation expense.

The Company accounts for stock-based compensation consistent with Accounting Principles Board ("APB") Opinion No. 25, "Accounting for Stock Issued to Employees." Under APB 25, compensation cost is measured as the excess, if any, of the fair value of the Company's common stock at the date of grant over the exercise price of the option granted.

Had compensation expense for the Company's stock options been recognized based on the fair value of the options at the grant dates, using the methodology prescribed by the Statement of Financial Accounting Standards No. 123, "Accounting for Stock-Based Compensation," the Company's net loss would have been as follows (in thousands):

	Three Months Ended March 31,	
	2005	2004
Net loss, as reported	\$ (629)	\$ (1,427)
Deduct: Net stock-based employee compensation expense determined under fair value based method	(40)	(197)
Pro forma net loss	\$ (669)	\$ (1,624)

Note 2. Investment in Enterworks

As of March 31, 2005, the Company owns 17,153,059 common stock shares of Enterworks, Inc. (“Enterworks”) and holds warrants to purchase 4,499,997 underlying common stock shares that equates to a fully diluted ownership percentage of 21.5%. The Company accounts for its investment in Enterworks under the equity method of accounting as prescribed by APB 18, “The Equity Method of Accounting for Investments in Common Stock.”

The Company also owns notes receivable from Enterworks totaling \$3.3 million. Such notes were received in exchange for rent and professional services performed by the Company pursuant to a lease and an intercompany services agreement. In accordance with APB 18 and EITF 98-13 “Accounting by an Equity Method Investor for Investee Losses when the Investor has Loans to and Investments in Other Securities of the Investee,” the Company has reduced the carrying amounts of the notes to zero during 2003 and 2002, as the Company’s share of the Enterworks’ losses exceeded the carrying value of the notes. All such notes, issued to the Company in 2003 and 2002, include a provision for repayment of four times principal and accrued interest in the event that Enterworks liquidates, enters into dissolution, or seeks bankruptcy protection.

In December 2003, the Company purchased a 50% interest in Enterworks International, which at the time of the transaction was a wholly-owned subsidiary of Enterworks, for \$500,000. Pursuant to the terms of the stock purchase agreement and the stockholder agreement (“Agreement”) setting forth the transaction, the Company agreed to fund up to 50% of Enterworks International’s 2004 operating costs for an amount not to exceed \$300,000 in the year 2004 and certain direct expenses which amounted to \$89,000 in 2004, and 50% of such operating costs and certain expenses thereafter. The Company estimates that such costs incurred and recorded amounted to approximately \$140,000 for the three months ended March 31, 2005.

Pursuant to the Agreement, the Company and Enterworks are required to fund the operations of Enterworks International, Inc. according to a funding schedule set forth in the Agreement. For calendar year 2005, Enterworks has been unable to fund its proportionate share of the scheduled funding, which amounted to \$99,000 as of March 31, 2005, and as such the \$99,000 was expensed by the Company. Consistent with subsection 3.4(d) of the Agreement, the non-defaulting party (Telos) has the right to transfer ownership (pursuant to a Penalty Ownership calculation) of the defaulting party’s interest in Enterworks International, Inc. The Agreement also provides for a cure period for the defaulting party. On April 22, 2005, the Company provided notice to Enterworks and demanded that such default be cured in a timely manner or the Company will exercise its rights under the Agreement to transfer the calculated ownership percentage to the Company. The amount of the default set forth in the notice was approximately \$157,000.

Separately, in December 2003, the Company entered into a two-year Original Equipment Manufacturer (OEM) software license agreement (“SLA”) with Enterworks, which, pursuant to an earn-out provision is comprised of cumulative license fees and/or Company services to Enterworks equal to at least \$2.0 million. The Company provided initial consideration of \$1.0 million, comprised of a \$100,000 cash payment and Company services in the amount of \$900,000, including \$300,000 for rent and services from July 2003 to December 2003, and an additional \$600,000 for rent and services for 2004. In addition to the above-described exchange, as part of the December 2003 agreement, the Company agreed to pay royalties of \$1.0 million for a period of two years and, upon payment of cumulative license fees and/or company services to Enterworks equal to at least \$2.0 million, will own a worldwide, non-exclusive, perpetual, irrevocable, royalty-free, fully paid-up license for the Enterworks Process Exchange™ (EPX) software. As of December 31, 2004, the Company paid approximately \$294,000 in such royalties. However, in December 2004, the Company entered into an amended agreement with Enterworks in which Enterworks acknowledged that the Company had met the earn-out requirements and now owns the above-mentioned license. As part of the amended agreement, the Company paid an additional \$350,000 and waived the \$400,000 fee for rent and services for 2005. Additionally, in exchange for a one-time fixed fee of \$300,000, Enterworks shall provide the Company with maintenance and OEM technical product support for two years, commencing in January of 2005; and for \$15,000 per month thereafter. The one-time fixed fee is being amortized over two years. In accordance with FASB Statement No. 142, “Goodwill and Other Intangible Assets,” intangible assets acquired shall be initially recognized and measured at fair value. As such, the Company has capitalized \$850,000 in consideration paid for EPX software (\$100,000 in 2003 and \$750,000 in 2004), as a fixed asset.

In accordance with APB 18 and EITF 98-13, the Company has accounted for both the investment in Enterworks International and the SLA as losses from affiliates in 2003. As such, losses from affiliates for 2003 amounted to \$1.4 million. Beginning in 2004, as a result of the adoption of FIN 46, Enterworks International’s operating costs have been consolidated.

