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VSE CORP  
Form 10-Q  
August 01, 2007

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 Quarter Ended June 30, 2007

Commission File Number: 0-3676

VSE CORPORATION  
(Exact Name of Registrant as Specified in its Charter)

DELAWARE  
(State or Other Jurisdiction of  
Incorporation or Organization)

54-0649263  
(I.R.S. Employer  
Identification No.)

2550 Huntington Avenue  
Alexandria, Virginia  
(Address of Principal Executive Offices)

22303-1499  
(Zip Code)

www.vsecorp.com  
(Webpage)

Registrant's Telephone Number, Including Area Code: (703) 960-4600

Securities registered pursuant to Section 12(b) of the Act:

| Title of each class<br>-----            | Name of each exchange<br>on which registered<br>----- |
|---|---|
| Common Stock, par value \$.05 per share | NASDAQ Global Market                                  |

Securities registered pursuant to Section 12(g) of the Act: None

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

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Rule 12b-2 of the Exchange Act). Yes [ ] No [x]

Number of shares of Common Stock outstanding as of August 1, 2007: 5,004,860.

VSE Corporation and Subsidiaries

### Forward Looking Statements

This filing contains statements which, to the extent they are not recitations of historical fact, constitute "forward looking statements" under federal securities laws. All such statements are intended to be subject to the safe harbor protection provided by applicable securities laws. For discussions identifying some important factors that could cause actual VSE Corporation ("VSE" or the "Company") results to differ materially from those anticipated in the forward looking statements contained in this filing, see VSE's discussions captioned "Business," "Risk Factors," "Management's Discussion and Analysis of Financial Condition and Results of Operations" and "Notes to Consolidated Financial Statements" contained in VSE's Annual Report on Form 10-K for the fiscal year ended December 31, 2006 filed with the Securities and Exchange Commission (the "SEC") on March 5, 2007.

Readers are cautioned not to place undue reliance on these forward looking statements, which reflect management's analysis only as of the date hereof. The Company undertakes no obligation to publicly revise these forward looking statements to reflect events or circumstances that arise after the date hereof. Readers should carefully review the risk factors described in other documents the Company files from time to time with the SEC, including this and other Quarterly Reports on Form 10-Q to be filed by the Company subsequent to its Annual Report on Form 10-K and any Current Reports on Form 8-K filed by the Company.

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### PART I. Financial Information

#### Item 1. Financial Statements

VSE Corporation and Subsidiaries  
Consolidated Financial Statements

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Consolidated Balance Sheets

(in thousands except share and per share amounts)

|   | June 30,<br>2007<br>-----<br>(Unaudited) | December 31,<br>2006<br>----- |
|---|--|-------------------------------|
| <b>Assets</b>   |  |                               |
| <b>Current assets:</b>  |  |                               |
| Cash and cash equivalents . . . . .   | \$ 1,267                                 | \$ 8,745                      |
| Accounts receivable, principally  |  |                               |
| U.S. Government, net . . . . .  | 107,589                                  | 66,730                        |
| Contract inventories . . . . .  | 1,323                                    | 4,459                         |
| Deferred tax assets . . . . .   | 1,307                                    | 1,196                         |
| Other current assets . . . . .  | 2,827                                    | 2,472                         |
|   | -----                                    | -----                         |
| Total current assets . . . . .  | 114,313                                  | 83,602                        |
| Property and equipment, net . . . . .   | 9,919                                    | 8,409                         |
| Deferred tax assets . . . . .   | 1,502                                    | 1,133                         |
| Intangible assets . . . . .   | 6,423                                    | -                             |
| Goodwill . . . . .  | 5,051                                    | 1,054                         |
| Other assets . . . . .  | 5,201                                    | 4,337                         |
|   | -----                                    | -----                         |
| Total assets . . . . .  | \$142,409                                | \$ 98,535                     |
|   | =====                                    | =====                         |
| <b>Liabilities and Stockholders' Equity</b>   |  |                               |
| <b>Current liabilities:</b>   |  |                               |
| Accounts payable . . . . .  | \$ 76,672                                | \$ 44,302                     |
| Accrued expenses . . . . .  | 14,722                                   | 13,486                        |
| Dividends payable . . . . .   | 200                                      | 168                           |
|   | -----                                    | -----                         |
| Total current liabilities . . . . .   | 91,594                                   | 57,956                        |
| Deferred compensation . . . . .   | 3,131                                    | 2,183                         |
| Other liabilities . . . . .   | 321                                      | 160                           |
|   | -----                                    | -----                         |
| Total liabilities . . . . .   | 95,046                                   | 60,299                        |
|   | -----                                    | -----                         |
| <b>Commitments and contingencies</b>  |  |                               |
| <b>Stockholders' equity:</b>  |  |                               |
| Common stock, par value \$.05 per share,<br>Authorized 15,000,000 shares; issued and<br>outstanding 5,004,860 in 2007 and 4,788,162<br>shares in 2006 . . . . . | 250                                      | 120                           |
| Paid-in capital . . . . .   | 10,375                                   | 7,283                         |
| Retained earnings . . . . .   | 36,738                                   | 30,833                        |
|   | -----                                    | -----                         |
| Total stockholders' equity . . . . .  | 47,363                                   | 38,236                        |
|   | -----                                    | -----                         |
| Total liabilities and stockholders' equity . . . . .  | \$142,409                                | \$ 98,535                     |
|   | =====                                    | =====                         |

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The accompanying notes are an integral part of these balance sheets.

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VSE Corporation and Subsidiaries  
Consolidated Financial Statements

Consolidated Statements of Income (Unaudited)

(in thousands except share and per share amounts)

|   | For the three months<br>ended June 30, |           | For the six months<br>ended June 30, |            |
|---|--|-----------|--------------------------------------|------------|
|   | 2007                                   | 2006      | 2007                                 | 2006       |
|   | ----                                   | ----      | ----                                 | ----       |
| Revenues . . . . .                                  | \$ 159,644                             | \$ 94,844 | \$ 280,333                           | \$ 158,144 |
| Costs and expenses of<br>contracts . . . . .        | 153,904                                | 91,354    | 270,152                              | 152,266    |
| Gross profit. . . . .                               | 5,740                                  | 3,490     | 10,181                               | 5,878      |
| Selling, general and<br>administrative expenses . . | 243                                    | 295       | 394                                  | 418        |
| Interest income, net. . . . .                       | (255)                                  | (83)      | (371)                                | (220)      |
| Income before income taxes. .                       | 5,752                                  | 3,278     | 10,158                               | 5,680      |
| Provision for income taxes. .                       | 2,205                                  | 1,251     | 3,882                                | 2,168      |
| Net income. . . . .                                 | \$ 3,547                               | \$ 2,027  | \$ 6,276                             | \$ 3,512   |
|   | =====                                  | =====     | =====                                | =====      |
| Basic earnings per share . .                        | \$ 0.72                                | \$ 0.43   | \$ 1.29                              | \$ .74     |
|   | =====                                  | =====     | =====                                | =====      |
| Basic weighted average shares<br>outstanding        | 4,931,942                              | 4,733,424 | 4,870,027                            | 4,728,002  |
|   | =====                                  | =====     | =====                                | =====      |
| Diluted earnings per share. .                       | \$ 0.71                                | \$ 0.42   | \$ 1.27                              | \$ .72     |
|   | =====                                  | =====     | =====                                | =====      |
| Diluted weighted average<br>shares outstanding      | 4,977,390                              | 4,840,448 | 4,933,705                            | 4,853,468  |
|   | =====                                  | =====     | =====                                | =====      |
| Dividends declared per share                        | \$ 0.04                                | \$ 0.035  | \$ 0.075                             | \$ 0.065   |
|   | =====                                  | =====     | =====                                | =====      |

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

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VSE Corporation and Subsidiaries  
Consolidated Financial Statements

Consolidated Statements of Stockholders' Equity (Unaudited)

-----  
(in thousands except per share data)

|   | Common<br>Shares | Stock<br>Amount | Paid-In<br>Surplus | Retained<br>Earnings | Total<br>Stockholders'<br>Investment |
|---|------------------|-----------------|--------------------|----------------------|--------------------------------------|
|   | -----            | -----           | -----              | -----                | -----                                |
| Balance at<br>December 31, 2006   | 2,394            | \$ 120          | \$ 7,283           | \$ 30,833            | \$38,236                             |
| Net income . . . . .  | -                | -               | -                  | 6,276                | 6,276                                |
| Stock-based compensation . . . . .  | 2                | -               | 172                | -                    | 172                                  |
| Exercised stock options . . . . .   | 106              | 5               | 1,555              | -                    | 1,560                                |
| Excess tax benefits from<br>Share-based payment<br>arrangements . . . . . | -                | -               | 1,490              | -                    | 1,490                                |
| Stock split effected in the<br>form of a 100% stock dividend .            | 2,503            | 125             | (125)              | -                    | -                                    |
| Dividends declared (\$.075) . . . . .                                     | -                | -               | -                  | (371)                | (371)                                |
|   | -----            | -----           | -----              | -----                | -----                                |
| Balance at<br>June 30, 2007   | 5,005            | \$ 250          | \$10,375           | \$ 36,738            | \$47,363                             |
|   | =====            | =====           | =====              | =====                | =====                                |

