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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, 2007

☐ **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)**	**52-0880974** **(I.R.S. Employer Identification No.)**
19886 Ashburn Road, Ashburn, Virginia **(Address of principal executive offices)**	**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)

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, or a non-accelerated filer. See definition of "accelerated filer and large accelerated filer" in Rule 12b-2 of the Exchange Act. (Check one):

Large Accelerated Filer ☐ Accelerated Filer ☐ Non-Accelerated Filer ☒

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 May 7, 2007, 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

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PART I—FINANCIAL INFORMATION

Item 1. Financial Statements

TELOS CORPORATION AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(Unaudited)
(amounts in thousands)

	Three Months Ended March 31, 2007	Three Months Ended March 31, 2006
Revenue		
Products	$19,559	$10,335
Services	20,656	14,839
	40,215	25,174
Costs and expenses		
Cost of sales - Products	13,900	9,302
Cost of sales - Services	13,447	11,377
Selling, general and administrative expenses	9,092	10,413
Operating income (loss)	3,776	(5,918)
Other income (expenses)		
Other income	2	11
Losses from affiliates	—	(92)
Interest expense	(2,066)	(2,120)
Income (loss) before taxes	1,712	(8,119)
Provision for income taxes	—	—
Net income (loss)	$ 1,712	$ (8,119)

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

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TELOS CORPORATION AND SUBSIDIARIES

CONDENSED CONSOLIDATED BALANCE SHEETS

(amounts in thousands)

	March 31, 2007 (Unaudited)	December 31, 2006
ASSETS		
Current assets		
Cash and cash equivalents	$ 15	$ 235
Accounts receivable, net of reserve of $420 and $407, respectively	26,441	25,710
Inventories, net of obsolescence reserve of $203 and $212, respectively	4,915	7,078
Other current assets	3,650	6,635
Total current assets	35,021	39,658
Property and equipment, net of accumulated depreciation of $15,541 and $15,162, respectively	8,268	8,534
Other assets	207	268
Total assets	$ 43,496	$ 48,460

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

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TELOS CORPORATION AND SUBSIDIARIES

CONDENSED CONSOLIDATED BALANCE SHEETS

(amounts in thousands)

	March 31, 2007 (Unaudited)	December 31, 2006
LIABILITIES, REDEEMABLE PREFERRED STOCK AND STOCKHOLDERS' DEFICIT		
Current liabilities		
Accounts payable	$ 27,243	$ 34,597
Accrued compensation and benefits	5,729	4,798
Deferred revenue	6,085	8,144
Capital lease obligations – short-term	596	594
Other current liabilities	5,067	3,630
Total current liabilities	44,720	51,763
Senior credit facility	11,743	12,568
Senior subordinated notes	5,179	5,179
Capital lease obligations	8,585	8,722
Senior redeemable preferred stock (Note 4)	9,128	9,023
Public preferred stock (Note 4)	89,211	87,987
Total	168,566	175,242
Stockholders' deficit		
Common stock	78	78
Additional paid-in capital	103	103
Accumulated deficit	(125,251)	(126,963)
Total stockholders' deficit	(125,070)	(126,782)
Total liabilities and stockholders' deficit	$ 43,496	$ 48,460

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, 2007	Three Months Ended March 31, 2006
Operating activities:		
Income (loss) from operations	$ 1,712	$ (8,119)
Adjustments to reconcile loss from continuing operations to cash provided by operating activities:		
Dividends and accretion of preferred stock as interest expense	1,328	1,404
Stock-based compensation		103
Depreciation and amortization	535	428
Other noncash items	13	121
Changes in other operating assets and liabilities	(4,550)	9,098
Cash (used in) provided by operating activities	(962)	3,035
Investing activities:		
Purchase of property and equipment	(114)	(374)
Cash used in investing activities	(114)	(374)
Financing activities:		
Repayment of borrowings under senior credit facility, net	(825)	(4,785)
Increase in book overdrafts	1,815	2,178
Payments under capital leases	(134)	(52)
Cash provided by (used in) financing activities	856	(2,659)
(Decrease) increase in cash and cash equivalents	(220)	2
Cash and cash equivalents at beginning of period	235	62
Cash and cash equivalents at end of period	$ 15	$ 64
Supplemental disclosures of cash flow information:		
Cash paid during the period for:		
Interest	$ 762	$ 739

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

The accompanying consolidated financial statements include the accounts of Telos Corporation and its subsidiaries, including Ubiquity.com, Inc., a wholly owned subsidiary, and 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 applied the equity method of accounting for its investment in Enterworks, Inc. (“Enterworks”). The Company also has an investment in Teloworks, Inc. (“Teloworks,” formerly Enterworks International, Inc.), and has consolidated its results of operations. See Note 2 – Investment in Enterworks. Significant intercompany transactions have been eliminated.

In the opinion of the Company, the accompanying 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. 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 2006 Annual Report on Form 10-K filed with the Securities and Exchange Commission (“SEC”). 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, 2006.

The accompanying financial statements have been prepared assuming that the Company will continue as a going concern. Additionally, as more fully described in Note 6 – 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 6. These financial statements do not include any adjustments that might result from the outcome of this uncertainty.

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 February 2007, the Financial Accounting Standards Board ("FASB") issued Statement of Financial Accounting Standards ("SFAS") No. 159, "The Fair Value Option for Financial Assets and Financial Liabilities." SFAS No. 159 allows an entity the irrevocable option to elect fair value for the initial and subsequent measurement for certain financial assets and liabilities on a contract-by-contract basis. Subsequent changes in fair value of these financial assets and liabilities would be recognized in earnings when they occur. SFAS No. 159 is effective for the Company's financial statements for the year beginning January 1, 2008, with earlier adoption permitted. The Company is currently evaluating the effect and timing that adoption of this statement will have on its consolidated financial position and results of operations.

In September 2006, the FASB issued SFAS No. 157 – "Fair Value Measurements," which defines fair value, establishes a framework for consistently measuring fair value under GAAP, and expands disclosures about fair value measurements. SFAS No. 157 defines fair value as the exchange price that would be received for an asset or paid to transfer a liability (an exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date. SFAS No. 157 is effective for the Company beginning January 1, 2008, and the provisions of SFAS No. 157 will be applied prospectively as of that date. The Company is currently evaluating the effect that adoption of this statement will have on its consolidated financial position or results of operations.

In September 2006, the SEC released Staff Accounting Bulletin ("SAB") No. 108, which provides guidance in the quantification and correction of financial statement misstatements. SAB No. 108 specifies that companies should apply a combination of the "rollover" and "iron curtain" methodologies when making determinations of materiality. The rollover method quantifies a misstatement based on the amount of the error originating in the current year income statement. The iron curtain approach quantifies misstatements based on the effects of correcting the misstatement existing in the balance sheet at the end of the current year, regardless of the year(s) of origination. SAB No. 108 instructs companies to quantify the misstatement under both methodologies and, if either method results in the determination of a material error, the Company must adjust its financial statements to correct the error. SAB No. 108 also reminds preparers that a change from an accounting principle that is not generally accepted to a principle that is generally accepted is a correction of an error. The Bulletin is effective for annual financial statements covering the first fiscal year ending after November 15, 2006. The adoption of this Bulletin did not have a material effect on the Company's results of operations or financial condition.

In July 2006, the FASB issued FASB Interpretation No. ("FIN") 48, "Accounting for Uncertainty in Income Taxes – an interpretation of FASB Statement 109." FIN 48 prescribes a comprehensive model for recognizing, measuring, presenting and disclosing in the financial statements tax positions taken or expected to be taken on a tax return, including a decision whether to file or not to file in a particular jurisdiction. FIN 48 is effective for fiscal years beginning after December 15, 2006. If there are changes in net assets as a result of application of FIN 48, these will be accounted for as an adjustment to retained earnings. The adoption of this FIN did not have a material effect on the Company's financial position or results of operations.

In February 2006, The FASB issued SFAS No. 155, "Accounting for Certain Hybrid Financial Instruments—an amendment of FASB Statements No. 133 and 140." This statement amends SFASs No. 133 and 140 by permitting fair value remeasurement for any hybrid financial instrument with an embedded derivative that otherwise would require bifurcation; clarifying which interest-only strips and principal-only strips are not subject to the requirements of SFAS No. 133; establishing a requirement to evaluate interests in securitized financial assets to identify interests that are freestanding derivatives or that are hybrid financial instruments that contain an embedded derivative requiring bifurcation; clarifying that concentrations of credit risk in the form of subordination are not embedded derivatives; and amending SFAS No. 140 to eliminate the prohibition on a qualifying special-purpose entity from holding a derivative financial instrument that pertains to a beneficial interest other than another derivative financial instrument. The statement is effective for fiscal years beginning after September 15, 2006. The adoption of this standard did not have a material impact on the Company's financial position and results of operations.

In June 2005, the FASB issued SFAS No. 154, "Accounting Changes and Error Corrections," which replaces Accounting Principles Board ("APB") Opinion No. 20, "Accounting Changes" and SFAS No. 3, "Reporting Accounting Changes in Interim Financial Statements." SFAS No. 154 requires that a voluntary change in accounting principle be applied retrospectively with all prior period financial statements presented on the new accounting principle. SFAS No. 154 also requires that a change in method of depreciating or amortizing a long-lived non-financial asset be accounted for prospectively as a change in estimate, and correction of errors in previously issued financial statements should be termed a "restatement." SFAS No. 154 is effective for accounting changes and correction of errors made in fiscal years beginning after December 15, 2005. The adoption of SFAS No. 154 did not have a material effect on the Company's results of operations or financial condition.