Note 3. Debt Obligations

Senior Revolving Credit Facility

On October 21, 2002, the Company entered into a \$22.5 million Senior Credit Facility Agreement (“Facility”) with Wells Fargo Foothill, Inc. (“Wells Fargo Foothill”) (formerly known as Foothill Capital Corporation) that was originally scheduled to mature on October 21, 2005. On April 15, 2005, the Company and Wells Fargo Foothill entered into a Waiver and Eighth Amendment to Loan and Security Agreement (“Waiver and Eighth Amendment”). Pursuant to the Waiver and Eighth Amendment, the revolving line limit was established at \$15 million and the interest rate at Wells Fargo “prime rate” plus 1%. The maturity date of the Facility was set to October 21, 2008. Borrowings under the Facility remain collateralized by substantially all of the Company’s assets including inventory, equipment, and accounts receivable. The amount of available borrowings fluctuates based on the eligible underlying asset-borrowing base, as defined in the Facility agreement.

The Facility has various covenants, which 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 cash flow targets based on earnings before interest, taxes, depreciation and amortization (EBITDA) as defined in the Facility. The Company and Wells Fargo Foothill have agreed upon modified cash flow covenants through October 21, 2008, to more accurately reflect the Company’s future performance. For the three months ended March 31, 2005, the Company was in compliance with the covenants contained in the Facility.

Unused borrowing availability on the Facility was \$1.4 million at March 31, 2005; however, such availability fluctuates on a daily basis based upon the amount of eligible underlying assets in the borrowing base. Interest on the Facility was charged at 1.25% over the Wells Fargo “prime rate” (as of March 31, 2005 the Wells Fargo “prime rate” was 5.75%), or 5.75%, whichever is higher. Effective April 15, 2005, the interest rate is the Wells Fargo “prime rate” plus 1%. The effective average interest rates, including all bank fees, were 9.4% and 10.9% for the three months ended March 31, 2005 and 2004, respectively.

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. The Series C Notes are unsecured. The maturity date of such Notes has been extended to October 31, 2008, with interest rates ranging from 14% to 17%, and paid quarterly on January 1, April 1, July 1, and October 1 of each year. In consideration for such extension, the Company agreed to pay a one-time fee of 1%. The Notes can be prepaid at the Company’s option. The Notes contain a cumulative payment 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 premium payment, any associated premium expense can only be quantified and recorded subsequent to the occurrence of such a qualifying triggering event. At March 31, 2005, if such a qualifying triggering event had occurred, the cumulative premium payment would have been approximately \$12.7 million.

The Company retired \$3 million of the Series B Notes in October 2002 upon the initial funding of the Facility. In consideration for a requested accelerated payment, the note holders waived the prepayment penalty on such Notes, which were due May 2003.

The balance of the Series B and C Notes was \$2.5 million and \$2.7 million, at March 31, 2005 and December 31, 2004, respectively.

[Table of Contents](#)

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

	<u>Year</u>	<u>Obligation Due</u>
Senior Subordinated Debt	2008	\$ 5,179 ¹
Senior Credit Facility	2008	\$ 4,584 ²

¹ Pursuant to Section 17 of a Subordination Agreement entered into in conjunction with the Facility, the senior subordinated note holders and the Company have entered into an agreement to extend the maturity date of the Notes to October 31, 2008.

² Balance due represents balance as of March 31, 2005, however, the Facility is a revolving credit facility with fluctuating balances based upon the eligible underlying asset-borrowing base and the varying working capital requirements of the Company.

Note 4. 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. Subject to limitations set forth below, the Company is scheduled to redeem all shares and accrued dividends outstanding on October 31, 2005. 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. Among the limitations with regard to the mandatory redemptions of the Senior Redeemable Preferred Stock are the legal availability of funds, pursuant to Maryland law, and the requirement of such payment to be from excess cash flows, as set forth in the Company's Articles of Amendment and Restatement. Consistent with the recapitalization or restructuring referenced in the Company's 2004 Form 10-K, Note 14 - Significant Company Filing, Item 8.01 - Other Events, or other more favorable recapitalization or restructuring options, the Company has the intent and ability to refinance the Senior Redeemable Preferred Stock on a long-term basis, in accordance with SFAS 6, "Classification of Short-Term Obligations Expected to Be Refinanced," by utilizing excess availability on the Facility. 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 March 31, 2005 and 2004, cumulative undeclared, unpaid dividends relating to Senior Redeemable Preferred stock totaled \$5.3 and \$4.9 million, respectively.

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. Such accretion for the three months ended March 31, 2005 and 2004 was \$451,000 and \$555,000, 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 March 31, 2005 was 3,185,586. The stock trades over the NASDAQ/ OTCBB Exchange.

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, 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 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 sufficient liquidity to undertake any stock redemption (which is presently unquantifiable), the Company believes that the likelihood is that it will not be able to meet the redemption schedule set forth in the terms of the Public Preferred Stock. Consistent with the recapitalization or restructuring referenced in the Company's 2004 Form 10-K, Note 14 - Significant Company Filing, Item 8.01 - Other Events, or other more favorable recapitalization or restructuring options, the Company has the intent and ability to refinance the Public Preferred Stock on a long-term basis due on December 1, 2005, and thereafter, in accordance with SFAS 6, "Classification of Short-Term Obligations Expected to Be Refinanced," and Article Five, Section C5 of the Company's Articles of Amendment and Restatement.