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

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VSE Corporation and Subsidiaries  
Consolidated Financial Statements (Unaudited)

Consolidated Statements of Cash Flows

(in thousands)

|  | For the six months<br>ended June 30 |          |
|--|-------------------------------------|----------|
|  | 2007                                | 2006     |
|  | ----                                | ----     |
| Cash flows from operating activities:  |                                     |          |
| Net income . . . . .   | \$ 6,276                            | \$ 3,512 |
| Adjustments to reconcile net income to net cash<br>provided by (used in) operating activities: |                                     |          |
| Depreciation and amortization . . . . .  | 1,357                               | 791      |
| Loss on sale of property and equipment . . . . .   | 1                                   | 8        |
| Deferred taxes . . . . .   | (480)                               | (559)    |
| Stock-based compensation . . . . .   | 172                                 | 182      |
| Change in operating assets and liabilities, net of<br>effect of business combination:          |                                     |          |
| (Increase) decrease in:  |                                     |          |
| Accounts receivable, net. . . . .  | (34,341)                            | (10,799) |
| Contract inventories . . . . .   | 3,136                               | (4,379)  |
| Other current assets and noncurrent assets . . . . .   | (1,218)                             | (1,453)  |
| Increase (decrease) in:  |                                     |          |
| Accounts payable and deferred compensation . . . . .   | 29,832                              | 8,370    |
| Accrued expenses . . . . .   | (1,213)                             | (1,616)  |
| Other liabilities . . . . .  | 161                                 | 33       |
| Net cash provided by (used in) operating activities  | 3,683                               | (5,910)  |
|  | -----                               | -----    |
| Cash flows from investing activities:  |                                     |          |
| Purchases of property and equipment . . . . .  | (2,271)                             | (1,658)  |
| Acquisition of ICRC . . . . .  | (11,601)                            | -        |
| Net cash used in investing activities  | (13,872)                            | (1,658)  |
|  | -----                               | -----    |
| Cash flows from financing activities:  |                                     |          |
| Dividends paid . . . . .   | (339)                               | (283)    |
| Excess tax benefits from share-based<br>payment arrangements . . . . .                         | 1,490                               | 92       |
| Proceeds from the exercise of options of common stock . . . . .                                | 1,560                               | 118      |
| Net cash provided by (used in) financing activities  | 2,711                               | (73)     |
|  | -----                               | -----    |

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|  |          |          |
|--|----------|----------|
| Net decrease in cash and cash equivalents . . . . .      | (7,478)  | (7,641)  |
| Cash and cash equivalents at beginning of period . . . . | 8,745    | 12,717   |
|  | -----    | -----    |
| Cash and cash equivalents at end of period . . . . .     | \$ 1,267 | \$ 5,076 |
|  | =====    | =====    |

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

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### VSE CORPORATION AND SUBSIDIARIES NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Unaudited)

#### (1) Basis of Presentation

The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States for interim financial information and the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by accounting principles generally accepted in the United States for complete financial statements. In the opinion of management, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation have been included. Operating results for the three and six months ended June 30, 2007 are not necessarily indicative of the results that may be expected for the year ending December 31, 2007. For further information refer to the consolidated financial statements and footnotes thereto included in the VSE Corporation Annual Report on Form 10-K for the year ended December 31, 2006.

Management of VSE's business operations is conducted under four reportable operating segments, the Federal Group, the International Group, the Energy and Environmental Group, and the Infrastructure and Information Technology Group.

#### Use of Estimates in the Preparation of Financial Statements

The preparation of financial statements in conformity with accounting principles generally accepted in the United States requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. Significant estimates affecting the financial statements include the allowance for doubtful accounts, accruals for loss contracts, contract disallowance reserves, self insured health claims and estimated cost to complete on firm fixed-price contracts.

#### Stock Split

On May 1, 2007, VSE announced a two for one stock split in the form of a 100% stock dividend payable to stockholders of record as of June 11, 2007. The stock dividend was made on June 28, 2007. All share and per share amounts

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have been adjusted to give retroactive effect to the increased number of common shares outstanding due to the stock split.

### (2) Contract Inventories

The components of contract inventories as of June 30, 2007 and December 31, 2006 were as follows (in thousands):

|                            | 2007     | 2006     |
|----------------------------|----------|----------|
|                            | ----     | ----     |
| Work in process . . . . .  | \$ 1,323 | \$ 4,459 |
|                            | -----    | -----    |
| Total contract inventories | \$ 1,323 | \$ 4,459 |
|                            | =====    | =====    |

Contract inventories consist of materials purchased, and other expenditures for use in a contract to modify and apply a protective system, the Tanker Ballistic Protection System ("TBPS") to military vehicles for the U.S. Army.

Although these costs are classified as inventories for accounting purposes, they are similar in nature to materials and direct supplies purchased for use in performance on the Company's other contracts in that they are solely and

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### VSE CORPORATION AND SUBSIDIARIES NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Unaudited)

directly attributable to the contract and will be billed to the customer within a relatively short time. These materials and direct supplies will not be restocked to maintain any permanent inventory levels. Contract inventories are relieved when units are delivered and revenue is recognized.

Work in process inventories consist of amounts for materials, supplies and other expenditures for which work has been performed but for which the end unit has not yet been completed and accepted. Work in process inventories at June 30, 2007 and December 31, 2006 included applicable indirect cost burdens, including general and administrative costs totaling approximately \$181 thousand and \$608 thousand, respectively. Indirect cost burdens, including general and administrative costs charged to cost of sales from inventories for the periods ended June 30, 2007 and December 31, 2006 totaled \$1.6 million and \$3.9 million, respectively.

### (3) Debt

VSE has a loan agreement with a bank under which credit is made available to the Company in the form of revolving loan amounts or letters of credit. The bank loan agreement provided loan financing up to a maximum commitment of \$15 million as of June 30, 2007. The expiration date of the loan agreement is May 31, 2008. From time to time the bank and the Company may negotiate an amendment to the loan to increase or decrease the amount of available credit, to change the expiration date to a later date, or make other changes in the terms of the agreement. The Company and its bank are currently in negotiation, and the Company has received a commitment letter from the bank, to increase the maximum commitment amount to \$25 million, extend the expiration date, and make certain other changes.

The loan agreement contains terms whereby the Company may borrow against the



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revolving loan and at any time and from time to time can prepay such borrowings in whole or in part without premium or penalty. There are collateral requirements by which Company assets secure amounts outstanding, restrictive covenants that include minimum tangible net worth and profitability requirements, a limit on annual dividends, and other affirmative and negative covenants. As of June 30, 2007 the Company has not been notified by the bank, nor is the Company aware of any default under the loan agreement.

The Company pays a commitment fee, interest on any revolving loan borrowings at a prime-based rate or an optional LIBOR-based rate, and fees on any letters of credit that are issued. As of June 30, 2007 and December 31, 2006, there were no revolving loan amounts outstanding or letters of credit in effect. There was no interest expense incurred on the loan for the six months ended June 30, 2007 or June 30, 2006.

### (4) Stock-based Compensation

#### 2006 Restricted Stock Plan

On May 2, 2006, the Company's stockholders approved the VSE Corporation 2006 Restricted Stock Plan (the "2006 Plan"). Under the 2006 Plan, not more than a total of 250,000 shares of VSE Common Stock, par value \$.05 per share ("shares" or "VSE Stock") may be issued. The shares issued under the 2006 Plan may, at the Company's option, be either shares held in treasury or shares originally issued.

On January 2, 2007 and June 27, 2006, the Company granted 4,800 shares and 3,600 shares, respectively, of restricted VSE Stock to the Company's outside Directors under the 2006 Plan. The fair market value on the grant date was \$16.84 and \$15.75 per share, respectively. The shares issued vested

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

immediately and cannot be sold, transferred, pledged or assigned before the second anniversary of the grant date.

The Company notified certain employees of their participation in the 2006 VSE Corporation Restricted Stock Plan for calendar year 2007 on January 3, 2007. Accordingly, such employees are eligible to receive an award based on VSE's financial performance for 2007. The earned amount will be expensed ratably over the vesting period of approximately three years, including the service period of one year which begins on January 1, 2007. As a result, the Company has recognized approximately \$86 thousand and \$139 thousand in related expense for the three and six months ended June 30, 2007, respectively.

#### Stock Option Plans

##### 2004 Stock Option Plan

As of June 30, 2007, options issued under the 2004 Plan for up to 88,476 shares remain outstanding. Each option granted under the 2004 Plan was issued at the fair market value of VSE shares on the date of grant. Each option vests 25% on date of award and 25% on each anniversary date thereafter, becoming 100% vested as of the third anniversary date of award. The 2004 Plan will terminate on the earliest of May 1, 2014, or the date on which all options issued under the 2004 Plan have been exercised, expire, or have been

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terminated.

### 1998 Stock Option Plan

As of June 30, 2007, options issued under the 1998 Plan for up to 32,876 shares remain outstanding. The 1998 Plan will terminate on the earliest of May 6, 2008, or the date on which all options issued under the 1998 Plan have been exercised, expire, or have been terminated.