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Revenue Recognition

Revenues are recognized in accordance with SAB No. 101, “Revenue Recognition in Financial Statements” as amended by 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 collectibility is reasonably assured. Additionally, revenues on arrangements requiring the delivery of more than one product or service are recognized in accordance with Emerging Issues Task Force (“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,” and SOP 98-9, “Modification of SOP 97-2, Software Revenue Recognition With Respect to Certain Transactions,” 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 AICPA’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.

Stock-Based Compensation

In December 2004, the FASB issued SFAS No. 123(R), "Share Based Payment," a revision of SFAS No. 123, "Accounting for Stock-Based Compensation." SFAS No. 123(R) supersedes APB Opinion ("APB") 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, be recognized in the income statement based on their fair values.

Prior to January 1, 2006, the Company accounted for stock-based compensation using the intrinsic value based method in accordance with APB No. 25. Under APB No. 25, the Company recognized no compensation cost for employee stock options, as the options granted had an exercise price equal to the fair value of the underlying common stock on the date of grant. The Company applied the disclosure 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 provided pro forma disclosures as if the fair value measurement provisions of SFAS No. 123 had been used in determining compensation expense. The Company used the Black-Scholes option-pricing model to determine the pro forma impact under SFAS Nos. 123 and 148 on the Company's net income. The model utilizes certain information, such as the interest rate on a risk-free security maturing generally at the same time as the option being valued and requires certain other assumptions, such as the expected amount of time an option will be outstanding until it is exercised or expired, to calculate the fair value of stock options granted. Disclosures for the three months ended March 31, 2007 and 2006 are not presented, because stock-based compensation was accounted for under SFAS No. 123(R)'s fair value method during these periods.

Effective January 1, 2006, the Company adopted the fair value recognition provisions of SFAS No. 123(R), using the modified prospective transition method. Under this transition method, stock-based compensation costs recognized in the income statement as of March 31, 2006 in the amount of $103,000, include compensation costs for all unvested stock options that were granted prior to December 31, 2005, based on the grant date fair value estimated in accordance with the original provisions of SFAS No. 123. There were no share-based payments granted on or after December 31, 2005. Results for prior periods have not been restated.

Note 2. Investment in Enterworks

Enterworks, Inc.

As of March 31, 2007, 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, and 8,571,429 shares of Series D Preferred Stock of Enterworks, Inc. ("Enterworks"), representing a fully diluted ownership percentage of 10.8%. 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 continues to do so due to the Company's continued significant influence through its representation on the Board of Directors of Enterworks.

On March 16, 2007, Enterworks completed a private financing through the issuance of 42,857,143 shares of Series D Preferred Stock to various investors, including Telos. For consideration of the equivalent of $600,000, consisting of $396,000 balance due to the Company from Enterworks, $100,000 of which had been previously evaluated for impairment and reduced to zero in 2006, and a transfer of 20% ownership interest in Teloworks (which had been forfeited by Enterworks in 2006) from the Company to Enterworks, which amounted to approximately $204,000 (which was expensed in 2006), the Company acquired 8,571,429 shares of Enterworks Series D Preferred Stock. In 2007, the Company reduced the $296,000 carrying value of the investment to zero in accordance with APB Opinion No. 18 based on impairment due to the inability of the investee to sustain an earnings capacity which would justify the carrying amount of the investment. As a result of this financing, the Company's fully diluted ownership percentage increased from 4.7%, as of December 31, 2006, to 10.8% as of March 16, 2007.

Effective as of January 1, 2007, the Company and Enterworks amended their Agreement for Services and Sublease ("Agreement"). 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 the amount of $180,000 for a period of one year, payable in 12 equal installments of $15,000 per month. Enterworks did not make payments under a similar agreement and arrearage plan that was in effect for 2006, resulting in a balance due to the Company of $100,000 as of March 15, 2007.

Additionally, the Company assumed $296,000 of funding obligations to Teloworks on Enterworks' behalf, resulting in a total receivable balance due from Enterworks to the Company of $396,000, which was settled as consideration in connection with the Enterworks March 16, 2007 private financing.

Effective January 1, 2007, Enterworks agreed to provide the Company with maintenance and OEM technical product support associated with the worldwide, non-exclusive, perpetual, irrevocable, royalty-free, fully paid-up license for the EPX software purchased in December 2003. In accordance with SFAS 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), and has reflected this asset on the balance sheet in "Other Assets." The net carrying value of the asset is $187,500 as of March 31, 2007. Scheduled amortization expense is $187,500 for the remainder of 2007.

Teloworks, Inc. (formerly Enterworks International, Inc.)

Pursuant to the Teloworks Agreements, the Company and Enterworks are required to fund the operations of Teloworks according to a funding schedule set forth in the Teloworks Agreements. The Company has expensed its proportionate share of the Teloworks operating expenses, which amount to approximately $177,000 for the first quarter of 2007, and $707,000 for 2006 (which had previously been disclosed as $463,000). Additionally, the Company assumed $296,000 of funding obligations to Teloworks on Enterworks' behalf, resulting in a total receivable balance due from Enterworks to the Company of $396,000, such receivable, as stated above, was settled as consideration in connection with the Enterworks March 16, 2007 private financing.

As a result of an Enterworks private financing transaction on March 16, 2007, discussed in the "Enterworks, Inc." disclosure above, the Company currently owns 60% of Teloworks.

Note 3. Debt Obligations

Senior Revolving Credit Facility

The Company has a $15 million revolving credit facility with Wells Fargo Foothill (the "Facility") that is scheduled to mature on October 21, 2008. Under the terms of the Facility, the interest rate is the Wells Fargo "prime rate" plus 1%. Pursuant to the terms of the Facility, 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, plus 4%. As of March 31, 2007, the Company has not elected the LIBOR rate option. As of March 31, 2007, the interest rate on the Facility was 9.25%.

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.

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 Earnings Before Interest, Taxes, Depreciation and Amortization (EBITDA), as defined in the Facility. The Company and Wells Fargo Foothill have amended the EBITDA covenants at various times to reflect revised projections. The Company has complied with its newly established covenants through March 31, 2007. Based on the Company's current projection of EBITDA, the Company expects that it will remain in compliance with its EBITDA covenants. Therefore, the Facility is classified as noncurrent as of March 31, 2007.

Effective January 1, 2007, the Company and Wells Fargo Foothill have amended the Facility to provide for availability block relief through April 30, 2007, to establish EBITDA covenants for 2007, to give consent to the formation of an LLC and subsequent sale of a portion of the membership interests in such LLC (disclosed in Note 6- Contingencies and Subsequent Events), and to provide various waivers in accordance with the Facility. The fees associated with such amendments amounted to $160,000.

At March 31, 2007, the Company had outstanding borrowings of $11.7 million and unused borrowing availability of $2.0 million on the Facility. As of May 8, 2007, the Company has availability under its current arrangement of approximately $1.8 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 10.9% and 9.9% for the three months ended March 31, 2007 and 2006, 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, 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 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. The Notes can be prepaid at the Company's option; however, 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, 2007, if such a qualifying triggering event had occurred, the cumulative premium payment would have been approximately $18.1 million.

The balances of the Series B and C Notes were $2.5 million and $2.7 million, respectively, each at March 31, 2007 and 2006.

The carrying value of the Notes as of March 31, 2007 and 2006 is consistent with the fair value as determined by an independent valuation performed by Navigant Consulting, Inc.

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

	Year	Obligation Due
Senior Subordinated Debt	2008	$ 5,179[1]
Senior Credit Facility	2008	$ 11,743[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 extended the maturity date of the Notes to October 31, 2008.

2 Balance due represents balance as of March 31, 2007, however, the Senior Credit Facility is a revolving credit facility with fluctuating balances based on 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. 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. Subject to limitations set forth below, the Company was scheduled to redeem 27.4% of the outstanding shares and accrued dividends outstanding on October 31, 2005. 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. Maryland law also prohibits distributions (including redemptions and dividends) if, after the distribution is made, liabilities exceed assets. 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 March 31, 2007, the remaining 27.4% 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 March 31, 2007 and 2006, cumulative undeclared, unpaid dividends relating to Senior Redeemable Preferred stock totaled $6.1 million and $5.7 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. 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 months ended March 31, 2007 and 2006 was $268,000 and $344,000, 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, 2007 was 3,185,586. The stock trades over the NASDAQ/OTCBB Exchange. The aggregate fair value of the public preferred stock at March 31, 2007 was $58.9 million.

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 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 (as discussed above), the Company did not make the first two scheduled redemption payments, and assuming insufficient liquidity to undertake any stock redemption (which is presently unquantifiable), the Company believes that the likelihood is that it will not be able to make the remaining three 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 balance sheet as of March 31, 2007 and 2006.

The Company and certain of its subsidiaries are parties to the Facility agreement with Wells Fargo Foothill, whose term expires on October 21, 2008. 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 October 21, 2008.

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 Wells Fargo Foothill Facility prohibits, among other things, the redemption of any stock, common or preferred, until October 21, 2008. 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 March 31, 2007. 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 capable and permitted to do so.