[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.

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 were paid at the rate of 6% of a share for each \$.60 of such dividends not paid in cash. Any such dividends payable by the Company, when and if declared by the Board of Directors, commencing June 1, 1990, and on each six month anniversary thereafter were paid out of legally available funds in accordance with Maryland law. For the years 1992 through 1994 and for the dividend payable June 1, 1995, the Company has accrued undeclared dividends in additional shares of Public Preferred Stock. Such accrued dividends 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. For the cash dividends payable since December 1, 1995, the Company has accrued \$38.7 million as of March 31, 2005. In 2004, the Company recorded cumulative exchangeable redeemable preferred stock dividends of \$3.8 million, which was recorded as interest expense.

In accordance with SFAS 150, and as reported beginning with the Form 10-Q for the quarter ended September 30, 2003, both the Senior Redeemable Preferred Stock and the Public Preferred Stock have been reclassified from equity to liability. Consequently, the accretion and dividends accrued in the three months ended March 31, 2005, of \$1.5, were recorded as interest expense. Pursuant to the disclosure provisions of FAS 107, the Public Preferred Stock traded on the NASDAQ/OTCBB Exchange (TLSRP) at \$5.50 per share on March 31, 2005, and consistent therewith the aggregate fair value of the outstanding shares of such publicly traded stock was \$17.5 million.

In its continuing effort to address the Company's capital structure and the adverse impact of SFAS 150 (Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity), which resulted in the reclassification of the redeemable preferred stock from equity to liability on November 23, 2004, the Company's Board of Directors established a committee comprised of independent directors to consider any and all proposals and alternatives with respect to the possible restructuring of the Company. The independent committee's charter includes addressing the unsuccessful restructuring efforts of the Board of Directors and management, undertaken pursuant to the resolution of the Board of Directors detailed in Form 8-K dated March 26, 2004. In January 2005, the independent committee informed the Board of Directors that it had retained legal counsel and engaged a financial advisor and had initiated its deliberations. On May 3, 2005, in a letter from certain of the public preferred stockholders to the independent committee, such stockholders set forth their views on matters pending before the independent committee. Such letter was incorporated in a Schedule 13D/A filed by Ewing & Partners on May 5, 2005, and by Wynnefield Capital Management, LLC and Costa Brava Partnership III, L.P. on May 9, 2005.

Note 5. Reportable Business Segments

As of March 31, 2005, the Company's operations are comprised of two operating segments, IT Solutions Group and Xacta. The segment information below has been reclassified to conform to management's internal operating structure implemented during the fourth quarter of 2003. Principally, the Company has included the results of its wireless and messaging product line (previously included as part of the Products Group segment) in the Xacta segment. Prior to December 2003, the Company had two operating segments: the Products Group and the Xacta Group.

IT Solutions Group: develops, markets and sells integration services that address a wide range of Government Information Technology (IT) requirements. Offerings consist of innovative IT solutions that consists of industry leading IT products from original equipment manufacturers ("OEMs") with complimentary integration and managed support services provided by Telos. The IT Solutions Group also provides general IT consulting and integration services in support of various U.S. Government customers.

Xacta: develops, markets and sells government-validated secure enterprise solutions to the U.S. Government and financial institutions, to address the growing demand for information security solutions. Xacta provides Secure Wireless LAN solutions, Enterprise Messaging solutions, Enterprise Credentialing solutions, Information Security Consulting services and IT Security Management software solutions.

Results from another former Systems and Support Services Group operating at Ft. Sill were also included in the Company's financial results until its deconsolidation in July 2000. At such time, the Company contributed its Ft. Sill net assets to TelosOK LLC. On March 10, 2003, the Company sold its interest in TelosOK LLC. See Note 6 - Sale of Telos Interest in TelosOK LLC.

The accounting policies of the reportable segments are the same as those referred to in Note 1. The Company evaluates the performance of its operating segments based on revenue, gross profit and segment profit (loss) before income taxes and interest income or expense.

[Table of Contents](#)

Summarized financial information concerning the Company's reportable segments for the three months ended March 31, 2005 and 2004 are set forth in the following table. The "other" column includes corporate related items.

	Three Months Ended			
	IT Solutions	Xacta	Other (1)	Total
March 31, 2005				
External revenues	\$13,321	\$21,641	\$ —	\$34,962
Gross profit	2,109	5,397	—	7,506
Segment profit (2)	335	142	—	477
Total assets	5,366	22,160	9,814	37,340
Capital expenditures	8	197	222	427
Depreciation and amortization (3)	84	137	252	473
March 31, 2004				
External revenues	\$13,543	\$13,244	\$ —	\$26,787
Gross profit	1,043	4,416	—	5,459
Segment (loss) profit (2)	(393)	1,158	—	765
Total assets	3,877	10,756	11,509	26,142
Capital expenditures	—	43	42	85
Depreciation and amortization (3)	92	57	224	373

(1) Corporate assets are property and equipment, cash and other assets.

(2) Segment profit (loss) represents operating income (loss).

(3) Depreciation and amortization include amounts relating to property and equipment, capital leases and spare parts inventory.

The Company does not have any material international revenues, profit (loss), assets or capital expenditures. The Company's business is not concentrated in any specific geographical area within the United States. The Company has six separate facilities located in various states, the District of Columbia and Germany.