### Accounting for Stock-based Compensation

As a result of adopting SFAS 123(R) on January 1, 2006, the Company has recognized approximately \$46 thousand and \$91 thousand in compensation costs for the three and six month periods ended June 30, 2007, respectively, and approximately \$63 thousand and \$126 thousand for the three and six month periods ended June 30, 2006, respectively. The Company's net income was approximately \$29 thousand lower or approximately \$.01 per share basic and diluted and \$57 thousand lower or approximately \$.01 per share basic and diluted for the three and six month periods ended June 30, 2007, respectively, and approximately \$39 thousand lower or approximately \$.01 per share basic and diluted and \$78 thousand lower or approximately \$.02 per share basic and diluted for the three and six month periods ended June 30, 2006, respectively, than if it had continued to account for share-based compensation under Opinion 25. The total compensation cost not yet recognized in the Company's income before income taxes as of June 30, 2007 is approximately \$91 thousand, to be recognized over approximately six months.

Prior to the adoption of SFAS 123(R), the Company presented all tax benefits of deductions resulting from the exercise of stock options as operating cash flows in the Statement of Cash Flows. SFAS 123(R) requires the cash flows resulting from the tax benefits resulting from tax deductions in excess of the compensation cost recognized for those options (excess tax benefits) to be classified as financing cash flows. Approximately \$1.5 million and \$92 thousand in excess tax benefits classified as cash provided by financing activities for the six months ended June 30, 2007 and 2006, respectively, would have been classified as cash provided by operating activities if the Company had not adopted SFAS 123(R).

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### VSE CORPORATION AND SUBSIDIARIES NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Unaudited)

Set forth below is a summary of the Company's stock option activity for the six months ended June 30, 2007 and 2006:

|                                       | 2007      | Weighted<br>Average<br>Exercise<br>Price | 2006     | Weighted<br>Average<br>Exercise<br>Price |
|---------------------------------------|-----------|--|----------|--|
|                                       | ----      | -----                                    | ----     | -----                                    |
| Number of shares under stock options: |           |  |          |  |
| Outstanding at beginning of period    | 333,250   | \$ 8.61                                  | 395,126  | \$ 7.92                                  |
| Exercised                             | (211,898) | 7.36                                     | (19,376) | 6.01                                     |
|                                       | -----     | -----                                    | -----    | -----                                    |
| Outstanding at end of period          | 121,352   | \$10.80                                  | 375,750  | \$ 8.01                                  |
|                                       | =====     | =====                                    | =====    | =====                                    |
| Exercisable at end of period          | 86,352    | \$10.07                                  | 273,500  | \$ 7.03                                  |
|                                       | =====     | =====                                    | =====    | =====                                    |
| Weighted average remaining            |           |  |          |  |

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contractual life                                      1 Year                                      2 Years

The aggregate intrinsic values of outstanding, exercisable and exercised stock options as of June 30, 2007 and 2006 are as follows (in thousands):

|                           | 2007    | 2006    |
|---------------------------|---------|---------|
|                           | -----   | -----   |
| Outstanding stock options | \$2,306 | \$2,582 |
| Exercisable stock options | \$3,152 | \$2,148 |
| Exercised stock options   | \$3,955 | \$ 94   |

### (5) Earnings Per Share

Basic earnings per share have been computed by dividing net income by the weighted average number of shares of common stock outstanding during each period. Shares issued during the period are weighted for the portion of the period that they were outstanding.

Diluted earnings per share have been computed in a manner consistent with that of basic earnings per share while giving effect to all potentially dilutive common shares that were outstanding during each period. Potentially dilutive common shares include incremental common shares issuable upon exercise of stock options.

|                           | Three Months   |           | Six Months     |           |
|---------------------------|----------------|-----------|----------------|-----------|
|                           | Ended June 30, |           | Ended June 30, |           |
|                           | 2007           | 2006      | 2007           | 2006      |
|                           | ----           | ----      | ----           | ----      |
| Basic weighted average    |                |           |                |           |
| common shares outstanding | 4,931,942      | 4,733,424 | 4,870,027      | 4,728,002 |
| Diluted effect of options | 45,448         | 107,024   | 63,678         | 125,466   |
|                           | -----          | -----     | -----          | -----     |
| Diluted weighted average  |                |           |                |           |
| common shares outstanding | 4,977,390      | 4,840,448 | 4,933,705      | 4,853,468 |
|                           | =====          | =====     | =====          | =====     |

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

### (6) Income Taxes

The Company adopted the provisions of FIN 48, "Accounting for Uncertainty in Income Taxes - an interpretation of FASB Statement No. 109," (FIN 48), on January 1, 2007. As a result of the implementation of FIN 48, the Company made a comprehensive review of its portfolio of uncertain tax positions in accordance with recognition standards established by FIN 48. In this regard, an uncertain tax position represents the Company's expected treatment of a tax position taken in a filed tax return, or planned to be taken in a future tax return, that has not been reflected in measuring income tax expense for financial reporting purposes. As a result of this review, the Company concluded that at this time there are no uncertain tax positions. As a result of applying the provisions of FIN 48, there was no cumulative effect on retained earnings.

The Company is subject to U.S. federal income tax as well as income tax of

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multiple state jurisdictions. The Company has substantially concluded all U.S. federal income tax matters for years through 2004. Substantially all material state and local matters have been concluded for years through 2002.

In the Consolidated Statement of Income, the Company classifies interest expense related to unrecognized tax benefits as "Interest income, net" and any penalties in "Selling, general and administrative expenses." No interest or penalty expense related to unrecognized tax benefits was recognized for the six months ended June 30, 2007. As of June 30, 2007, no interest or penalties related to unrecognized tax benefits were accrued.

The Company had accrued approximately \$75 thousand related to expected interest payments to the Internal Revenue Service ("IRS") for an open tax issue. This tax issue was settled for approximately \$20 thousand of interest expense during the three months ended June 30, 2007. No penalty was assessed on the issue resolved.

### (7) Litigation

VSE and its subsidiaries have, in the normal course of business, certain claims against them and against other parties. In the opinion of management, the resolution of these claims will not have a material adverse effect on the Company's results of operations or financial position. However, the results of any legal proceedings cannot be predicted with certainty.

### (8) Segment Information

Management of VSE's business operations is conducted under four reportable operating segments, the Federal Group, the International Group, the Energy and Environmental Group, and the Infrastructure and Information Technology Group.

Federal Group - VSE's Federal Group provides engineering, technical, management, integrated logistics support, and information technology services to all U.S. military services and other government agencies. It consists of five divisions: CED, ELD, FSS, MSD and SED.

International Group - VSE's International Group provides engineering, industrial, logistics, and foreign military sales services to the U.S. military and other government agencies. It consists of three divisions: BAV, VCG and FMD.

Energy and Environmental Group - VSE's Energy and Environmental Group provides high-level consulting services in the field of energy and environmental

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

management. The Energy and Environmental Group includes VSE's wholly owned subsidiary, Energetics, Inc.

Infrastructure and Information Technology Group - VSE's Infrastructure and Information Technology Group, a new segment in the quarter ended June 30, 2007, consists of its wholly owned subsidiary, ICRC. ICRC is engaged principally in providing diversified technical and management services to the

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U.S. Government, including information technology, advanced vehicle technology, aerospace services, and engineering and transportation infrastructure services.

These segments operate under separate management teams and discrete financial information is produced for each segment. The Company evaluates segment performance based on consolidated revenues and profits or losses from operations before income taxes. The Company's segment information for the three and six months ended June 30, 2007 and 2006 is as follows (in thousands):

|   | Three Months   |          | Six Months     |           |
|---|----------------|----------|----------------|-----------|
|   | Ended June 30, |          | Ended June 30, |           |
|   | 2007           | 2006     | 2007           | 2006      |
|   | ----           | ----     | ----           | ----      |
| <b>Revenues:</b>                                |                |          |                |           |
| Federal Group                                   | \$ 83,292      | \$46,690 | \$153,795      | \$ 66,895 |
| International Group                             | 69,111         | 44,406   | 116,015        | 84,255    |
| Energy and Environmental Group                  | 3,607          | 3,720    | 6,853          | 6,944     |
| Infrastructure and Information Technology Group | 3,619          | -        | 3,619          | -         |
| Corporate                                       | 15             | 28       | 51             | 50        |
|   | -----          | -----    | -----          | -----     |
| Total revenues                                  | \$159,644      | \$94,844 | \$280,333      | \$158,144 |
|   | =====          | =====    | =====          | =====     |
| <b>Income before income taxes:</b>              |                |          |                |           |
| Federal Group                                   | \$ 3,038       | \$ 1,369 | \$ 5,764       | \$ 2,075  |
| International Group                             | 2,256          | 1,527    | 3,743          | 2,849     |
| Energy and Environmental Group                  | 454            | 460      | 767            | 836       |
| Infrastructure and Information Technology Group | 167            | -        | 167            | -         |
| Corporate/unallocated expenses                  | (163)          | (78)     | (283)          | (80)      |
|   | -----          | -----    | -----          | -----     |
| Income before income taxes                      | \$ 5,752       | \$ 3,278 | \$ 10,158      | \$ 5,680  |
|   | =====          | =====    | =====          | =====     |