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. 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. Maryland law also prohibits distributions (including redemptions and dividends) if, after the distribution is made, liabilities exceed assets. For the cash dividends payable since December 1, 1995, the Company has accrued $58.6 million and $41.1 million as of March 31, 2007 and 2006, 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, for the three months ended March 31, 2007 and 2006, dividends totaling $1.1 million 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 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 full 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 the payment of these 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 dividends 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 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 of Directors 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 difference between those two amounts, $9.9 million, by recording an additional $9.9 million charge to interest expense for the second quarter of 2006, resulting in a balance of $89.2 million for the principal amount and all accrued dividends on the Public Preferred Stock as of March 31, 2007. This action is 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 5. Reportable Segments

As of March 31, 2007, the Company's operations are comprised of two operating segments, Managed Solutions and Xacta. Descriptions for each of these operating segments are as follows:

Managed Solutions: Develops, markets and sells integration services that address a wide range of government information technology (IT) requirements. Offerings consist of innovative IT solutions that consist of industry leading IT products from OEMs with complimentary integration and managed support services provided by Telos. Managed Solutions 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, Identity Management solutions, Information Security Consulting services and IT Security Management software solutions.

The accounting policies of the reportable segments are the same as those referred to in Note 1 – General and Basis of Presentation. 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.

Summarized financial information concerning the Company's reportable segments for the three months ended March 31, 2007 and 2006 is set forth in the following table (in thousands). The "other" column includes corporate related items.

	Three Months Ended			
	Managed Solutions	Xacta	Other(1)	Total
March 31, 2007				
External revenues	$12,025	$28,190	$ —	$40,215
Gross margin	(343)	13,211	—	12,868
Segment (loss) profit (2)	(2,420)	6,196	—	3,776
Total assets	11,509	23,145	8,842	43,496
Capital expenditures	29	38	47	114
Depreciation and amortization (3)	68	160	307	535

	Managed Solutions	Xacta	Other(1)	Total
March 31, 2006				
External revenues	$ 9,428	$15,746	$ —	$25,174
Gross margin	245	4,250	—	4,495
Segment (loss) profit (2)	(1,922)	(3,996)	—	(5,918)
Total assets	8,885	16,733	9,937	35,555
Capital expenditures	—	109	265	374
Depreciation and amortization (3)	3	133	292	428

(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 maintains a facility in Germany; however, the Company does not have material international revenues, profit (loss), assets or capital expenditures. The Company's business is not concentrated in a specific geographical area within the United States, as it has 5 separate facilities located in various states and the District of Columbia.

Note 6. Contingencies and Subsequent Events

Telos Identity Management Solutions, LLC

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 all of the assets of its Identity Management business and assigned its rights to perform under its government contract with the Defense Manpower Data Center ("DMDC") to TIMS LLC. The net book value of assets contributed by the Company totaled $17,000. 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. Mr. Wood's brother holds a 2% interest in TIMS LLC. The Company will utilize all such funds to address ongoing working capital requirements.

The Company had previously attempted to sell 100% of its Identity Management business, but its efforts to find a strategic buyer caused it to conclude that it could not obtain adequate value from a sale of the entire unit. The Company has obtained a fairness opinion from a nationally recognized investment banking firm that the consideration received in the transaction from the financial investor is fair, from a financial point of view, to the Company.

The parties have signed an operating agreement which provides for a Board of Directors comprised of five (5) members. The operating agreement also provides for two subclasses of membership units, Classes A (the Company) and B (the Investors). Class A membership unit owns 60% of TIMS LLC, and as such is entitled to 60% of the profits, and is entitled to appoint three (3) members of the Board of Directors. Class B membership unit owns 40% of TIMS LLC, and as such is entitled to 40% of the profits, and is entitled to appoint two (2) members of the Board of Directors.

As indicated in the operating agreement, one of the Class A members will be designated the Chairman of the Board. John B. Wood, Chairman and CEO of the Company will be designated as the Chairman of the Board of TIMS LLC. The Company has entered into a corporate services agreement with TIMS LLC whereby the Company will provide certain administrative support services to TIMS LLC, including but not limited to finance, accounting and human resources.

Financial Condition and Going Concern Considerations

The consolidated financial statements for the quarter ended March 31, 2007 that are included in this Form 10-Q have been prepared on a going concern basis, which contemplates the realization of assets and the satisfaction of liabilities in the normal course of business. However, primarily due to total expenses directly related to unreimbursed litigation-related and other legal expenses, the Company's working capital deficit was $9.5 million as of March 31, 2007. Total expenses related to litigation and other legal costs were $3.0 million for the first quarter of 2007, $5.7 million (net of $3.1 million in reimbursements by the Company's insurers) for 2006, and $4.1 million for 2005. Such unreimbursed litigation-related and other legal expenses continue to adversely affect working capital, and $8.9 million of such expenses are unpaid as of March 31, 2007. The Company is actively working with its vendors, including law firms, partners and subcontractors to mitigate the effect of these working capital constraints during this period. As the Company continues to evaluate its performance with the goals of achieving greater consistency in its financial results, increasing cash flow and achieving higher profitability, it has undertaken a company-wide reorganization and cost reduction plan, which was initially presented to the Transaction Committee of the Board in July 2006, and which the Company has begun to execute and continues to implement.

There can be no assurances as to the continuing ability of the Company to successfully work with vendors, partners and subcontractors or Wells Fargo Foothill to mitigate these current working capital constraints. See Note 3 – Debt Obligations. Although no assurances can be given, the Company expects that it will be in compliance throughout the term of the amended credit facility with respect to the financial and other covenants.

Also, the Company derives substantially all of its revenue from U.S. Government contracting, and as such it is annually subject to the seasonality of the U.S. Government purchasing. As the U.S. Government fiscal year ends on September 30, it is not uncommon for U.S. Government agencies to award extra tasks in the weeks immediately prior to the end of its fiscal year in order to avoid the loss of unexpended fiscal year funds. As a result of this cyclicality, the Company has historically experienced higher revenues in its third and fourth fiscal quarters, ending September 30, and December 31, respectively, with the pace of orders substantially reduced during the January to June time period.

The Company believes that available cash and borrowings under the 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 2007.

Notice of Delisting

On April 18, 2007 the Company was notified by the National Association of Securities Dealers ("NASD") that its securities will be removed from quotation on the Over-the Counter Bulletin Board ("OTCBB") because the Company filed three periodic reports late in the past twenty-four months, in violation of the OTCBB eligibility rules. On April 23, 2007 the Company appealed this decision to the NASD Hearings Panel. On May 7, 2007 the Company applied for a waiver of late filing from the SEC's Division of Corporation Finance. As of the filing date of this Form 10-Q, no determination has been made with regard to either matter.

Legal Proceedings

Costa Brava Partnership III, L.P.

As previously reported, Costa Brava Partnership III, L.P. ("Costa Brava"), a holder of the Company's 12% Cumulative Exchangeable Redeemable Preferred Stock ("Public Preferred Stock"), filed a lawsuit on October 17, 2005 in the Circuit Court of Baltimore City in the State of Maryland ("Complaint") against the Company, its directors, and certain of its officers. According to Amendment No. 6 to Schedule 13D filed by Costa Brava on October 18, 2005, Costa Brava owns 15.9% of the outstanding Public Preferred Stock.

The Complaint alleges that the Company and its officers and directors have engaged in tactics to avoid paying mandatory dividends on the Public Preferred Stock, and asserts that the Public Preferred Stock has characteristics of debt instruments even though issued by the Company in the form of stock. Costa Brava alleges, among other things, that the Company and an independent committee of the Board of Directors have done nothing to improve what they claim to be the Company's insolvency, or its ability to redeem the Public Preferred Stock and pay accrued dividends. They also challenge 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") comprised of independent directors to review and evaluate the matters raised in the derivative suit filed against the Company by Costa Brava relating to the Company's Public Preferred Stock.

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, Judge Albert J. Matricciani granted the motions in part and denied them in part, but also 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 Judge Matricciani, designating Wynnefield Partners as the plaintiff with Costa Brava in the lawsuit. Costa Brava and Wynnefield are hereinafter referred to as "Plaintiffs."

On April 28, 2006, the Company filed its answer to the Complaint.

On May 26, 2006, Plaintiffs filed a motion for a preliminary injunction to prevent the sale or disposal of Xacta Corporation 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. However, the Plaintiffs objected to the wording of the order, insisting that the Company give Plaintiffs at least 30-day prior notice of any pending transaction. Nevertheless, on January 29, 2007, the Court reissued the order, dismissing the Plaintiff's motion without the notice requirement.

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. However, as previously reported on August 22, 2006, within a week of the resignations, three new independent board members were added. Then the announcement of two additional independent board members was made on October 31, 2006, bringing the total board membership to eight. Thus, the board and all board committees, including the Special Litigation Committee and the Transaction Committee have been fully reconstituted.

The hearing on the motion for receivership was held on October 18, 2006 in Baltimore, Maryland. As previously reported, the Plaintiffs' motion for receivership was denied on November 29, 2006.

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 until such time that two new Class D directors have been elected. This followed the Plaintiff's February 7, 2007 letter to the corporate secretary requesting a special meeting to elect new Class D directors to replace the two board seats left vacant by the resignations in August 2006. As previously reported, the special meeting is scheduled for May 31, 2007. The hearing on the motion was held on April 16, 2007. On April 19, 2007, Judge Matricciani issued an opinion denying the Plaintiffs' motion.