Note 6. Sale of TelosOK LLC

On March 10, 2003 the Company and other TelosOK LLC investors (“Purchaser”) entered into a unit purchase agreement whereby the Company sold all of its 50% interest in TelosOK LLC for a total cash consideration of \$4.0 million. The Company had accounted for its investment in TelosOK LLC under the equity method and, at the time of this transaction, had a negative basis for its investment. The parties also agreed to certain payments to the Company through March 2004, to recover the Company’s fixed infrastructure costs associated with providing certain accounting and support services. During the first quarter of 2004, the Company has recorded \$0.1 million of these payments as other service revenue.

Pursuant to a separate agreement, the Company provided certain accounting and support services to TelosOK LLC through March 2004. An amount of \$0.1 million has been recorded as other service revenue during the first quarter related to this agreement.

As additional consideration for the sale of the Telos membership units, the Company and TelosOK LLC committed to certain “noncompete” and “nonsolicitation” agreements between the two parties. The “nonsolicitation” commitment provided for a sole exception relating to the employment by TelosOK LLC of the former President, CEO and Director of the Company. At the effective date of closing, all Telos Corporation employees serving as officers of TelosOK LLC resigned said positions in TelosOK LLC.

Upon the sale of its interest in TelosOK LLC, the Company recognized a gain of approximately \$10.1 million, comprised of \$6.1 million of deferred gain and \$4.0 million of gain from the proceeds received on March 10, 2003. The deferred gain was recorded in July 2000 as a result of Staff Accounting Bulletin No. 81, “Gain Recognition on the Sale of a Business or Operating Assets to a Highly Leveraged Entity,” which required the gain be deferred until the Company disposed of its interest in TelosOK LLC.

Note 7. Sale of Telos Corporation (California)

On July 19, 2002, the Company and L-3 Communications Corporation (“L-3”) entered into a Stock Purchase Agreement whereby the Company sold all of the issued and outstanding shares of its wholly owned subsidiary, Telos Corporation (California) (“TCC”) to L-3 for a purchase price of approximately \$20 million which included: 1) approximately \$15.3 million to the Company at closing; 2) \$2.0 million held in an escrow account, \$1.0 million of which was released and paid in October 2003 and the remaining \$1.0 million was released and paid in February 2005. During the 30-month period after July 19, 2002, the escrow amount may be subject to a reduction if any claims for indemnification by L-3 arise that are finally determined in favor of L-3 per the terms and conditions of the mutually agreed upon dispute resolution process; and 3) approximately \$2.7 million held back as deposits for liabilities relating to leased properties in which at the time of closing TCC was a lessee or guarantor. Approximately \$1 million of such hold-back was released and paid in August 2002, \$0.8 million paid in August 2004 with the remaining \$0.8 million scheduled to be released in 2007.

According to the Stock Purchase Agreement, the purchase price was to be increased or decreased on a dollar for dollar basis by the amount by which the closing date net assets deviated from \$2.3 million. The closing date net assets were \$4.6 million, an increase of an additional \$2.3 million. Such amount was invoiced by the Company and collected in October 2002 from L-3. Accordingly, as a result of the increase in purchase price during the fourth quarter 2002, the Company adjusted the gain by \$2.3 million to \$13.2 million. The Company recognized a bonus accrual for certain key employees considered critical to the sale in the amount of \$560,000 and, accordingly, the gain was adjusted to \$12.6 million. In accordance with the Company’s Senior Credit Facility, proceeds from the sale were used to pay down the Company’s Facility.

As additional consideration for the sale of the shares of TCC, the Company and its affiliates committed to certain “Non-Compete” and “Non-Solicitation” provisions relating primarily to the business and employees associated with its TCC/Ft. Monmouth operations.

The sale of TCC has been treated as a discontinued operation in accordance with SFAS 144, “Accounting for the Impairment or Disposal of Long-Lived Assets.” Pursuant to SFAS 144, the revenue, costs and expenses of TCC have been excluded from their respective captions in the Company’s consolidated statements of operations and the net results of these operations have been reported separately as “Income (loss) from discontinued operations,” accordingly, for the quarter ended March 31, 2005, a gain on sale of TCC (under the discontinued operations caption) was recorded on the receipt of the \$1.0 million received in February 2005.

Note 8. Contingencies

Pursuant to the Discretionary Incentive Bonus Plan and based upon current and projected performance, the Company accrued \$.5 million in the first quarter of 2005.

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

Government oversight

As a U.S. Government contractor, the Company is subject to oversight by many agencies and entities of the U.S. Government that may investigate and make inquiries of the Company's business practices and conduct audits of contract performance and cost accounting. Depending on the results of any such audits and investigations, the U. S. Government may make claims against the Company. Under U.S. Government procurement regulations and practices, an indictment of a U.S. Government contractor could result in that contractor being fined and/or suspended for a period of time from eligibility for bidding on, or for the award of, new U.S. Government contracts. A conviction could result in debarment for a specified period of time. To the best of management's knowledge, there are no pending investigations, inquiries, claims or audits against the Company likely to have a material adverse effect on the Company's business or its consolidated results of operations, cash flows or financial position.

General

The Company continued its investment in creating value added solutions to address the ever increasing market for systems integration services and secure enterprise solutions. For example, with the release of Xacta IA Manager™ Process Enforcer Edition in March of 2004, Xacta built upon the continuous assessment functionality that was introduced in March of 2003. Leveraging the rich IT asset information that can be automatically collected with continuous assessment, Process Enforcer allows on-going vulnerability management and automated remediation. Additionally, because vulnerabilities can now be actively managed and remediated, Xacta IA Manager will serve to improve the overall security posture of the network, and when fully deployed, will save systems administrators time and effort.