### Customer Information

The Company is engaged principally in providing engineering, design, logistics, management and technical services to the U.S. Government (the "government"), other government prime contractors, and commercial entities. The largest customer for the Company's services is the U.S. Department of Defense ("Defense"), including agencies of the U.S. Navy, Army, and Air Force. The Company's revenue by customer is as follows (in thousands):

| Source of Revenues | Three Months   |          | Six Months     |           |
|--------------------|----------------|----------|----------------|-----------|
|                    | Ended June 30, |          | Ended June 30, |           |
|                    | 2007           | 2006     | 2007           | 2006      |
|                    | ----           | ----     | ----           | ----      |
| Army/Army Reserve  | \$ 78,142      | \$47,670 | \$144,026      | \$ 58,993 |
| Navy               | 59,755         | 42,413   | 100,176        | 87,453    |
| Treasury           | 13,450         | 267      | 22,328         | 506       |
| Other              | 8,297          | 4,494    | 13,803         | 11,192    |
|                    | -----          | -----    | -----          | -----     |
| Total Revenues     | \$159,644      | \$94,844 | \$280,333      | \$158,144 |
|                    | =====          | =====    | =====          | =====     |

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

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VSE does not measure revenue or profit by product or service lines, either for internal management or external financial reporting purposes, because it would be impractical to do so. Products offered and services performed are determined by contract requirements and the types of products and services provided for one contract bear no relation to similar products and services provided on another contract. Products and services provided vary when new contracts begin or current contracts expire. In many cases, more than one product or service is provided under a contract or contract task order. Accordingly, cost and revenue tracking is designed to best serve contract requirements and segregating costs and revenues by product or service lines in situations for which it is not required would be difficult and costly to both VSE and its customers.

### (9) Acquisition - Integrated Concepts and Research Corporation

On June 4, 2007, the Company acquired 100% of the voting equity of Integrated Concepts and Research Corporation ("ICRC") of Alexandria, Virginia. ICRC's core expertise lies in information technology, advance vehicle technology, aerospace, engineering and transportation infrastructure.

The Company paid approximately \$11.6 million in cash for the ICRC stock, with the potential for additional payments to ICRC shareholders of up to approximately \$5.8 million if certain financial targets are met during the next six years. Management believes that the addition of ICRC will provide the Company with an opportunity to expand and diversify its business across a number of project areas including smart vehicles, alternate fuels, large-scale port engineering development and security, and information technology services. The results of ICRC's operations are included in the accompanying consolidated financial statements beginning as of June 4, 2007.

Of the purchase price, approximately \$5.1 million was allocated to customer related intangibles to be amortized over six to eight years. In addition, approximately \$1.4 million was allocated to ICRC's trade name, which has an indefinite life, and approximately \$4 million was allocated to goodwill. Goodwill and intangible assets with indefinite lives are subject to review for impairment at least annually.

The Company plans to file an election under the Internal Revenue Code Section 338(h)(10) which will treat the transaction as a sale of assets for tax purposes.

The Company is following the guidance of SFAS No. 141 to record the purchase of ICRC. The Company is in the process of valuing the assets and liabilities of the acquisition. The purchase price allocation has not been finalized. The following table summarizes the preliminary estimated fair value of assets acquired and liabilities assumed at the date of acquisition (in thousands):

| Description                    | Fair Value |
|--------------------------------|------------|
| -----                          | -----      |
| Current assets                 | \$ 6,544   |
| Property and equipment         | 429        |
| Other assets                   | 27         |
| Intangibles - customer related | 5,124      |
| Intangibles - trade name       | 1,360      |
| Goodwill                       | 3,997      |
|                                | -----      |
| Total assets acquired          | 17,481     |
|                                |            |
| Liabilities assumed            | (5,880)    |
|                                | -----      |

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|                    |                   |
|--------------------|-------------------|
| Net purchase price | \$11,601<br>===== |
|--------------------|-------------------|

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

### Pro Forma Information

The following unaudited condensed pro forma results of operations sets forth the consolidated revenue, net income, and basic and diluted earnings per share of the Company for the three and six months ended June 30, 2007. The information has been compiled as if the ICRC acquisition had occurred at the beginning of the period presented. The pro forma results include the amortization of customer related intangible assets, net of tax, of approximately \$112 thousand and \$225 thousand for the three and six month periods ended June 30, 2007, respectively. These intangible assets are being amortized over a period of six to eight years. The pro forma results also include non-recurring acquisition costs, net of tax, of approximately \$389 thousand and \$449 thousand (\$.08 per share basic and diluted and \$.09 per share basic and diluted) incurred by ICRC for the three and six month periods ended June 30, 2007, respectively. This unaudited pro forma information does not purport to be indicative of the actual results that would have occurred if the acquisition had actually been completed on January 1, 2007 due in part to the acquisition related expenses.

|                            | (in thousands)                                 |  |
|----------------------------|--|--|
|                            | Three Months<br>Ended June 30,<br>2007<br>---- | Six Months<br>Ended June 30,<br>2007<br>---- |
| Revenues                   | \$166,089<br>=====                             | \$297,666<br>=====                           |
| Net income                 | \$ 3,283<br>=====                              | \$ 5,989<br>=====                            |
| Basic earnings per share   | \$ .67<br>=====                                | \$ 1.23<br>=====                             |
| Diluted earnings per share | \$ .66<br>=====                                | \$ 1.21<br>=====                             |

### (10) Recent Accounting Pronouncements

In February 2007, the FASB issued Statement of Financial Accounting Standards (SFAS) No. 159, "The Fair Value Option for Financial Assets and Financial Liabilities - Including an amendment of FASB Statement No. 115." SFAS No. 159 permits entities to choose to measure eligible items at fair value at specified election dates and report unrealized gains and losses on items for which the fair value option has been elected in earnings at each subsequent reporting date. SFAS No. 159 is effective for fiscal years beginning after November 15, 2007. Management is currently evaluating the effect that adoption of this statement will have on the Company's consolidated financial position and results of operations when it becomes effective in 2008.

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

Executive Overview

VSE Organization

VSE's business operations consist primarily of services performed by the Company's unincorporated divisions and wholly owned subsidiaries. The Company uses multiple operating entities to bid on and perform contract work. The use of an operating structure with multiple entities gives the Company certain competitive advantages and the flexibility to pursue a diverse business base. The term "VSE" or "Company" refers to VSE and its divisions and subsidiaries unless the context indicates operations of the parent company only.

Unincorporated divisions include BAV Division ("BAV"), Communications and Engineering Division ("CED"), Coast Guard Division ("VCG"), Engineering and Logistics Division ("ELD") beginning in 2006, Field Support Services Division ("FSS") beginning in June 2007, Fleet Maintenance Division ("FMD"), Management Sciences Division ("MSD"), and Systems Engineering Division ("SED"). Energetics Incorporated ("Energetics") and Integrated Concepts and Research Corporation ("ICRC"), acquired in June 2007, are VSE's currently active subsidiaries.

VSE previously conducted business operations in other subsidiaries and divisions that had no operating activity in 2006 and 2007.

VSE Customers and Services

The Company is engaged principally in providing engineering, design, logistics, management and technical services to the U.S. Government (the "government"), other government prime contractors, and commercial entities. The largest customer for the Company's services is the U.S. Department of Defense ("Defense"), including agencies of the U.S. Navy, Army, and Air Force.

VSE Operating Segments

Management of VSE's business operations is conducted under four reportable operating segments, the Federal Group, the International Group, the Energy and Environmental Group, and the Infrastructure and Information Technology Group.

Federal Group - VSE's Federal Group provides engineering, technical, management, integrated logistics support, and information technology services to all U.S. military services and other government agencies. It consists of five divisions - CED, ELD, FSS, MSD, and SED.

CED is dedicated to supporting the Army's Communications and Electronics Command (CECOM) in the management and execution of the Rapid Response (R2) Program, which supports clients across DoD and the Federal Government. CED manages execution of tasks involving research and development, technology insertion, systems integration and engineering, hardware/software fabrication and installation, testing and evaluation, studies and analysis, technical data management, logistics support, training, and acquisition support.

CED Army Equipment Support Program - In December 2005, VSE's CED Division was



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awarded a task order on its Rapid Response support contract to provide maintenance and logistics services in support of U.S. Army equipment in Iraq and Afghanistan. Services provided under this program include deployed sustainment management, deployed logistics and repairs management, unique system training and curriculum support, resource management, and acquisition and administrative support. Work on this program began in 2006.

A large majority of the services on this program are provided by CED's subcontractor. CED provides certain program management services. The contract task order has a base year valued at approximately \$139 million and an additional one-year option period valued at approximately \$212 million. In

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June 2007, VSE's FSS division began providing some field service support on this program. This program contributed significantly to VSE's revenues in 2006 and the first two quarters of 2007, and based on the contract value and a significant level of contract funding and funded backlog, is expected to contribute significantly to VSE's revenues in the remaining two quarters of 2007; however, profit margins on subcontract work such as this are lower than on work performed by Company personnel.