On February 27, 2007, the Plaintiffs filed a second amended complaint and added Mr. John R. C. Porter, the Company's majority shareholder, as a defendant. The Company filed its motion to strike/dismiss and motion for summary judgment on March 28, 2007. The motion states that the court should strike or dismiss as a matter of law or on summary judgment certain claims. The hearing on the motion originally scheduled for April 25, 2007 took place on May 8, 2007 before Judge Matricciani. The court's ruling concerning this motion is expected by the end of May 2007.

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 vigorously defend the matter, and will 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.

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

General

As of March 31, 2007, the Company's operations are comprised of two operating segments, Managed Solutions and Xacta.

Managed Solutions: Develops, markets and sells integration services which address a wide range of government information technology ("IT") requirements. Offerings consist of innovative IT solutions consisting of industry leading IT products from original equipment manufacturers ("OEMs") with complementary integration and managed support services provided by Telos. Managed Solutions also provides general IT consulting and integration services in support of various U.S. Government customers. Telos has global experience with integration engagements to anticipate and address the requirements of defense and federal agencies of any scope. Technical capabilities include a 67,000-square-foot assembly and integration area and warehouse facilities, as well as the Telos Customer Support Center ("TCSC"), which provides 24/7/365 help desk and field support.

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 Network solutions, Enterprise Messaging solutions, Identity Management solutions (formerly known as Enterprise Credentialing solutions), Information Security Consulting services and IT Security Management software solutions.

- Secure Network solutions – Xacta's Secure Network solutions business line ("Secure Network") offers wireless local area network ("WLAN") solutions that enable DoD users to extend their enterprise network beyond offices and other wired facilities. With WLAN technology, users in remote or hard-to-wire locations, including flightlines, on-board ships, in warehouses, or forwardly deployed locations can access databases, information, and applications just as if they were connected to the wired enterprise LAN. Xacta uses extensive proprietary knowledge and experience coupled with commercial-off-the-shelf ("COTS") products to deliver a solution that significantly reduces user costs and enhances efficiency.
- Secure Messaging – Xacta's Secure Messaging business line ("Secure Messaging") designs, sells, deploys and supports a web-based system for secure automated distribution and management of organizational electronic messages across a user's enterprise through its own Automated Message Handling System ("AMHS"). In addition, the Secure Messaging business line provides support services to the U.S. Government's Defense Message System ("DMS"). The goal of DMS and AMHS is to make messaging information available as quickly as possible to those who need it, whether in the office or on the battlefield. AMHS operates at all security levels for Department of Defense ("DoD"), civilian and intelligence community messaging requirements.
- Information Assurance – Xacta's Information Assurance business line ("IA") designs, sells, deploys and manages solutions that protect and support the security of enterprise IT resources throughout the U.S. Government and certain financial federally insured depositary institution businesses. The IA business line offers software and service solutions for compliance assessment, continuous risk and sustained compliance management, and security process enforcement through its software product offering, Xacta IA ManagerTM. Xacta IA Manager is the leading solution for U.S. Government certification and accreditation ("C&A") activities in the marketplace today. In addition, the business line's cleared, highly-skilled, and IA-certified security professionals offer a full range of enterprise security consulting and implementation services.
- Identity Management – Xacta's Identity Management ("IM") business line provides identity management solutions. Xacta IM solutions offer control of physical access to military bases, office buildings, disaster sites, workstations, and other facilities, as well as control of logical access to databases, host systems, and other IT resources. They create a perimeter that protects and defends the physical and virtual resources of key defense and civilian agencies. Xacta partners with leading technology companies to deliver integrated solutions that ensure virtually impenetrable physical and logical protection. The Company also has experience with wireless technologies, PKI security, information assurance, systems integration, maintenance, and support to ensure optimal performance and integrity.

Backlog

The Company's total backlog was $103.8 million and $113.1 million at March 31, 2007 and 2006, respectively. Backlog was $92.1 million at December 31, 2006. The total backlog of each of the segments at March 31, 2007 and 2006 was as follows: Managed Solutions Group—$26.6 million and $20.5 million, respectively; and Xacta—$77.2 million and $92.6 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, 2007 and 2006 was $86.0 million and $67.0 million, respectively. Of these amounts, approximately $59.7 million and $46.9 million, respectively, were for Xacta's business with the remaining amount attributed to Managed Solutions.

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. As the Company continues to evaluate its performance with the goals of achieving greater consistency in its financial results, increasing cash flow and achieving higher profitability, it has undertaken a company-wide reorganization and cost reduction plan, which was initially presented to the Transaction Committee of the Board in July 2006, and which the Company has begun to execute and continues to implement.

The principal element of the Company's operating expenses as a percentage of sales for the three months ended March 31, 2007 and 2006 are as follows:

	Three Months Ended March 31,	
	2007	2006
Sales	100.0%	100.0%
Cost of sales	68.0	82.1
Selling, general and administrative expenses	22.6	41.4
Operating income (loss)	9.4	(23.5)
Losses from affiliate	—	(0.4)
Interest expense	(5.1)	(8.4)
Income (loss) before taxes	4.3	(32.3)
Provision for income taxes	—	—
Net income (loss)	4.3%	(32.3)%

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, 2007	2006
Sales		
Managed Solutions	$12,025	$ 9,428
Xacta	28,190	15,746
Total	$40,215	$25,174
Gross Profit		
Managed Solutions	$ (343)	$ 245
Xacta	13,211	4,250
Total	$12,868	$ 4,495
Gross Margin		
Managed Solutions	(2.9)%	2.6%
Xacta	46.9%	27.0%
Total	32.0%	17.9%

The Company's sales for the first quarter of 2007 were $40.2 million, an increase of $15.0 million or 59.7%, compared to the first quarter 2006 sales of $25.2 million. Such increase consists of a $12.4 million increase in sales from Xacta, primarily attributable to increased sales from the NETCENTS contract in its Secure Messaging and Secure Network solutions business lines, and a $3.0 million increase in sales from Managed Solutions. On a nonsegmented basis, as displayed on the face of the statement of operations, product revenue increased from $10.3 million for the first quarter in 2006 to $19.5 million for the same period in 2007, primarily attributable to increased product sales of $4.4 in Managed Solutions and $4.5 in the Secure Messaging business lines. Services revenue increased from $14.8 million for the first quarter in 2006 to $20.7 million for the same period in 2007, primarily attributable to increase in revenue in the Secure Network solutions business line.

The Company's cost of sales for the first quarter of 2007 was $27.3 million, an increase of $6.7 million compared to the same period in 2006, due primarily to the increase in sales.

The Company's gross profit for the first quarter of 2007 increased by $8.4 million, to $12.9 million, compared to the same period in 2006. Gross margin increased to 32.0% in the first quarter of 2007, from 17.9% in the same period in 2006. The increase in gross margin is attributable to the increase in sales of high margin business lines. The Xacta gross margin increased to 46.9% in the first quarter of 2007, from 27.0% for the same period in 2006, primarily due to increases in software sales in the Secure Messaging and Information Assurance business lines and solutions sales in the Secure Network solutions business line, as well as cost reductions and reorganizations implemented in the fourth quarter of 2006. The Managed Solutions gross margin decreased to (2.9%) in the first quarter of 2007, from 2.6% for the same period in 2006, due to several factors including continued downward pressure on prices in the product reselling sector, orders under the NETCENTS contract that have realized smaller margins, and working capital constraints which have, in some cases, limited the Company's supplier options with respect to order fulfillment. On a nonsegmented basis, as displayed on the face of the statement of operations, gross margin attributable to products increased to 28.9% in the first quarter of 2007, from 10.0% for the same period in 2006, primarily due to increased software sales in the Secure Messaging and Information Assurance business lines. Gross margin attributable to services increased to 34.9% in the first quarter of 2007, from 23.3% for the same period in 2006, primarily due to solutions sales in the Secure Network solutions business line.

The Company's selling, general, and administrative expense ("SG&A") for the first quarter of 2007 was $9.1 million, a decrease of approximately $1.3 million or 12.7% compared to the same period in 2006 primarily due to cost reductions implemented in the fourth quarter of 2006.

The Company's operating income for the first quarter of 2007 was $3.8 million, compared to $5.9 million of operating loss in the same period in 2006, due primarily to an increase in gross profit noted above.

The Company's interest expense for the first quarter of 2007 was $2.1 million, a decrease of $54,000 compared to the same period in 2006.

The Company recorded a full valuation allowance against its deferred tax assets as of March 31, 2007 and December 31, 2006. The Company maintained its full valuation position during the quarter ended March 31, 2007.

The Company's net income for the first quarter of 2007 was $1.7 million, an increase of $9.8 million compared to the $8.1 million net loss in the same period in 2006.

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

The Company has a $15 million revolving credit facility with Wells Fargo Foothill (the "Facility") that is scheduled to mature on October 21, 2008. Under the terms of the Facility, the interest rate is the Wells Fargo "prime rate" plus 1%. Pursuant to the terms of the Facility, 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, plus 4%. As of March 31, 2007, the Company has not elected the LIBOR rate option. As of March 31, 2007, the interest rate on the Facility was 9.25%.

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.

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 Earnings Before Interest, Taxes, Depreciation and Amortization (EBITDA), as defined in the Facility. The Company and Wells Fargo Foothill have amended the EBITDA covenants at various times to reflect revised projections. The Company has complied with its newly established covenants through March 31, 2007. Based on the Company's current projection of EBITDA, the Company expects that it will remain in compliance with its EBITDA covenants. Therefore, the Facility is classified as noncurrent as of March 31, 2007.