The Company's secure messaging solution is called the Automated Message Handling System ("AMHS"). AMHS version 2003 is the U.S. Government's exclusive certified stand-alone messaging application. The AMHS 2003 stand-alone architecture is more efficient and cost effective than competitive client/server architectures as it enables users to access their messages securely from a single server using a simple web browser. In addition to its more intuitive user interface, AMHS 2003 provides outbound message processing and numerous advanced message management capabilities such as retrospective search and simplified user profiling, which functionality is essential to large organizations with time sensitive formal message requirements. This application has been successfully fielded to over 50 critical government organizations. AMHS has been selected by the U.S. Air Force, Army, Navy and Marines (collectively, the "U.S. Military Services") as their NETCENTRIC Enterprise messaging capability.

The Company also made a significant investment in developing new business and establishing critical new contract vehicles with the U.S. Government. Specifically, Telos won a multiple award, multi-year, GWAC IT contract with the U.S. Air Force. This NETCENTS contract is mandated for use by the Air Force. Telos has a number of high profile partners on its NETCENTS team to include Verizon and EDS which will sell their products and services through the NETCENTS contract. NETCENTS will also be an important sales mechanism for Xacta and the IT Solutions Group offerings.

Backlog

The Company's total backlog was \$89.2 million and \$43.7 million at March 31, 2005 and 2004, respectively. Backlog was \$106.4 million at December 31, 2004. The total backlog of each of the segments at March 31, 2005 and 2004 was as follows: IT Solutions Group - \$8.7 million and \$4.9 million, respectively; and Xacta - \$80.5 million and \$38.8 million, respectively.

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 March 31, 2005 and 2004 was \$80.0 million and \$43.4 million, respectively.

[Table of Contents](#)**Exit from the Systems and Support Services Business**

The Company sold its 50% interest in TelosOK LLC, on March 10, 2003, which is reported in Note 6 - Sale of TelosOK LLC. The primary business of TelosOK LLC was to provide post-deployment and post-production software and systems development and support services including technology insertion, system redesign and software re-engineering. The largest customer of TelosOK LLC was the U.S. Army's Communications and Electronics Command ("CECOM") with significant operations at Ft. Sill in Lawton, Oklahoma. TelosOK LLC tasks were performed on a time and materials basis and on a firm fixed price basis.

Consolidated Results of Operations

The Company's operating cycle involves many types of solution, 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 condensed consolidated statements of operations include the results of Telos Corporation and its wholly owned subsidiaries. The Company substantially achieved its operating goals.

The principal element of the Company's operating expenses as a percentage of sales for the three months ended March 31, 2005 and 2004 are as follows:

	Three Months Ended March 31,	
	2005	2004
Sales	100.0%	100.0%
Cost of sales	78.5	79.6
SG&A expenses	20.1	17.5
Operating income	1.4	2.9
Other income	0.1	—
Interest expense	(6.1)	(8.2)
Loss before taxes	(4.6)	(5.3)
Income tax expense	—	—
Loss from continuing operations	(4.6)	(5.3)
Gain on sale of TCC	2.8	—
Net loss	(1.8)%	(5.3)%

[Table of Contents](#)**Financial Data by Market Segment**

Sales, gross profit, and gross margin by market segment for the periods designated below are as follows:

	Three Months Ended March 31,	
	2005	2004
Sales		
IT Solutions Group	\$13,321	\$13,543
Xacta	21,641	13,244
Total	\$34,962	\$26,787
Gross Profit		
IT Solutions Group	\$ 2,109	\$ 1,043
Xacta	5,397	4,416
Total	\$ 7,506	\$ 5,459
Gross Margin		
IT Solutions Group	15.8%	7.7%
Xacta	24.9%	33.3%
Total	21.5%	20.4%

The Company's sales for the first quarter of 2005 were \$35.0 million, an increase of \$8.2 million or 30.5% over the first quarter 2004 sales of \$26.8 million. Such increase consists of an \$8.4 million increase in sales from Xacta, offset by a \$.2 million decrease in sales from the IT Solutions Group. The increase in Xacta sales is primarily attributable to increased sales of its wireless and messaging solutions. The IT Solutions group continues to perform in accordance with the Company's plans.

The Company's cost of sales for the first quarter of 2005 was \$27.5 million, an increase of \$6.1 million compared to the same period in 2004.

The Company's gross profit for the first quarter in 2005 increased by \$2.0 million to \$7.5 million compared to the same period in 2004. Gross margin increased to 21.5% from 20.4% in the comparable period in 2004. The decline in gross margin from 33.3% to 24.9% for Xacta is due to the change in revenue mix within the segment, such as the reduction in software revenue and increased downward pressure on hardware margins. Gross margin for IT Solutions Group increased from 7.7% to 15.8%, primarily attributable to higher margin on the ARISS (Army Recruiting Information Security System) laptop resale program.

[Table of Contents](#)

The Company's selling, general, and administrative expense ("SG&A") for the first quarter of 2005 was \$7.0 million, an increase of approximately \$2.3 million or 49.7% compared to the same period in 2004, primarily due to commissions and bonus accruals in the first quarter of 2005, as well as growth in sales, marketing and special committee expenses.