ELD provides full life cycle engineering, logistics, maintenance, and refurbishment services to extend and enhance the life of existing equipment. ELD principally supports the U.S. Army, Army Reserve, and Army National Guard with core competencies in combat and combat service support system conversions, technical research, sustainment and re-engineering, system integration, and configuration management.

FSS was formed in June 2007 to provide worldwide field maintenance and logistics support services for a wide variety of military vehicles and equipment including performance of organizational, intermediate and specialized depot-level maintenance. FSS principally supports the U.S. Army and Marine Corps by providing specialized Field Service Representatives (FSR) and Field Support Teams (FST) in areas of combat operations and austere environments.

MSD provides nationally and internationally recognized experts in product and process improvement, supporting a variety of government and commercial clients. MSD provides training, consulting, and implementation support in the areas of: Enterprise Excellence, Lean Six Sigma, process and product optimization, project management, leadership quality engineering, Integrated Product and Process Development (IPPD), and reliability engineering. MSD's services range from individual improvement projects to global organizational change programs.

SED provides comprehensive systems and software engineering, logistics, and prototyping services to DoD. SED principally supports U.S. Army, Air Force, and Marine Corps combat and combat support systems. SED's core competencies include: systems technical support, configuration management, and life cycle support for wheeled and tracked vehicles and ground support equipment; obsolescence management, service life extension, and technology insertion programs; and technical documentation and data packages.

TBPS Program - VSE's SED Division performs work on a program to provide a protection system, the Tanker Ballistic Protection System ("TBPS"), for vehicles deployed by the U.S. Army in Iraq. Under this program, SED applies a polyurethane based ballistic coating system and necessary Add-on Armor Panels for Army Fuel Dispensing Tankers as protection from hostile fire. Delivery of completed vehicle protection systems began in January 2005.

SED has performed on the TBPS program under multiple firm fixed price per unit

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contracts. Subsequent to program implementation, VSE has received modifications to consolidate contracting activity into fewer contracts and to adjust the number of tankers based on Army tanker availability and needs, and the possibility remains that there may be future contract modifications as the Army's needs change. The total contract ceiling value on the TBPS Program contracts as of June 30, 2007 was approximately \$78 million, and the remaining available contract ceiling as of June 30, 2007 was approximately \$5.2 million. These contract ceiling amounts are fully funded. The U. S. Army recently identified additional work to continue the TBPS program, and subsequent to June 30, 2007, added contract value and funding of approximately \$11.3 million and extended contractual coverage on the program through July 2008.

The TBPS Program contributed to increases in VSE financial results in 2006 and the first two quarters of 2007. The work performed on this program increases the amount of fixed price contract work performed by the Company. In general, fixed price contract work carries a higher level of risk and has higher profit margins than work on other contract types. Accordingly, the TBPS program presents VSE's business with the potential for both increased profit margins and increased risks of incurring a loss.

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International Group - VSE's International Group provides engineering, industrial, logistics, and foreign military sales services to the U.S. military and other government agencies. It consists of three divisions - BAV, FMD, and VCG.

BAV provides assistance to the U.S. Navy in executing its Foreign Military Sales (FMS) Program for surface ships sold, leased or granted to foreign countries by providing program management, engineering, technical support, and logistics services for ship reactivations and transfers, as well as follow-on support. BAV's expertise includes: ship reactivation/transfer, overhaul and maintenance, follow-on technical support, FMS integrated logistics support, engineering and industrial services, training, and spare and repair parts support.

BAV Ship Transfer Program - BAV provides its ship transfer services to the Navy under large omnibus contracts. During its life, this program has been a significant revenue producer for the Company. The level of revenues and associated profits resulting from fee income generated by this program varies depending on a number of factors, including the timing of ship transfers and associated support services ordered by foreign governments and economic conditions of potential customers worldwide. The Company has experienced significant quarterly and annual revenue fluctuations and anticipates that future quarterly and annual revenues will be subject to variation due to changes in the level of activity associated with the Navy's ship transfer program. The transfer of four U.S. Navy ships to Taiwan conducted under this program was a major contributor to the Company's revenues in 2006.

The original contract associated with this program was a ten-year cost-plus award fee contract awarded in 1995 with a total ceiling value of more than \$1 billion. BAV was awarded a second contract in April 2005 to continue work on this program. The new contract is a five-year cost-plus award fee contract with a total ceiling value of approximately \$544 million. The Navy began issuing orders on the new contract in the second quarter of 2005 and ceased issuing orders for new work on the original contract at that time. BAV continued work associated with the transfer of four ships to Taiwan under delivery orders issued on the original contract until the work was substantially completed in 2006.

Contract terms under both the original and new contracts specify base fee payments and award fee payments to BAV. Base fee payments are determined by

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level of contract activity and base fee income is recognized each month. Award fee payments are determined by performance and level of contract activity. A contract modification authorizing the award fee payment is issued subsequent to the period in which the work is performed. The Company does not recognize award fee income until the fees are fixed and determinable, generally upon contract notification confirming the award fee. Award fees are made three times during the year. Accordingly, the Company typically has three quarterly reporting periods per year that include the recognition of BAV award fee income and one quarterly reporting period that does not include BAV award fee income. Due to such timing, and to fluctuations in the level of revenues, profits as a percentage of revenues will fluctuate from period to period. The Company recognized BAV award fee income in the three-month periods ended March 31 and June 30, 2007. In 2006, the Company recognized BAV award fee income in each of the three-month periods ended March 31, June 30, and December 31, and did not recognize any BAV award fee income in the three-month period ended September 30.

FMD provides global field engineering, logistics, maintenance, and information technology services to the U.S. Navy and Air Force, including fleet-wide ship and aircraft support programs. FMD's expertise includes ship repair and modernization, ship systems installations, ordnance engineering and logistics, facility operations, war reserve materials management, aircraft sustainment and maintenance automation, and IT systems integration. FMD also provides management, maintenance, storage, and disposal support for the U.S. Department of Treasury's seized and forfeited general property program.

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Treasury Seized Asset Program - In August 2006, VSE was awarded a contract to support the U.S. Department of the Treasury seized and forfeited general property program. VSE assembled a team of experts to support all phases of the contract including consolidating general personal property into Regional Property Management Centers, optimizing vehicle sales at facilities nationwide, providing field representatives nationwide to support local seizures, and utilizing the services of recognized sales and marketing organizations to increase the sales of general property and vehicles while providing the Government with visibility, accountability, and controls. This is a single award, cost-plus-incentive-fee contract that includes a base period of performance, four option periods, and award term provisions. Phase in work on the contract began in 2006 to transition the program from a predecessor contractor. This program has the potential to be a significant contributor to VSE's financial results in 2007 and future years. If all option and award term periods are exercised, contract performance is expected to continue through September 30, 2014. While the contract award specified an amount of approximately \$113 million under the base and option periods, revenues may be more or less than this amount depending on service requirements.

Contract terms specify base fee payments and incentive fee payments to VSE. Base fee payments are determined by level of contract activity and base fee income is recognized each month. Incentive fee payments are determined by performance and level of contract activity. Incentive fees are earned once annually and incentive fee amounts are determined based on the evaluation of the incentive by the customer following the government's September 30 fiscal year end. The Company does not know the amount of incentive fee income for the year until after notification of the results of this evaluation. The Company does not recognize incentive fee income until the fees are fixed and determinable. Accordingly, the Company will not recognize incentive fee income until after notification of the results of the evaluation and will recognize the entire annual amount of incentive fee income at one time. Due to such timing, and to fluctuations in the level of revenues, profits as a percentage of revenues will vary from period to period. The Company recognized base fee

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income on this contract for the six months ended June 30, 2007, but has not yet recognized any incentive fee income during this period.

VCG provides the U.S. Coast Guard with FMS support and life cycle support for vessels transferred to foreign governments. VCG's core competencies include pre-transfer joint vessel inspections, reactivations, crew training, transit assistance, heavy-lift contracting, logistics support, technical support, and overseas husbandry.

Energy and Environmental Group - VSE's Energy and Environmental Group provides high-level consulting services in the field of energy and environmental management. The Energy and Environmental Group includes VSE's wholly owned subsidiary, Energetics, Inc.

Energetics, Inc. is a full-service energy and environmental consulting company providing technical and management support in all aspects of technology research, development, and demonstration. The company's expertise lies in state-of-the-art and advanced technology assessment, technical and economic feasibility analysis, technology transfer, R&D program planning, engineering studies, market assessment, strategic resource management, regulatory analysis, environmental compliance, and risk management. Founded in 1979 and acquired by VSE in 1995, Energetics has enjoyed steady growth as a result of its dedication to providing superior products and services to clients in both the public and private sectors.

Infrastructure and Information Technology Group - VSE's Infrastructure and Information Technology Group, a new segment in the second quarter of 2007, consists of its wholly owned subsidiary, ICRC. VSE purchased ICRC in June 2007 for approximately \$11.6 million in cash, with the potential for additional payments of up to approximately \$5.8 million if certain financial targets are met during the next six years.