Effective January 1, 2007, the Company and Wells Fargo Foothill have amended the Facility to provide for availability block relief through April 30, 2007, to establish EBITDA covenants for 2007, to give consent to the formation of an LLC and subsequent sale of a portion of the membership interests in such LLC (disclosed in Note 6—Contingencies and Subsequent Events), and to provide various waivers in accordance with the Facility. The fees associated with such amendments amounted to $160,000.

At March 31, 2007, the Company had outstanding borrowings of $11.7 million and unused borrowing availability of $2.0 million on the Facility. As of May 8, 2007, the Company has availability under its current arrangement of approximately $1.8 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 10.9% and 9.9% for the three months ended March 31, 2007 and 2006, respectively.

Senior Subordinated Notes

The Company's Senior Subordinated Notes ("Notes") totaled $5.2 million at March 31, 2007. 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. During the first three months of 2007 and 2006, 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 $18.1 million at March 31, 2007. 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, 2007, the total carrying amount of redeemable preferred stock, including accumulated and unpaid dividends was $98.3 million. The Company accrues dividends and provides for accretion related to the redeemable preferred stock. During the first three months of 2007 and 2006, the Company recorded $1.1 million of dividends on the two classes of redeemable preferred stock.

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. 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. Maryland law also prohibits distributions (including redemptions and dividends) if, after the distribution is made, liabilities exceed assets. 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 March 31, 2007, the remaining 27.4% is also classified as noncurrent.

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, 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 (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 of Maryland law (as discussed above), 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. 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 March 31, 2007 and 2006.

The Company and certain of its subsidiaries are parties to the Facility agreement with Wells Fargo Foothill, whose term expires on October 21, 2008. 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 October 21, 2008.

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 Wells Fargo Foothill Facility prohibits, among other things, the redemption of any stock, common or preferred, until October 21, 2008. 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 March 31, 2007. 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 capable and 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

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. 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. Maryland law also prohibits distributions (including redemptions and dividends) if, after the distribution is made, liabilities exceed assets. For the cash dividends payable since December 1, 1995, the Company has accrued $58.6 million and $ 41.1 million as of March 31, 2007 and 2006, 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, for the three months ended March 31, 2007 and 2006, dividends totaling $1.1 million 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 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 full 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 the payment of these dividends by the issuance of additional shares of Public Preferred Stock. In consequence, in accordance with 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 dividends 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 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 of Directors 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 difference between those two amounts, $9.9 million, by recording an additional $9.9 million charge to interest expense for the second quarter of 2006, resulting in a balance of $89.2 million for the principal amount and all accrued dividends on the Public Preferred Stock as of March 31, 2007. This action is 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."

Borrowing Capacity

At March 31, 2007, the Company had outstanding debt and long-term obligations of $124.4 million, consisting of $11.7 million under the Facility, $5.2 million in subordinated debt, $9.2 million in capital lease obligations and $98.3 million in redeemable preferred stock classified as liability in accordance with SFAS No. 150.

The consolidated financial statements for the quarter ended March 31, 2007 that are included in this Form 10-Q have been prepared on a going concern basis, which contemplates the realization of assets and the satisfaction of liabilities in the normal course of business. However, primarily due to total expenses directly related to unreimbursed litigation-related and other legal expenses, the Company's working capital deficit was $9.5 million as of March 31, 2007. Total expenses related to litigation and other legal costs were $3.0 million for the first quarter of 2007, $5.7 million (net of $3.1 million in reimbursements by the Company's insurers) for 2006, and $4.1 million for 2005. Such unreimbursed litigation-related and other legal expenses continue to adversely affect working capital, and $8.9 million of such expenses are unpaid as of March 31, 2007. The Company is actively working with its vendors, including law firms, partners and subcontractors to mitigate the effect of these working capital constraints during this period. As the Company continues to evaluate its performance with the goals of achieving greater consistency in its financial results, increasing cash flow and achieving higher profitability, it has undertaken a company-wide reorganization and cost reduction plan, which was initially presented to the Transaction Committee of the Board in July 2006, and which the Company has begun to execute and continues to implement.

There can be no assurances as to the continuing ability of the Company to successfully work with vendors, partners and subcontractors or Wells Fargo Foothill to mitigate these current working capital constraints. See Note 3 – Debt Obligations. Although no assurances can be given, the Company expects that it will be in compliance throughout the term of the amended credit facility with respect to the financial and other covenants.

Also, the Company derives substantially all of its revenue from U.S. Government contracting, and as such it is annually subject to the seasonality of the U.S. Government purchasing. As the U.S. Government fiscal year ends on September 30, it is not uncommon for U.S. Government agencies to award extra tasks in the weeks immediately prior to the end of its fiscal year in order to avoid the loss of unexpended fiscal year funds. As a result of this cyclicality, the Company has historically experienced higher revenues in its third and fourth fiscal quarters, ending September 30, and December 31, respectively, with the pace of orders substantially reduced during the January to June time period.

The Company believes that available cash and borrowings under the 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 2007.

Contractual Obligations and Off-Balance Sheet Arrangements

The following summarizes the Company's contractual obligations at March 31, 2007, 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	< 1 year	1 to 3 years	3 to 5 years	> 5 years
Long-term debt (1)	$ 16,922	$ —	$ 16,922	$ —	$ —
Capital lease obligations (2)	16,329	1,875	5,487	5,380	3,587
Operating lease obligations (2)	1,723	546	1,177	—	—
Senior preferred stock (3)	9,128	—	9,128	—	—
Public preferred stock redemption (4)	89,211	—	89,211	—	—
Total	$133,313	$2,421	$121,925	$5,380	$ 3,587

(1) Includes amounts due October 31, 2008, pursuant to senior credit facility and senior subordinated note agreements.
(2) Includes total lease payments.
(3) Includes dividends accrual of $6.4 million. See Note 4 – Redeemable Preferred Stock.
(4) Includes dividends and accretion accrual of $82.8 million, payment of which presumes conditions precedent being satisfied. See Note 4 – Redeemable Preferred Stock.

Recent Accounting Pronouncements

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

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, 2006, as filed with the SEC.

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. Effective April 2005, interest on the Facility is charged at 1% over the Wells Fargo "prime rate" (as of March 31, 2007 the Wells Fargo "prime rate" was 8.25%), or 5.75%, whichever is higher. The interest rate for the additional availability amount ranged from 12.75% to 13.25% during its term, which was 5% over the Wells Fargo "prime rate." The effective average interest rates, including all bank fees, for the first three months of 2007 and 2006 were 10.9% and 9.9%, respectively. The Facility had an outstanding balance of $11.7 million at March 31, 2007.

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) under the Exchange Act), as of March 31, 2007, and concluded that those disclosure controls and procedures are effective in ensuring that information required to be disclosed by the Company in reports filed or submitted under the Securities Exchange Act of 1934 is recorded, processed, summarized and reported, within the time periods specified in the Securities and Exchange Commission's rules and forms, and is accumulated and communicated to the Company's management including the Chief Executive Officer and Chief Financial Officer, as appropriate to allow timely decisions regarding timely disclosures.

There have been no changes in the Company's internal control over financial reporting during the quarter ended March 31, 2007 or in other factors that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

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PART II—OTHER INFORMATION

Item 1. <u>Legal Proceedings</u>

Information regarding legal proceedings may be found in Note 6 to the Consolidated Financial Statements.

Item 1A. Risk Factors

There were no material changes in the Company's risk factors in the first quarter of 2007.

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, 2007, total undeclared unpaid dividends accrued for financial reporting purposes are $6.1 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. Subject to limitations set forth below, the Company was scheduled to redeem 27.4% 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. Maryland law also prohibits distributions (including redemptions and dividends) if, after the distribution is made, liabilities exceed assets. Accordingly, due to the Company's current financial position, 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 adjusted to $3.5 million and $13.4 million, respectively. As more fully disclosed in Note 4 – 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 $58.6 million in cash dividends as of March 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 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 (as discussed above), the Company did not make the first two scheduled redemption payments, and assuming insufficient liquidity to undertake any stock redemption (which is presently unquantifiable), the Company believes that the likelihood is that it will not be able to make the remaining three 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 balance sheet as of March 31, 2007 and December 31, 2006, and throughout all of 2006.

Item 5. Other Information

Notice of Delisting

On April 18, 2007 the Company was notified by the NASD that its securities will be removed from quotation on the OTCBB because the Company filed three periodic reports late in the past twenty-four months, in violation of the OTCBB eligibility rules. On April 23, 2007 the Company appealed this decision to the NASD Hearings Panel. On May 7, 2007 the Company applied for a waiver of late filing from the SEC's Division of Corporation Finance. As of the filing date of this Form 10-Q, no determination has been made with regard to either matter.

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Item 6. Exhibits

Exhibit Number	Description of Exhibit
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 March 8, 2000. (Incorporated by reference to Exhibit 10.104 to the Company's Form 10-K report for the year ended December 31, 2005)
10.17*	Thirteenth Amendment to Loan and Security Agreement between Telos Corporation, a Maryland corporation, and Wells Fargo Foothill, Inc.
10.18*	Consent, Waiver, and Fourteenth Amendment to Loan and Security Agreement between Telos Corporation, a Maryland corporation, and Wells Fargo Foothill, Inc.
23.1	Consent of Navigant Consulting, Inc. (Incorporated by reference to Exhibit 23.1 to the Company's Form 10-K for the year ended December 31, 2006)
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

Part II Items 2 and 4 are not applicable and have been omitted.