The Company's operating income for the first quarter of 2005 was \$.5 million, a decrease of \$.3 million compared to \$.8 million of operating income in the same period in 2004.

The Company's interest expense decreased by 2.4% to \$2.1 million in the first quarter in 2005 compared to the same period in 2004.

The Company recorded a full valuation allowance against its deferred tax assets as of December 31, 2004 and 2003. The Company maintained its full valuation position during the quarter ended March 31, 2005.

The Company's net loss for the first quarter of 2005 was \$.6 million, a decrease of \$.8 million compared to \$1.4 million net loss in the same period in 2004.

Liquidity and Capital Resources

In addition to the Company's common stock, the Company's capital structure consists of a revolving credit facility, subordinated notes, capital lease obligations, and redeemable preferred stock.

Senior Revolving Credit Facility

On October 21, 2002, the Company entered into a \$22.5 million Senior Credit Facility Agreement with Wells Fargo Foothill, Inc. that was originally scheduled to mature on October 21, 2005. On April 15, 2005, the Company and Wells Fargo Foothill entered into a Waiver and Eighth Amendment to Loan and Security Agreement. Pursuant to the Waiver and Eighth Amendment, the revolving line limit was established at \$15 million and the interest rate at Wells Fargo "prime rate" plus 1%. The maturity date of the Facility was set to October 21, 2008. Borrowings under the Facility remain collateralized by substantially all of the Company's assets including inventory, equipment, and accounts receivable. The amount of available borrowings fluctuates based on the eligible underlying asset-borrowing base, as defined in the Facility agreement. At March 31, 2005, the Company had outstanding borrowings of \$4.6 million and unused borrowing availability of \$1.4 million on the Facility. As of March 31, 2005, the interest rate on the Facility was 7.0%.

The Facility has various covenants, which, 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 cash flow targets based on EBITDA as defined in the Facility. The Company and Wells Fargo Foothill have agreed upon modified cash flow covenants through October 21, 2008. For the three months ended March 31, 2005, the Company was in compliance with the covenants contained in the Facility.

For the three months ended March 31, 2005, cash provided by continuing operating activities was \$6.1 million. Cash provided by investing activities was approximately \$0.6 million. Cash used in financing activities was approximately \$6.6 million.

Senior Subordinated Notes

The Company's Notes totaled \$5.2 million at March 31, 2005. The maturity date of such Notes has been extended to October 31, 2008, with interest rates ranging from 14% to 17%, and paid quarterly on January 1, April 1, July 1, and October 1 of each year. In consideration for such extension, the Company agreed to pay a one-time fee of 1%. During the first three months of 2005, the Company paid \$187,000 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 \$12.7 million at March 31, 2005. See Note 3 – Debt Obligations.

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%. At March 31, 2005, the total carrying amount of redeemable preferred stock, including accumulated and unpaid dividends was \$75.1 million. The Company accrues dividends and provides for accretion related to the redeemable preferred stock. During the first three months of 2005, the Company recorded \$1.1 million of dividends on the two classes of redeemable preferred stock.

Mandatory redemption for all shares of the Senior Redeemable Preferred Stock plus all accrued dividends on those shares is scheduled, subject to limitations detailed below, on October 31, 2005. 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. Among the limitations with regard to the mandatory redemptions of the Senior Redeemable Public Preferred Stock are the legal availability of funds, pursuant to Maryland law, and the requirement of such payment to be from excess cash flows, as set forth in the Company's Articles of Amendment and Restatement. Consistent with the recapitalization or restructuring referenced in the Company's 2004 Form 10-K, Note 14 - Significant Company Filing, Item 8.01 - - Other Events, or other more favorable recapitalization or restructuring options, the Company has the intent and ability to refinance the Senior Redeemable Preferred Stock on a long-term basis, in accordance with SFAS 6, "Classification of Short-Term Obligations Expected to Be Refinanced," by utilizing excess availability on the Facility.

Mandatory 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, 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 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 sufficient liquidity to undertake any stock redemption (which is presently unquantifiable), the Company believes the likelihood is that it will not be able to meet the redemption schedule set forth in the terms of the Public Preferred Stock instrument. Consistent with the recapitalization or restructuring referenced in the Company's 2004 Form 10-K, Note 14 - Significant Company Filing, Item 8.01 - Other Events, or other more favorable recapitalization or restructuring options, the Company has the intent and ability to refinance the Public Preferred Stock on a long-term basis due on December 1, 2005, and thereafter, in accordance with SFAS 6, "Classification of Short-Term Obligations Expected to Be Refinanced," and Article Five, Section C5 of the Company's Articles of Amendment and Restatement.

[Table of Contents](#)

The Company has noted in previous filings (see Form 10-Q for the period ending September 30, 2003 – Reclassifications) that its ability to successfully restructure its debt obligations could affect the Company's future operating results and that for a variety of reasons, the Company believes it will more likely than not be unable to meet the redemption schedule set forth in the terms of the Company's Public Preferred Stock instrument.