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ICRC is engaged principally in providing diversified technical and management services to the U.S. Government, including information technology, advanced vehicle technology, aerospace services, and engineering and transportation infrastructure services. The acquisition of ICRC provides VSE with an opportunity to expand VSE's presence in the markets it serves; opens or expands markets in smart vehicles, alternate fuels, large-scale port engineering development and security, and information technology services; adds approximately 200 technical and professional employees to VSE's staff; and adds several long-term contracts to VSE's business base. For its fiscal year ended March 31, 2007, ICRC recorded revenues of approximately \$59 million and net income of approximately \$1.5 million. VSE consolidated results of operations for the six months ended June 30, 2007 include ICRC operations from the June 4, 2007 date of acquisition through June 30, 2007.

### Pro Forma Information

The following unaudited condensed pro forma results of operations sets forth the consolidated revenue, net income, and basic and diluted earnings per share of the Company for the three and six months ended June 30, 2007. The information has been compiled as if the ICRC acquisition had occurred at the beginning of the period presented. The pro forma results include the amortization of customer related intangible assets, net of tax, of approximately \$112 thousand and \$225 thousand for the three and six month periods ended June 30, 2007, respectively. These intangible assets are being amortized over a period of six to eight years. The pro forma results also include non-recurring acquisition costs, net of tax, of approximately \$389 thousand and \$449 thousand (\$.08 per share basic and diluted and \$.09 per share basic and diluted) incurred by ICRC for the three and six month periods

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ended June 30, 2007, respectively. This unaudited pro forma information does not purport to be indicative of the actual results that would have occurred if the acquisition had actually been completed on January 1, 2007 due in part to the acquisition related expenses.

|                            | (in thousands)                         |                                      |
|----------------------------|--|--------------------------------------|
|                            | Three Months<br>Ended June 30,<br>2007 | Six Months<br>Ended June 30,<br>2007 |
|                            | ----                                   | ----                                 |
| Revenues                   | \$166,089                              | \$297,666                            |
|                            | =====                                  | =====                                |
| Net income                 | \$ 3,283                               | \$ 5,989                             |
|                            | =====                                  | =====                                |
| Basic earnings per share   | \$ .67                                 | \$ 1.23                              |
|                            | =====                                  | =====                                |
| Diluted earnings per share | \$ .66                                 | \$ 1.21                              |
|                            | =====                                  | =====                                |

### Government Procurement Policies and Practices

VSE's business is subject to the risks arising from economic conditions and political factors that may impact the budgets and program funding of customers served through VSE's contracts. VSE's revenues have historically been subject to annual fluctuations resulting from changes in the level of Defense spending. Future budgetary and funding decisions by government lawmakers or Defense restructuring efforts could affect the types and level of services provided by VSE to its government customers and could potentially have a material adverse impact on the Company's results of operations or financial condition.

The revenues of the Company depend on its ability to win new contracts and on the amount of work ordered by the government under the Company's existing contracts. The Company's ability to win new contracts is affected by government acquisition policies and procedures, including government procurement practices that in some years have tended toward bundling work efforts under large comprehensive ("omnibus") management contracts. This emphasis on large contracts presents challenges to winning new contract work, including making it more difficult for the Company to qualify as a bidder, increasing the level of competition due to the award of fewer contracts, and forcing the Company into competition with larger organizations that have

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greater financial resources and larger technical staffs. Competing for these contracts requires the Company to use teams of subcontractors to be able to offer the range of technical competencies needed to do the work. While the use of subcontractors on a large scale basis allows the Company to compete for this work, profit margins on subcontract work are lower than on work performed by Company personnel, thereby reducing the Company's overall profit margins.

The use of subcontractors on government contracts also raises certain performance and financial risks to VSE because government prime contractors are responsible for performing to the requirements of the contract and ensuring compliance with U.S. Government regulations relative to the performance by subcontractors.

Other government procurement practices that can affect the Company's revenues are 1) the length of contracts issued, which may vary depending on changes in contracting regulations and other factors; 2) the use of past performance criteria that may preclude entrance into new government markets; and 3)

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government social programs that limit contract work to small, woman, or minority owned businesses. Additional risk factors that could potentially affect the Company's results of operations are the government's right to terminate contracts for convenience, the government's right to not exercise all of the option periods on a contract, and funding delays caused by government political or administrative actions.

### Global Economic Conditions and Political Factors

VSE's business is subject to the risks arising from global economic conditions and political factors associated with current and potential customers served through VSE's contracts with the U.S. Government. An economic slowdown in countries served under the BAV Ship Transfer Program could potentially affect sales. Failure by the government of a potential foreign customer to approve and fund acquisition of U.S. Navy ships serviced under this program could affect sales. In any one year, a significant amount of the Company's revenues may result from sales on the BAV Ship Transfer Program to a single foreign government. BAV sales to Egypt have historically comprised a large percentage of the Company's total sales in any one year.

The ongoing international situation posed by potential terrorist activity and conflicts in the Middle East could potentially increase the political risks for revenues from the BAV Ship Transfer, TBPS, and CED Army Equipment Support Programs. International tensions can also affect work by FMD on U.S. Navy ships when they are deployed outside of U.S. Navy facilities and are unavailable for maintenance work during this time period. Adverse results arising from these global economic and political risks could potentially have a material adverse impact on the Company's results of operations.

### Concentration of Revenues (in thousands) For the six months ended June 30,

| Source of Revenue             | 2007      | %   | 2006      | %   |
|-------------------------------|-----------|-----|-----------|-----|
| -----                         | Revenues  | -   | Revenues  | -   |
| CED Army Equipment Support    | \$ 92,701 | 33  | \$ 28,366 | 18  |
| BAV India                     | 31,489    | 11  | -         | -   |
| BAV Egypt                     | 28,444    | 10  | 24,792    | 16  |
| BAV Taiwan                    | 3,671     | 1   | 29,969    | 19  |
| BAV Other                     | 2,011     | 1   | 4,248     | 2   |
|                               | -----     | --- | -----     | --- |
| Total BAV                     | 65,615    | 23  | 59,009    | 37  |
| TBPS Program                  | 13,366    | 5   | 14,200    | 9   |
| Treasury Seized Asset Program | 21,650    | 8   | -         | -   |
| VSE Other                     | 87,301    | 31  | 56,569    | 36  |
|                               | -----     | --- | -----     | --- |
| Total Revenues                | \$280,333 | 100 | \$158,144 | 100 |
|                               | =====     | === | =====     | === |

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### Management Outlook

The Company's growth in revenues and profits continued in the first six months of 2007. Subject to the risk elements discussed above, VSE believes it has the potential to sustain these revenue and profit levels through the remainder of 2007. Discussion of some of the events and circumstances that will impact the

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Company's results follows below.

CED Army Equipment Support Program. CED began work on this program in 2006 and revenues from this program in 2006 were approximately \$106 million. Work on the program is expected to increase in 2007. Revenues for the six months ended June 30, 2007 were approximately \$93 million. The contract task orders for this program are incrementally funded, with funded backlog of approximately \$134 million as of June 30, 2007. While profit margins on this program are expected to be low, the Company expects to benefit from the increased revenue base that this program provides.

ICRC Acquisition. The acquisition of ICRC will immediately contribute to VSE's revenues and profits in 2007 and in future years, making ICRC a key contributor to the Company's future growth. Revenues for ICRC were approximately \$59 million in its most recently completed fiscal year ended March 31, 2007.

Treasury Seized Asset Program. Phase in work on this program began in 2006 to transition the program from a predecessor contractor. Revenues for the six months ended June 30, 2007 were approximately \$22 million. This program has the potential to be a significant contributor to VSE's financial results in 2007 and future years.

BAV Ship Transfer Program. Work on the transfer of four U.S. Navy ships to Taiwan under this program was substantially completed in September 2006, marking the end of a major contributor to the Company's revenues in recent years. Despite the absence of this work going forward, BAV has some solid prospects for follow on work in Taiwan and additional work in other countries, including work currently performed to transfer a ship to India. The Company expects the BAV Ship Transfer Program to continue to be a major provider of revenues in 2007 and future years. Funded backlog on the BAV Ship Transfer Program was approximately \$68 million as of June 30, 2007.

TBPS Program. The U. S. Army recently identified additional work to continue the TBPS program, added funding, and extended contractual coverage on the program through July 2008. Revenues from this program were approximately \$30 million in both 2006 and 2005. While 2007 revenues are expected to be slightly less than this level, the TBPS program will continue to be a strong contributor to VSE financial results in 2007. Funded backlog remaining on the program was approximately \$5.2 million as of June 30, 2007, and additional contract value and funding of approximately \$11.3 million was received in July 2007.

ELD Equipment Refurbishment Services. VSE has provided the U. S. Army Reserve with military vehicle and equipment refurbishment services for several years. Beginning in 2006, VSE formed ELD to continue the performance of these services. ELD has expanded its workforce, facilities, capacity to perform work, contractual coverage and funding since its inception, resulting in increases in revenues from these services in 2006 and the first six months of 2007. The Company expects further increases in the remainder of 2007 and future years.

Other Significant Contracts. VSE has three multiyear, multiple award, indefinite delivery, indefinite quantity contracts that have large nominal ceiling amounts with no funding committed at the time of award. VSE is one of several awardees on each contract. While future VSE revenue from these contracts cannot be predicted with certainty, the award of these contracts provides the Company with the opportunity to compete for work that could contribute to future revenue growth, including new work in 2007. These three contracts are described below.