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SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

Date: May 15, 2007	TELOS CORPORATION
	/s/ John B. Wood
	John B. Wood Chief Executive Officer
	/s/ Michele Nakazawa
	Michele Nakazawa Chief Financial Officer

Exhibit 10.17

THIRTEENTH AMENDMENT TO
LOAN AND SECURITY AGREEMENT

THIS THIRTEENTH AMENDMENT TO LOAN AND SECURITY AGREEMENT (this "Amendment") is entered into as of April 20, 2007 by and among **TELOS CORPORATION**, a Maryland corporation ("Parent"), **XACTA CORPORATION**, a Delaware corporation ("Xacta"; Parent and Xacta are referred to hereinafter each individually as a "Borrower", and individually and collectively, jointly and severally, as the "Borrowers"), **TELOS DELAWARE, INC.**, a Delaware corporation ("Telos-Delaware"), **UBIQUITY.COM, INC.**, a Delaware corporation ("Ubiquity"), **TELOS.COM, INC.**, a Delaware corporation ("Telos.com"), **TELOS INTERNATIONAL CORP.**, a Delaware corporation ("TIC"), **TELOS INTERNATIONAL ASIA, INC.**, a Delaware corporation ("TIA"), **SECURE TRADE, INC.**, a Delaware corporation ("STI"), **KUWAIT INTERNATIONAL, INC.**, a Delaware corporation ("KII"), **TELOS INFORMATION SYSTEMS, INC.**, a Delaware corporation ("TIS"), **TELOS FIELD ENGINEERING, INC.**, a Delaware corporation ("TFE"), and **TELOS FEDERAL SYSTEMS, INC.**, a Delaware corporation ("TFS"; Telos-Delaware, Ubiquity, Telos.com, TIC, TIA, STI, KII, TIS, TFE and TFS are referred to hereinafter each individually as a "Credit Party" and collectively, jointly and severally, as the "Credit Parties"), and **WELLS FARGO FOOTHILL, INC.** (formerly known as Foothill Capital Corporation), as agent ("Agent") for the Lenders (defined below) and as a Lender.

WHEREAS, Borrowers, Credit Parties, Agent and certain other financial institutions from time to time party thereto (the "Lenders") are parties to that certain Loan and Security Agreement dated as of October 21, 2002 (as amended from time to time, the "Loan Agreement");

WHEREAS, subject to the terms and conditions contained herein, Borrowers, Credit Parties, Agent and Lenders have agreed to amend the Loan Agreement in certain respects.

NOW THEREFORE, in consideration of the premises and mutual agreements herein contained, the parties hereto agree as follows:

1. Defined Terms. Unless otherwise defined herein, capitalized terms used herein shall have the meanings ascribed to such terms in the Loan Agreement.

2. Amendments to Loan Agreement. Subject to the satisfaction of the conditions set forth in Section 4 hereof, the Loan Agreement is amended in the following respect:

The definition of "Availability Block" as set forth in Section 1.1 of the Loan Agreement is amended and restated in its entirety, as follows:

"Availability Block" means an amount equal to $500,000; provided, that Availability Block shall mean an amount equal to $0 for the period from October 27, 2006 through and including January 31, 2007.

3. Ratification. This Amendment, subject to satisfaction of the conditions set forth in Section 4 below, shall constitute an amendment to the Loan Agreement and all of the Loan Documents as appropriate to express the agreements contained herein. Except as specifically set forth herein, the Loan Agreement and the Loan Documents shall remain unchanged and in full force and effect in accordance with their original terms.

4. Conditions to Effectiveness. This Amendment shall become effective retroactive to December 30, 2006 upon the satisfaction of the following conditions precedent:

(a) Each party hereto shall have executed and delivered this Amendment to Agent;

(b) Agent shall have received the fee described in Section 5 hereof;

(c) Borrowers shall have delivered to Agent such documents, agreements and instruments as may be requested or required by Agent in connection with this Amendment, each in form and content acceptable to Agent;

(d) No Default or Event of Default shall have occurred and be continuing on the date hereof or as of the date of the effectiveness of this Amendment; and

(e) All proceedings taken in connection with the transactions contemplated by this Amendment and all documents, instruments and other legal matters incident thereto shall be satisfactory to Agent and its legal counsel.

5. Additional Availability Fee. To induce Agent and Lenders to enter into this Amendment, Borrowers shall pay to Agent, for the benefit of Lenders, a non-refundable fee equal to $10,000, which shall be due and payable on the date hereof.

6. Miscellaneous.

(a) Warranties and Absence of Defaults. To induce Agent and Lenders to enter into this Amendment, each Company hereby represents and warrants to Agent and Lenders that:

(i) The execution, delivery and performance by it of this Amendment and each of the other agreements, instruments and documents contemplated hereby are within its corporate power, have been duly authorized by all necessary corporate action, have received all necessary governmental approval (if any shall be required), and do not and will not contravene or conflict with any provision of law applicable to it, its articles of incorporation and by-laws, any order, judgment or decree of any court or governmental agency, or any agreement, instrument or document binding upon it or any of its property;

(ii) Each of the Loan Agreement and the other Loan Documents, as amended by this Amendment, are the legal, valid and binding obligation of it enforceable against it in accordance with its terms, except as the enforcement thereof may be subject to (A) the effect of any applicable bankruptcy, insolvency, reorganization, moratorium or similar laws affecting creditor's rights generally, and (B) general principles of equity;

(iii) The representations and warranties contained in the Loan Agreement and the other Loan Documents are true and accurate as of the date hereof with the same force and effect as if such had been made on and as of the date hereof; and

(iv) It has performed all of its obligations under the Loan Agreement and the Loan Documents to be performed by it on or before the date hereof and as of the date hereof, it is in compliance with all applicable terms and provisions of the Loan Agreement and each of the Loan Documents to be observed and performed by it and no event of default or other event which upon notice or lapse of time or both would constitute an event of default has occurred.

(b) Expenses. Companies, jointly and severally, agree to pay on demand all costs and expenses of Agent (including the reasonable fees and expenses of outside counsel for Agent) in connection with the preparation, negotiation, execution, delivery and administration of this Amendment and all other instruments or documents provided for herein or delivered or to be delivered hereunder or in connection herewith. In addition, Companies agree, jointly and severally, to pay, and save Agent harmless from all liability for, any stamp or other taxes which may be payable in connection with the execution or delivery of this Amendment or the Loan Agreement, as amended hereby, and the execution and delivery of any instruments or documents provided for herein or delivered or to be delivered hereunder or in connection herewith. All obligations provided herein shall survive any termination of the Loan Agreement as amended hereby.

(c) Governing Law. This Amendment shall be a contract made under and governed by the internal laws of the State of Illinois.

(d) Counterparts. This Amendment may be executed in any number of counterparts, and by the parties hereto on the same or separate counterparts, and each such counterpart, when executed and delivered, shall be deemed to be an original, but all such counterparts shall together constitute but one and the same Amendment.

7. Release.

(a) In consideration of the agreements of Agent and Lenders contained herein and for other good and valuable consideration, the receipt and sufficiency of which is hereby acknowledged, each Company, on behalf of itself and its successors, assigns, and other legal representatives, hereby absolutely, unconditionally and irrevocably releases, remises and forever discharges Agent and Lenders, and their successors and assigns, and their present and former shareholders, affiliates, subsidiaries, divisions, predecessors, directors, officers, attorneys, employees, agents and other representatives (Agent, each Lender and all such other Persons being hereinafter referred to collectively as the "Releasees" and individually as a "Releasee"), of and from all demands, actions, causes of action, suits, covenants, contracts, controversies, agreements, promises, sums of money, accounts, bills, reckonings, damages and any and all other claims, counterclaims, defenses, rights of set-off, demands and liabilities whatsoever (individually, a "Claim" and collectively, "Claims") of every name and nature, known or unknown, suspected or unsuspected, both at law and in equity, which such Company or any of its successors, assigns, or other legal representatives may now or hereafter own, hold, have or claim to have against the Releasees or any of them for, upon, or by reason of any circumstance, action, cause or thing whatsoever which arises at any time on or prior to the day and date of this Amendment, including, without limitation, for or on account of, or in relation to, or in any way in connection with any of the Loan Agreement, or any of the other Loan Documents or transactions thereunder or related thereto.

(b) Each Company understands, acknowledges and agrees that the release set forth above may be pleaded as a full and complete defense and may be used as a basis for an injunction against any action, suit or other proceeding which may be instituted, prosecuted or attempted in breach of the provisions of such release.

(c) Each Company agrees that no fact, event, circumstance, evidence or transaction which could now be asserted or which may hereafter be discovered shall affect in any manner the final, absolute and unconditional nature of the release set forth above.

[signature pages follow]

IN WITNESS WHEREOF, the parties hereto have caused this Amendment to be executed by their respective officers thereunto duly authorized and delivered as of the date first above written.