In its continuing effort to address the Company's capital structure, and the adverse impact of SFAS 150 (Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity), which resulted in the reclassification of the redeemable preferred stock from equity to liability (see Note 4 – Redeemable Preferred Stock) on November 23, 2004, the Company's Board of Directors established a committee comprised of independent directors to consider any and all proposals and alternatives with respect to the possible restructuring of the Company. The independent committee's charter includes addressing the unsuccessful restructuring efforts of the Board of Directors and management, undertaken pursuant to the resolution of the Board of Directors detailed in Form 8-K dated March 26, 2004. In January 2005, the independent committee informed the Board of Directors that it had retained legal counsel and engaged a financial advisor and had initiated its deliberations. On May 3, 2005, in a letter from certain of the public preferred stockholders to the independent committee, such stockholders set forth their views on matters pending before the independent committee. Such letter was incorporated in a Schedule 13D/A filed by Ewing & Partners on May 5, 2005, and by Wynnefield Capital Management, LLC and Costa Brava Partnership III, L.P. on May 9, 2005.

To the best of the Company's knowledge, after diligent inquiry, none of the Company's present directors has disclosed any material financial interest with any holder of the Notes, Senior Redeemable Preferred Stock or Public Preferred Stock. Also, other than directors fees and stock options received for their service as members of the Board of Directors of the Company or fees for service as members of the Company's Proxy Board, none of the non-executive directors receive any consulting or advisory fees or other compensation from the Company or any of its subsidiaries.

Borrowing Capacity

At March 31, 2005, the Company had outstanding debt and long-term obligations of \$95.0 million, consisting of \$4.6 million under the Facility, \$5.2 million in subordinated debt, \$10.1 million in capital lease obligations and \$75.1 million in preferred stock classified as liability in accordance with FAS 150.

Based on current requirements, management considers the Company's borrowing capacity sufficient to fund its capital and liquidity needs.

Contractual Obligations and Off-Balance Sheet Arrangements

The following summarizes the Company's contractual obligations at March 31, 2005, both on and off balance sheet, and their anticipated impact upon the Company's liquidity and cash flow in future periods (in thousands):

	Payments due by Period				
	Total	2005	2006 - 2008	2009 - 2011	2012 and later
Long term debt	\$ 9,763	\$ —	\$ 9,763	\$ —	\$ —
Capital lease obligations	17,718	1,872	5,534	5,380	4,932
Operating lease obligations	2,511	496	1,341	674	—
Senior preferred stock (1)	8,280	—	8,280	—	—
Public preferred stock redemption (2)	66,831	—	40,099	26,732	—
Total	\$ 105,103	\$ 2,368	\$ 65,017	\$ 32,786	\$ 4,932

(1) includes dividends accrual

(2) includes dividends and accretion accrual, scheduled to be redeemed as stated above

[Table of Contents](#)

Recent Accounting Pronouncements

In January 2003, the FASB issued FASB Interpretation No. 46 (FIN 46), Consolidation of Variable Interest Entities, an Interpretation of Accounting Research Bulletin No. 51. FIN 46 requires certain variable interest entities to be consolidated by the primary beneficiary of the entity, if equity investors in an entity do not have the characteristics of a controlling financial interest or do not have sufficient equity at risk for the entity to finance its activities without additional subordinated financial support from other parties. In December 2003, the FASB completed deliberations of proposed modifications to FIN 46 resulting in multiple effective dates in 2003 and 2004 based on the nature as well as the creation date of the variable interest entity. The revised FIN 46 will be effective for non-SPE variable interest entities created prior to February 1, 2003 no later than the first quarter of 2004. For variable interest entities created or acquired after January 31, 2003, the provisions of FIN 46 must be applied. The adoption of FIN 46 did not materially affect the results of operations or financial position of the Company. For further discussion, see Note 2 - Investment in Enterworks.

In December 2004, the FASB issued Statement of Financial Accounting Standards No. 123(R), "Share Based Payment" ("SFAS No. 123(R)"), a revision of SFAS No. 123, "Accounting for Stock-Based Compensation." SFAS No. 123(R) supersedes APB Opinion No. 25, "Accounting for Stock Issued to Employees." SFAS No. 123(R) requires all share-based payments to employees, including grants of employee stock options, to be recognized in the income statement based on their fair values. SFAS No. 123(R) must be adopted by the Company by the third quarter of 2005. In April 2005, the effective date was amended for calendar year companies until the beginning of 2006. The Company currently accounts for share-based compensation using APB No. 25's intrinsic value method and, accordingly, recognizes no compensation cost for employee stock options. The Company is in the process of determining which transitional method it will elect upon the adoption of SFAS No. 123(R).

Forward-Looking Statements

This Annual 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 below under the caption "Certain Factors That May Affect Future Results."

Certain Factors That May Affect Future Results

The following important factors could cause actual results to differ materially from those indicated by forward-looking statements made in this Quarterly Report on Form 10-Q and presented elsewhere by management from time to time.

A number of uncertainties exist that could adversely affect the Company's future operating results, including, without limitation, general economic conditions that may include the cost and continued availability of the Company to secure adequate capital and financing to support its business; the ability to attract and retain personnel; the impact of adverse economic conditions on the Company's customers and suppliers; the ability to sell assets or to obtain alternative sources of commercially reasonable refinancing for the Company's debt; or the ability to successfully restructure the Company without costly and/or extended litigation related to such restructuring. Additional uncertainties include the Company's ability to convert contract backlog to revenue, the success of the Company's investment in Enterworks and Xacta and the Company's access to ongoing development, product support and viable channel partner relationships with its partners and suppliers.

While in the past the Company has not experienced contract terminations with the U.S. Government, the U.S. Government can terminate at its convenience. Should such a termination occur the Company's operating results could be adversely impacted.