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VSE's CED Division has a multiyear Rapid Response support contract awarded by the U.S. Army Communications and Electronics Command (CECOM) in January 2003. The contract enhances the Company's revenue producing capabilities by allowing it to provide services through any of VSE's operating entities or through third party subcontractors for various end user government customers. If all options are exercised, this contract has a potential total nominal ceiling of approximately \$2.9 billion over an eight-year period. While it is unlikely that the full ceiling amount will be realized, the Company has received over \$721 million in task order awards and over \$588 million of funding since inception of the contract. This contract generated revenues for all of VSE of approximately \$143 million during 2006, including revenues of approximately \$106 million on the CED Army Equipment Support Program. CED was awarded a new task order under this contract in December 2006 for work to support U.S. Army PM Assured Mobility Systems and TACOM, most of which will be subcontracted, that represents potential revenues to the Company of about \$164.8 million over a 16-month period if all options are exercised. VSE continues to pursue new orders on this contract that present potential revenue opportunities for the future.

VSE's FMD Division has a contract with the U.S. Navy, SeaPort Enhanced, awarded in April 2004, which includes a five-year base period and two five-year option periods. This contract is a procurement vehicle for the Navy to use for ordering services from a wide range of contractors to support all phases of naval ship and shipboard weapons systems acquisition and life-cycle support. While this award does not guarantee any revenues for VSE, the Company is one of several contractors eligible to bid for services during the life of the contract. As of June 30, 2007, FMD has been awarded approximately \$20.8 million in contract task orders under this contract.

ELD has a contract, the Field and Installation Readiness Support Team ("FIRST") Contract, awarded in November 2006, with the U.S. Army to provide a broad range of logistics and engineering and technical services to Army activities in the continental United States and overseas locations. The contract has a five-year base period and three five-year option periods. VSE is one of several awardees eligible to share in the potential total contract ceiling amount, which is expected to be several billion dollars. The award of this contract provides VSE with the opportunity to compete for work which may contribute to future revenue growth.

### Funded Backlog

Revenues in government contracting businesses are dependent upon contract funding ("Bookings") and funded contract backlog is an indicator of potential future revenues. A summary of VSE's bookings, funded contract backlog, and revenues for the six months ending June 30, 2007, including ICRC from the acquisition in June, is as follows:

|   | (in millions) |
|---|---------------|
|   | -----         |
| Bookings for the six months ended June 30, 2007 | \$321         |
| Funded backlog as of June 30, 2007              | \$372         |
| Revenues for the six months ended June 30, 2007 | \$280         |

Funded backlog includes approximately \$43 million from the acquisition of ICRC in June 2007.

### Longer Term

The growth in VSE revenue and profits during 2006 and the first two quarters of 2007, and the expected continuation of this growth in the remainder of 2007 will present the Company with both challenges and opportunities for future



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years. Certain work efforts that have supported VSE's growth in recent years have expired or are due to expire. VSE has received significant contributions to its revenue growth 1) from the Taiwan Ship Transfer work, which was substantially completed in September 2006; 2) from the TBPS Program work, for which a large majority of the originally proposed work has been delivered and current contractual coverage is scheduled to expire in July 2008; and, 3) from the CED Army Equipment Support Program, which is scheduled to expire in

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December 2007. The expiration of these programs may reduce VSE annual revenues if the expiring work is not replaced by new or follow-on work.

The Company believes it is well prepared to meet the challenge of replacing the expiring work. Progress has already been made toward this end with the start up of the Treasury Seized Property Management program awarded in August 2006, the FIRST contract awarded in November 2006, the new task order awarded under the Rapid Response support contract in December 2006, continued increases in ELD's equipment refurbishment services, and the acquisition of ICRC.

Opportunities associated with VSE's recent growth include a more competitive price structure with which to bid on future work, a wider range of employee skill sets, and a broader name recognition and past performance record for use in expanding the Company's customer base. The larger revenue level and capital base built up in recent years improves the Company's ability to pursue larger programs and potential acquisition opportunities.

### Recent Accounting Pronouncements

In February 2007, the FASB issued Statement of Financial Accounting Standards (SFAS) No. 159, "The Fair Value Option for Financial Assets and Financial Liabilities - Including an amendment of FASB Statement No. 115." SFAS No. 159 permits entities to choose to measure eligible items at fair value at specified election dates and report unrealized gains and losses on items for which the fair value option has been elected in earnings at each subsequent reporting date. SFAS No. 159 is effective for fiscal years beginning after November 15, 2007. Management is currently evaluating the effect that adoption of this statement will have on the Company's consolidated financial position and results of operations when it becomes effective in 2008.

### Critical Accounting Policies

VSE's consolidated financial statements are prepared in accordance with accounting principles generally accepted in the United States, which require VSE to make estimates and assumptions. The Company believes the following critical accounting policies affect our more significant judgments, estimates and assumptions used in the preparation of its consolidated financial statements.

### Revenue Recognition

Substantially all of the Company's services are performed for its customers on a contract basis. The three primary types of contracts used are cost-type contracts, time and materials contracts, and fixed-price contracts. Revenues result from work performed on these contracts by the Company's employees and from pass-through of costs for material and work performed by subcontractors. Revenues on cost-type contracts are recorded as contract allowable costs are incurred and fees earned. Profits on cost-type contracts are equal to the fees that are earned. The BAV contract terms specify award fee payments that are

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determined by performance and level of contract activity. Award fees are made three times during the year and a contract modification authorizing the award fee payment is issued subsequent to the period in which the work is performed. The Company does not recognize award fee income until the fees are fixed and determinable, generally upon contract notification confirming the award fee. Due to such timing, and to fluctuations in the level of revenues, profits as a percentage of revenues on this contract will fluctuate from period to period. Revenues for time and materials contracts are recorded on the basis of contract allowable labor hours worked times the contract defined billing rates, plus the cost of materials used in performance on the contract. Profits on time and material contracts result from the difference between the cost of services performed and the contract defined billing rates for these services.

Revenue recognition methods on fixed-price contracts will vary depending on the nature of the work and the contract terms. On certain fixed-price

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contracts revenues are recorded as costs are incurred, using the percentage-of-completion method of accounting, since these contracts require design, engineering, and manufacturing performed to the customer's specifications. Revenues on fixed-price service contracts are recorded as work is performed. Revenues on fixed-price contracts that require delivery of specific items may be recorded based on a price per unit as units are delivered. Profits on fixed-price contracts result from the difference between the incurred costs and the revenue earned.

Revenues by contract type for the six months ended June 30, 2007 and 2006 were as follows (in thousands):

|                       | 2007      |     | 2006      |     |
|-----------------------|-----------|-----|-----------|-----|
| Contract Type         | Revenues  | %   | Revenues  | %   |
| -----                 | -----     | -   | -----     | -   |
| Cost-type . . . . .   | \$ 97,431 | 35  | \$ 81,058 | 51  |
| Time and materials.   | 160,684   | 57  | 57,182    | 36  |
| Fixed-price . . . . . | 22,218    | 8   | 19,904    | 13  |
|                       | -----     | --- | -----     | --- |
|                       | \$280,333 | 100 | \$158,144 | 100 |
|                       | =====     | === | =====     | === |

A large amount of the time and materials revenues shown in the table above is attributable to revenues from the CED Army Equipment Support contract that started in 2006. Substantially all of the revenues on this contract have resulted from the pass through of subcontractor support services that have a very low profit margin for VSE.

The Company will occasionally perform work at risk, which is work that is performed prior to the government formalizing funding for such work. Revenue related to work performed at risk is not recognized until it can be reliably estimated and its realization is probable. VSE recognizes this "risk funding" as revenue when the associated costs are incurred or the work is performed. VSE is at risk of loss for any risk funding not received. The Company provides for anticipated losses on contracts by a charge to income during the period in which losses are first identified. As of June 30, 2007, VSE has recognized approximately \$539 thousand in risk funding. The Company received funding modifications for approximately \$143 thousand of this amount as of July 2007, leaving approximately \$396 thousand of revenues classified as risk funding. VSE believes that it will receive funding for this remaining risk funding revenue.

Long-Lived Assets

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In assessing the recoverability of long-lived assets, including goodwill and other intangibles, VSE must make assumptions regarding estimated future cash flows and other factors to determine the fair value of the respective assets. If these estimates or their related assumptions change in the future, VSE may be required to record impairment charges for these assets not previously recorded.

### Goodwill and Intangible Assets

Goodwill and intangible assets with indefinite lives are subject to a review for impairment at least annually. The Company performs its annual impairment test on September 30. As of June 30, 2007, the Company had approximately \$1.1 million of goodwill associated with its acquisition of Energetics in 1995 and approximately \$5.4 million of goodwill and intangible assets with indefinite lives associated with its acquisition of ICRC in 2007. The Company has not recognized any reduction to the goodwill or intangibles due to the impairment rules. If at some time in the future it is determined that impairment has occurred, such impairment could potentially have a material adverse impact on the Company's results of operations or financial condition.