BORROWERS:

TELOS CORPORATION,
a Maryland corporation

By /s/ Michael P. Flaherty
Title

XACTA CORPORATION,
a Delaware corporation

By /s/ Michael P. Flaherty
Title

CREDIT PARTIES:

TELOS DELAWARE, INC.,
a Delaware corporation

By /s/ Michael P. Flaherty
Title

UBIQUITY.COM, INC.,
a Delaware corporation

By /s/ Michael P. Flaherty
Title

Signature Page to Thirteenth Amendment to Loan and Security Agreement

TELOS.COM, INC.,
a Delaware corporation

By /s/ Michael P. Flaherty
Title

TELOS INTERNATIONAL CORP.,
a Delaware corporation

By /s/ Michael P. Flaherty
Title

TELOS INTERNATIONAL ASIA, INC.,
a Delaware corporation

By /s/ Michael P. Flaherty
Title

SECURE TRADE, INC.,
a Delaware corporation

By /s/ Michael P. Flaherty
Title

KUWAIT INTERNATIONAL, INC.,
a Delaware corporation

By /s/ Michael P. Flaherty
Title

TELOS INFORMATION SYSTEMS, INC.,
a Delaware corporation

By /s/ Michael P. Flaherty
Title

TELOS FIELD ENGINEERING, INC.,
a Delaware corporation

By /s/ Michael P. Flaherty
Title

TELOS FEDERAL SYSTEMS, INC.,
a Delaware corporation

By /s/ Michael P. Flaherty
Title

AGENT AND LENDER:

WELLS FARGO FOOTHILL, INC. (formerly known as Foothill Capital Corporation)

By /s/ David Sanchez
Title V.P.

CONSENT, WAIVER AND FOURTEENTH AMENDMENT TO LOAN AND SECURITY AGREEMENT

THIS CONSENT, WAIVER AND FOURTEENTH AMENDMENT TO LOAN AND SECURITY AGREEMENT (this "Amendment") is entered into as of April 20, 2007 by and among **TELOS CORPORATION**, a Maryland corporation ("Parent"), **XACTA CORPORATION**, a Delaware corporation ("Xacta"; Parent and Xacta are referred to hereinafter each individually as a "Borrower", and individually and collectively, jointly and severally, as the "Borrowers"), **TELOS DELAWARE, INC.**, a Delaware corporation ("Telos-Delaware"), **UBIQUITY.COM, INC.**, a Delaware corporation ("Ubiquity"), **TELOS.COM, INC.**, a Delaware corporation ("Telos.com"), **TELOS INTERNATIONAL CORP.**, a Delaware corporation ("TIC"), **TELOS INTERNATIONAL ASIA, INC.**, a Delaware corporation ("TIA"), **SECURE TRADE, INC.**, a Delaware corporation ("STI"), **KUWAIT INTERNATIONAL, INC.**, a Delaware corporation ("KII"), **TELOS INFORMATION SYSTEMS, INC.**, a Delaware corporation ("TIS"), **TELOS FIELD ENGINEERING, INC.**, a Delaware corporation ("TFE"), and **TELOS FEDERAL SYSTEMS, INC.**, a Delaware corporation ("TFS"; Telos-Delaware, Ubiquity, Telos.com, TIC, TIA, STI, KII, TIS, TFE and TFS are referred to hereinafter each individually as a "Credit Party" and collectively, jointly and severally, as the "Credit Parties"), and **WELLS FARGO FOOTHILL, INC.** (formerly known as Foothill Capital Corporation), as agent ("Agent") for the Lenders (defined below) and as a Lender.

WHEREAS, Borrowers, Credit Parties, Agent and certain other financial institutions from time to time party thereto (the "Lenders") are parties to that certain Loan and Security Agreement dated as of October 21, 2002 (as amended from time to time, the "Loan Agreement");

WHEREAS, the Companies (A) failed to deliver to Agent (x) the audited financial statements for the fiscal year ended December 31, 2006 required by Section 6.3(b) and (y) the Compliance Certificates for each of the months ended January 31, 2007 and February 28, 2007 required by Section 6.3(a), which resulted in Events of Default under Section 8.2 of the Loan Agreement and (B) failed to have the minimum Sales for each of the 5 week periods ending June 2, 2006, June 9, 2006 and June 16, 2006 as required by Section 7.20(a)(iii) of the Loan Agreement, which resulted in Events of Default under Section 8.2 of the Loan Agreement (all of the foregoing, collectively, the "Existing Defaults"); and

WHEREAS, Borrowers have notified Agent that Parent desires to form a new Subsidiary ("New Subsidiary") and contribute the assets described on Exhibit A hereto relating to its identity management business to the New Subsidiary in exchange for 99.999% of the membership interests of the New Subsidiary, as set forth in greater detail in the Contribution Agreement attached hereto as Exhibit B ("Contribution Agreement");

WHEREAS, Parent further desires to sell 39.999% of its membership interest in New Subsidiary to Hoya ID Fund A, LLC, a California limited liability company ("Investor LLC") for an aggregate purchase price of $6,000,000 (the "Sale of Interests") pursuant to the Membership Interest Purchase & Assignment Agreement attached hereto as Exhibit C (the "Purchase Agreement");

WHEREAS, in connection with the Sale of Interests, the New Subsidiary desires to adopt the Amended and Restated Operating Agreement attached hereto as Exhibit D (the “Operating Agreement”);

WHEREAS, absent the prior written consent of Agent and the undersigned Lenders, (i) the formation of New Subsidiary and contribution of assets to New Subsidiary pursuant to the Contribution Agreement, (ii) the consummation of the Sale of Interests and (iii) the adoption of the Operating Agreement (collectively, the transactions described in clauses (i), (ii) and (iii) above, the “Joint Venture Transaction”) would constitute a breach of Sections 7.4, 7.5 and 7.13 of the Loan Agreement, constituting separate Events of Default pursuant to Section 8.2(c) of the Loan Agreement, and Borrowers have requested that Agent and the Lenders consent to the consummation thereof so as to avoid any such Events of Default;

WHEREAS, subject to the terms and conditions contained herein, Borrowers, Credit Parties, Agent and Lenders have agreed to waive the Existing Defaults, consent to the Joint Venture Transaction and amend the Loan Agreement in certain respects.

NOW THEREFORE, in consideration of the premises and mutual agreements herein contained, the parties hereto agree as follows:

1. Defined Terms. Unless otherwise defined herein, capitalized terms used herein shall have the meanings ascribed to such terms in the Loan Agreement.

2. Waiver. Subject to the satisfaction of the conditions set forth in Section 6 hereof, Agent and the undersigned Lenders hereby waive the Existing Defaults. The foregoing waiver shall not constitute a waiver of any other Event of Default that may exist, or a waiver of any future Event of Default that may occur.

3. Consent. Subject to the satisfaction of the conditions set forth in Section 6 hereof, Agent and the undersigned Lenders hereby consent to the Joint Venture Transaction as such transaction is described in the Contribution Agreement, Purchase Agreement and Operating Agreement. Except as expressly set forth in this Section 3, the foregoing consent shall not constitute a consent to any transaction other than the Joint Venture Transaction or a waiver of any Event of Default that may arise from any such transaction or the Joint Venture Transaction.

4. Amendments to Loan Agreement. Subject to the satisfaction of the conditions set forth in Section 6 hereof, the Loan Agreement is amended in the following respects:

(a) The definition of “Availability Block” as set forth in Section 1.1 of the Loan Agreement is amended and restated in its entirety, as follows:

“Availability Block” means an amount equal to $500,000; provided, that Availability Block shall mean an amount equal to $0 for the period from October 27, 2006 through and including April 30, 2007.

(b) The definition of “EBITDA” as set forth in Section 1.1 of the Loan Agreement is amended and restated in its entirety, as follows:

“EBITDA” means, with respect to any fiscal period, Parent’s and its Subsidiaries’ consolidated net earnings (or loss), minus extraordinary gains, plus non-cash extraordinary losses, plus interest expense, income taxes, and depreciation and amortization for such period, as determined in accordance with GAAP. Notwithstanding anything herein to the contrary, for purposes of the determination of EBITDA, TIMS LLC shall not be deemed to be a Subsidiary of Parent.

(c) The definition of “Permitted Investments” as set forth in Section 1.1 of the Loan Agreement is amended and restated in its entirety, as follows:

“Permitted Investments” means (a) investments in Cash Equivalents, (b) investments in negotiable instruments for collection, (c) advances made in connection with purchases of goods or services in the ordinary course of business, (d) investments by any Borrower in any other Borrower or any Credit Party provided that if any such investment is in the form of Indebtedness, such Indebtedness investment shall be subject to the terms and conditions of the Intercompany Subordination Agreement and provided, further, that Borrowers may not invest more than $50,000 in the aggregate in the Credit Parties and then only so long as the proceeds of such investments are used to facilitate the dissolution of such Credit Parties and (e) investments by Parent of up to $1,000,000 in the aggregate in TIMS LLC provided, that investments pursuant to this clause (e) may only be made (i) during the period on or prior to October 20, 2007 and (ii) if Excess Availability after giving effect to such investment is equal to or greater than $1,000,000.

(d) The following defined term is hereby added in Section 1.1 of the Loan Agreement in alphabetical order therein:

“TIMS LLC” means Telos Identity Management Solutions, LLC (d/b/a XACTA Identity Management Solutions), a Delaware limited liability company.