Due to heightened security awareness and the ongoing military and peacekeeping actions in Iraq and Afghanistan, all U.S. Government programs, especially those pertaining to national security, have been subject to extensive review and reprioritization as evidenced by the Homeland Defense Act, and the continued funding requirements of the U.S. activities in Iraq and Afghanistan. While the Company believes its products and services are well positioned to benefit from such reprioritization of U.S. Government demands, the magnitude of recent and prospective events pertaining to national security serves to emphasize how the Company's high percentage of revenue derived from business with the U.S. Government could alternatively be dramatically, swiftly and adversely impacted.

In addition, as a high percentage of the Company's revenue is derived from business with the U.S. Government, the Company's operating results could also be adversely impacted should the U.S. Government's annual budget not be approved in a timely fashion.

The Company has many patents and patents pending, trademarks and copyrights and other valuable proprietary information and has taken reasonable and prudent steps to protect its intellectual property. With regard to the Company's wholly-owned subsidiary, Xacta, whose software products require constant monitoring as it develops future releases and creates additional intellectual property, vigilant oversight of such intellectual property rights is imperative. All of the Company's propriety solutions require constant oversight with regard to the development and protection of their respective intellectual property. Accordingly, any event that brings into question the Company's ownership of its intellectual property and propriety solutions could materially and adversely impact the Company.

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 Senior Credit Facility. Interest on the Facility is charged at 1.25% over the Wells Fargo “prime rate” (as of March 31, 2005 the Wells Fargo “prime rate” was 5.75%), or 5.75%, whichever is higher. Effective April 2005, the interest rate is the Wells Fargo “prime rate” plus 1%. The effective average interest rates, including all bank fees, for the first three months of 2005 and 2004 were 9.4% and 10.9%, respectively. The Facility had an outstanding balance of \$4.6 million at March 31, 2005.

Item 4. Controls and Procedures

The Company’s chief executive officer and chief financial officer have evaluated the Company’s disclosure controls and procedures (as defined in Rule 13a-15(e)) and Rule 15d-15(e) under the Exchange Act), as of March 31, 2005, and concluded that those disclosure controls and procedures are effective in timely alerting them to any material changes in information required to be included in the Company’s periodic Securities and Exchange Commission filings.

Since such evaluation, such officers are unaware of any material subsequent changes in the Company’s internal controls or in other factors that could affect internal controls, including any corrective actions with regard to significant deficiencies and material weaknesses.

The Company intends to continue its diligent review and evaluation of the design and effectiveness of the controls, with the intention of continuous improvements to such controls, and to correct in a timely manner any significant deficiencies and material weaknesses that may be discovered. The Company’s goal is to provide senior management with detailed information and timely access to all material information concerning the business. While the Company believes the present design of its disclosure controls and procedures effectively achieves its objectives, additional regulatory requirements, such as Sarbanes-Oxley Section 404 - Management Assessment of Internal Controls, scheduled for implementation by the Company by December 2006, and future unforeseen events may cause the Company to significantly modify such disclosure controls and procedures.

PART II—OTHER INFORMATION

Item 1. Legal Proceedings

The Company is a party to various lawsuits arising in the ordinary course of business. Based upon all available information and to the best of management's knowledge, the final outcome of any such matters will not have a material adverse effect on the Company's consolidated financial position, results of operations, or cash flows.

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 March 31, 2005, total undeclared unpaid dividends accrued for financial reporting purposes are \$5.3 million for the Series A-1 and A-2 Preferred Stock.

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). Dividends are payable by the Company, provided that the Company has legally available funds under Maryland law and is able to pay dividends under its charter and other corporate 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 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 dividend 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. For the cash dividends payable since December 1, 1995, the Company has accrued \$38.7 million as of March 31, 2005.

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, 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 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 sufficient liquidity to undertake any stock redemption (which is presently unquantifiable), the Company believes that the likelihood is that it will not be able to meet the redemption schedule set forth in the terms of the Public Preferred Stock. Consistent with the recapitalization or restructuring referenced in the Company's 2004 Form 10-K, Note 14 - Significant Company Filing, Item 8.01 - Other Events, or other more favorable recapitalization or restructuring options, the Company has the intent and ability to refinance the Public Preferred Stock on a long-term basis due on December 1, 2005, and thereafter, in accordance with SFAS 6, "Classification of Short-Term Obligations Expected to Be Refinanced," and Article Five, Section C5 of the Company's Articles of Amendment and Restatement.

Item 6. Exhibits

- (1) Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002;
- (2) Certification of Chief Financial Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002;
- (3) Certification Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

Part II items 2, 4 and 5 are not applicable and have been omitted.

SIGNATURE

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: May 16, 2005

TELOS CORPORATION

/s/ John B. Wood

John B. Wood
Chief Executive Officer

CERTIFICATIONS

I, John B. Wood, Chief Executive Officer of Telos Corporation, 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)) 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) 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

c) 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 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 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: May 16, 2005

/s/ John B. Wood

Chief Executive Officer

CERTIFICATIONS

I, Michele Nakazawa, Chief Financial Officer of Telos Corporation, 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)) 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) 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

c) 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 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 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: May 16, 2005

/s/ 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 March 31, 2005 as filed with the Securities and Exchange Commission on the date hereof (the "report"), we, John B. Wood and Michele Nakazawa, Chief Executive Officer and Chief Financial Officer, respectively, of the Company, 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.

May 16, 2005

/s/ John B. Wood

John B. Wood
Chief Executive Officer

/s/ Michele Nakazawa

Michele Nakazawa
Chief Financial Officer