(e) Section 7.20(a)(i) of the Loan Agreement is hereby amended and restated in its entirety as follows:

(i) **Minimum EBITDA.** EBITDA, measured on a fiscal month-end basis, for each period set forth below, of not less than the required amount set forth in the following table for the applicable period set forth opposite thereto;

Applicable Amount	Applicable Period
$(307,767)	For the 1 month period ending January 31, 2007
$(295,624)	For the 2 month period ending February 28, 2007
$(2,827,784)	For the 3 month period ending March 31, 2007
$(5,031,612)	For the 4 month period ending April 30, 2007
$(6,427,164)	For the 5 month period ending May 31, 2007
$(6,232,277)	For the 6 month period ending June 30, 2007
$(5,773,289)	For the 7 month period ending July 31, 2007
$(4,460,556)	For the 8 month period ending August 30, 2007
$(3,185,384)	For the 9 month period ending September 30, 2007
$(211,780)	For the 10 month period ending October 31, 2007
$1,741,025	For the 11 month period ending November 30, 2007
$2,140,200	For the 12 month period ending December 31, 2007
85% of EBITDA for such period as reflected in the most recent Projections delivered to Agent pursuant to Section 6.3(c) and approved by Required Lenders but in no event less than $2,140,200	For the 12 month period ending January 31, 2008 and the 12 month period ending on the last day of each fiscal month thereafter

5. Ratification; Other Agreements. This Amendment, subject to satisfaction of the conditions set forth in Section 6 below, shall constitute a waiver and amendment to the Loan Agreement and all of the Loan Documents as appropriate to express the agreements contained herein. Except as specifically set forth herein, the Loan Agreement and the Loan Documents shall remain unchanged and in full force and effect in accordance with their original terms. Notwithstanding anything in the Loan Agreement or any other Loan Document to the contrary, none of the Borrowers nor any other Credit Party may make any Investment, or transfer funds or property to, or enter into any transaction with, Telos Identity Management Solutions, LLC (d/b/a XACTA Identity Management Solutions), a Delaware limited liability company ("TIMS LLC") except as expressly provided in this Amendment. Any breach of the foregoing covenant shall constitute an Event of Default.

6. Conditions to Effectiveness. This Amendment shall become effective as of the date hereof upon the satisfaction of the following conditions precedent (provided, that the amendments set forth in Section 4 shall become effective retroactive to January 1, 2007 upon the satisfaction of such conditions precedent):

(a) Each party hereto shall have executed and delivered this Amendment to Agent;

(b) Agent shall have received the fee described in Section 7 hereof;

(c) Borrowers shall have delivered to Agent fully executed copies of all documents, agreements and instruments delivered in connection with the Joint Venture Transaction;

(d) Borrowers shall have delivered to Agent such other documents, agreements and instruments as may be requested or required by Agent in connection with this Amendment, each in form and content acceptable to Agent;

(e) The aggregate cash consideration for the Sale of Interests shall be not less than $6,000,000 and such cash consideration shall be wire transferred directly to Agent for application to the Obligations in accordance with the terms of the Loan Agreement;

(f) No Default or Event of Default other than the Existing Defaults shall have occurred and be continuing on the date hereof or as of the date of the effectiveness of this Amendment; and

(g) All proceedings taken in connection with the transactions contemplated by this Amendment and all documents, instruments and other legal matters incident thereto shall be satisfactory to Agent and its legal counsel.

7. Amendment Fee. To induce Agent and Lenders to enter into this Amendment, Borrowers shall pay to Agent, for the benefit of Lenders, a non-refundable additional amendment fee equal to $150,000, which shall be due and payable on the date hereof.

8. Covenants. Companies agree to deliver to Agent, on or before April 30, 2007:

(a) the audited financial statements for the fiscal year ended December 31, 2006 required by Section 6.3(b) of the Loan Agreement; and

(b) a fully executed pledge agreement, in form and substance satisfactory to Agent, pursuant to which Parent shall have pledged and granted to Agent, for its benefit and the benefit of Lenders, a security interest in all of its membership interests in the New Subsidiary.

Failure to deliver to Agent the items set forth in (a) and (b) above on or prior to April 30, 2007 shall constitute an Event of Default.

9. Miscellaneous.

(a) Warranties and Absence of Defaults. To induce Agent and Lenders to enter into this Amendment, each Company hereby represents and warrants to Agent and Lenders that:

(i) The execution, delivery and performance by it of this Amendment and each of the other agreements, instruments and documents contemplated hereby are within its corporate power, have been duly authorized by all necessary corporate action, have received all necessary governmental approval (if any shall be required), and do not and will not contravene or conflict with any provision of law applicable to it, its articles of incorporation and by-laws, any order, judgment or decree of any court or governmental agency, or any agreement, instrument or document binding upon it or any of its property;

(ii) Each of the Loan Agreement and the other Loan Documents, as amended by this Amendment, are the legal, valid and binding obligation of it enforceable against it in accordance with its terms, except as the enforcement thereof may be subject to (A) the effect of any applicable bankruptcy, insolvency, reorganization, moratorium or similar laws affecting creditor's rights generally, and (B) general principles of equity;

(iii) The representations and warranties contained in the Loan Agreement and the other Loan Documents are true and accurate as of the date hereof with the same force and effect as if such had been made on and as of the date hereof; and

(iv) It has performed all of its obligations under the Loan Agreement and the Loan Documents to be performed by it on or before the date hereof and as of the date hereof, it is in compliance with all applicable terms and provisions of the Loan Agreement and each of the Loan Documents to be observed and performed by it and no event of default or other event which upon notice or lapse of time or both would constitute an event of default has occurred.

(b) Expenses. Companies, jointly and severally, agree to pay on demand all costs and expenses of Agent (including the reasonable fees and expenses of outside counsel for Agent) in connection with the preparation, negotiation, execution, delivery and administration of this Amendment and all other instruments or documents provided for herein or delivered or to be delivered hereunder or in connection herewith. In addition, Companies agree, jointly and severally, to pay, and save Agent harmless from all liability for, any stamp or other taxes which may be payable in connection with the execution or delivery of this Amendment or the Loan Agreement, as amended hereby, and the execution and delivery of any instruments or documents provided for herein or delivered or to be delivered hereunder or in connection herewith. All obligations provided herein shall survive any termination of the Loan Agreement as amended hereby.

(c) Governing Law. This Amendment shall be a contract made under and governed by the internal laws of the State of Illinois.

(d) Counterparts. This Amendment may be executed in any number of counterparts, and by the parties hereto on the same or separate counterparts, and each such counterpart, when executed and delivered, shall be deemed to be an original, but all such counterparts shall together constitute but one and the same Amendment.

10. Release.

(a) In consideration of the agreements of Agent and Lenders contained herein and for other good and valuable consideration, the receipt and sufficiency of which is hereby acknowledged, each Company, on behalf of itself and its successors, assigns, and other legal representatives, hereby absolutely, unconditionally and irrevocably releases, remises and forever discharges Agent and Lenders, and their successors and assigns, and their present and former shareholders, affiliates, subsidiaries, divisions, predecessors, directors, officers, attorneys, employees, agents and other representatives (Agent, each Lender and all such other Persons being hereinafter referred to collectively as the “Releasees” and individually as a “Releasee”), of and from all demands, actions, causes of action, suits, covenants, contracts, controversies, agreements, promises, sums of money, accounts, bills, reckonings, damages and any and all other claims, counterclaims, defenses, rights of set-off, demands and liabilities whatsoever (individually, a “Claim” and collectively, “Claims”) of every name and nature, known or unknown, suspected or unsuspected, both at law and in equity, which such Company or any of its successors, assigns, or other legal representatives may now or hereafter own, hold, have or claim to have against the Releasees or any of them for, upon, or by reason of any circumstance, action, cause or thing whatsoever which arises at any time on or prior to the day and date of this Amendment, including, without limitation, for or on account of, or in relation to, or in any way in connection with any of the Loan Agreement, or any of the other Loan Documents or transactions thereunder or related thereto.

(b) Each Company understands, acknowledges and agrees that the release set forth above may be pleaded as a full and complete defense and may be used as a basis for an injunction against any action, suit or other proceeding which may be instituted, prosecuted or attempted in breach of the provisions of such release.

(c) Each Company agrees that no fact, event, circumstance, evidence or transaction which could now be asserted or which may hereafter be discovered shall affect in any manner the final, absolute and unconditional nature of the release set forth above.

[signature pages follow]

IN WITNESS WHEREOF, the parties hereto have caused this Amendment to be executed by their respective officers thereunto duly authorized and delivered as of the date first above written.

BORROWERS:

TELOS CORPORATION,
a Maryland corporation

By /s/ Michael P. Flaherty
Title

XACTA CORPORATION,
a Delaware corporation

By /s/ Michael P. Flaherty
Title

CREDIT PARTIES:

TELOS DELAWARE, INC.,
a Delaware corporation

By /s/ Michael P. Flaherty
Title

UBIQUITY.COM, INC.,
a Delaware corporation

By /s/ Michael P. Flaherty
Title

TELOS.COM, INC.,
a Delaware corporation

By /s/ Michael P. Flaherty
Title

TELOS INTERNATIONAL CORP.,
a Delaware corporation

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TELOS INTERNATIONAL ASIA, INC.,
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SECURE TRADE, INC.,
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By /s/ Michael P. Flaherty
Title

TELOS FEDERAL SYSTEMS, INC.,
a Delaware corporation

By /s/ Michael P. Flaherty
Title

AGENT AND LENDER:

WELLS FARGO FOOTHILL, INC. (formerly known as Foothill Capital Corporation)

By /s/ David Sanchez
Title V.P.

Exhibit 31.1

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)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and we 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 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 15, 2007

/s/ John B. Wood
John B. Wood
Chief Executive Officer

Exhibit 31.2

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)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and we 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 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 15, 2007

/s/ Michele Nakazawa

Michele Nakazawa
Chief Financial Officer

Exhibit 32

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, 2007 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 15, 2007

/s/ John B. Wood
John B. Wood
Chief Executive Officer

/s/ Michele Nakazawa
Michele Nakazawa
Chief Financial Officer