### Employee Stock Options

In accordance with SFAS 123(R), VSE recognizes expense associated with employee stock options in the income statement based on their fair values. The amount of this expense for 2006 was approximately \$252 thousand and for the

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six months ended June 30, 2007 was approximately \$91 thousand. VSE discontinued awarding employee stock options as of December 30, 2005. Options outstanding as of that date are not affected by this action.

### Contingencies

From time to time VSE is subject to proceedings, lawsuits, and other claims related to environmental, labor, and other matters. VSE is required to assess the likelihood of any adverse judgments or outcomes to these contingencies as well as potential ranges of probable losses and establish reserves accordingly. The amount of reserves required may change in future periods due to new developments in each matter or changes in approach to a matter such as a change in settlement strategy.

### Income Taxes

The carrying value of VSE net deferred tax assets is based on assumptions regarding VSE's ability to generate sufficient future taxable income to utilize these deferred tax assets. If the estimates and related assumptions regarding VSE's future taxable income change, VSE may be required to record valuation allowances against its deferred tax assets, resulting in additional income tax expense.

### Results of Operations

The following table sets forth certain items for VSE, including consolidated revenues, pre-tax income and net income, and the changes in these items for the three and six month periods ended June 30, 2007 and 2006 (in thousands):

| Description | Three Months   |      | Six Months     |      | 2007<br>Increase Compared<br>to 2006 |        |
|-------------|----------------|------|----------------|------|--------------------------------------|--------|
|             | Ended June 30, |      | Ended June 30, |      | Three                                | Six    |
|             | 2007           | 2006 | 2007           | 2006 | Months                               | Months |

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|                            |           |          |           |           |          |           |
|----------------------------|-----------|----------|-----------|-----------|----------|-----------|
| Revenues                   | \$159,644 | \$94,844 | \$280,333 | \$158,144 | \$64,800 | \$122,189 |
| Income before income taxes | \$ 5,752  | \$ 3,278 | \$ 10,158 | \$ 5,680  | \$ 2,474 | \$ 4,478  |
| Provision for income taxes | 2,205     | 1,251    | 3,882     | 2,168     | 954      | 1,714     |
| Net Income                 | \$ 3,547  | \$ 2,027 | \$ 6,276  | \$ 3,512  | \$ 1,520 | \$ 2,764  |

Revenues increased by approximately 68% and 77% for the three and six month periods ended June 30, 2007, as compared to the same periods of 2006. The primary reasons for the increases in revenues were 1) revenues associated with the CED Army Equipment Support program and CED's U.S. Army PM Assured Mobility Systems and TACOM support; 2) revenues from the start of FMD's Treasury Seized Property Management Program and increases in other FMD services; 3) revenues associated with BAV's ship transfer to India; 4) an increase in the level of ELD equipment refurbishment services; and 5) revenues from newly acquired ICRC.

Income before income taxes increased by approximately 76% and 79% for the three month and six month periods ended June 30, 2007, as compared to the same periods of 2006. The increases were primarily due to the increase in revenues on the CED Army Equipment Support program, increased profitability of SED services performed, revenue and margin increases on ELD's equipment refurbishment services, increased BAV award fee income, the Treasury Seized Property Management program, and revenues from newly acquired ICRC.

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Federal Group Results

The following table shows consolidated revenues and income before income taxes and the changes in these items for the Federal Group for the three and six month periods ended June 30, 2007 and 2006 (in thousands).

| Description                | Three Months        |          | Six Months          |          | 2007 Increase Compared to 2006 |            |
|----------------------------|---------------------|----------|---------------------|----------|--------------------------------|------------|
|                            | Ended June 30, 2007 | 2006     | Ended June 30, 2007 | 2006     | Three Months                   | Six Months |
| Revenues                   | \$83,292            | \$46,690 | \$153,795           | \$66,895 | \$36,602                       | \$86,900   |
| Income before income taxes | \$ 3,038            | \$ 1,369 | \$ 5,764            | \$ 2,075 | \$ 1,669                       | \$ 3,689   |
| Profit percent             | 3.6%                | 2.9%     | 3.7%                | 3.1%     |                                |            |

Revenues for the Federal Group increased by approximately 78% and 130% for the three and six month periods ended June 30, 2007, as compared to the same periods for the prior year. A substantial portion of the increases in revenues for 2007 was attributable to revenues associated with the CED Army Equipment Support Program work. Other reasons for the increases in 2007 revenues included: 1) work on additional CED task orders, including CED's U.S. Army PM Assured Mobility Systems and TACOM support; 2) increases in SED contract services performed other than the TBPS Program; and 3) increased revenues from ELD's equipment refurbishment services for the U. S. Army Reserve. The increases in revenues of this segment were offset slightly by a decline in MSD revenues for both the three and six month period.

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Income before income taxes for the Federal Group increased by approximately 122% and 178% for the three and six month periods ended June 30, 2007, as compared to the same periods for the prior year. The increases in income before income taxes were primarily due to increased revenue levels and profitability of SED services performed on the TBPS Program and other SED services; profits associated with the increased military equipment refurbishment services performed by ELD for the U. S. Army Reserve; and the increase in revenues on the CED Army Equipment Support Program work and other CED task orders. The increases in income before income taxes of this segment were offset slightly by a decline in MSD profits for both the three and six month period.

Most of the work on The CED Army Equipment Support Program work is performed by a subcontractor and these costs are passed on to the government essentially at cost. Accordingly, the Federal Group profit percent can vary from year to year depending on the level of subcontractor activity.

### International Group Results

The following table shows consolidated revenues and income before income taxes and the changes in these items for the International Group for the three and six month periods ended June 30, 2007 and 2006 (in thousands).

| Description<br>-----          | Three Months   |          | Six Months     |          | 2007<br>Increase Compared<br>to 2006 |          |
|-------------------------------|----------------|----------|----------------|----------|--------------------------------------|----------|
|                               | Ended June 30, |          | Ended June 30, |          | Three                                | Six      |
|                               | 2007           | 2006     | 2007           | 2006     | Months                               | Months   |
| -----                         | -----          | -----    | -----          | -----    | -----                                | -----    |
| Revenues                      | \$69,111       | \$44,406 | \$116,015      | \$84,255 | \$24,705                             | \$31,760 |
|                               | =====          | =====    | =====          | =====    | =====                                | =====    |
| Income before income<br>taxes | \$ 2,256       | \$ 1,527 | \$ 3,743       | \$ 2,849 | \$ 729                               | \$ 894   |
|                               | =====          | =====    | =====          | =====    | =====                                | =====    |
| Profit percent                | 3.3%           | 3.4%     | 3.2%           | 3.4%     |                                      |          |

Revenues for the International Group increased by approximately 56% and 38% for the three and six month periods ended June 30, 2007, as compared to the

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same periods for the prior year. The increases in revenues were primarily due to revenues provided by the start of FMD's Treasury Seized Property Management Program and to revenues associated with BAV's ship transfer to India. These additional revenues were offset somewhat by the decrease in revenues of BAV in 2007 due to the substantial completion of work associated with the transfer of U.S. Navy ships to Taiwan. The increases in revenues of this segment were offset slightly by a decline in VCG revenues for the three month period and helped slightly by an increase in VCG revenues for the six month period.

Income before income taxes for the International Group increased by approximately 48% and 31% for the three and six month periods ended June 30, 2007, as compared to the same periods for the prior year. The increase was primarily due to profits from FMD's Treasury Seized Property Management Program and to increased BAV award fee income. The increases in income before income taxes of this segment were helped slightly by an increase in profits for VCG for the three and six month periods.

### Energy and Environmental Group Results

The following table shows consolidated revenues and income before income taxes

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and the changes in these items for the Energy and Environmental Group for the three and six month periods ended June 30, 2007 and 2006 (in thousands).

| Description<br>-----          | Three Months           |         | Six Months             |         | 2007<br>Increase Compared<br>to 2006 |               |
|-------------------------------|------------------------|---------|------------------------|---------|--------------------------------------|---------------|
|                               | Ended June 30,<br>2007 | 2006    | Ended June 30,<br>2007 | 2006    | Three<br>Months                      | Six<br>Months |
| -----                         | -----                  | -----   | -----                  | -----   | -----                                | -----         |
| Revenues                      | \$3,607                | \$3,720 | \$6,853                | \$6,944 | \$ (113)                             | \$ (91)       |
|                               | =====                  | =====   | =====                  | =====   | =====                                | =====         |
| Income before income<br>taxes | \$ 454                 | \$ 460  | \$ 767                 | \$ 836  | \$ (6)                               | \$ (69)       |
|                               | =====                  | =====   | =====                  | =====   | =====                                | =====         |
| Profit percent                | 12.6%                  | 12.4%   | 11.2%                  | 12.0%   |                                      |               |

Revenues in the Energy and Environmental Group declined by approximately 3% and 1% for the three and six month periods ended June 30, 2007, as compared to the same periods for the prior year.

Income before income taxes in the Energy and Environmental Group declined by approximately 1% and 8% for the three and six month periods ended June 30, 2007, as compared to the same periods for the prior year. The decrease in income before income taxes in 2007 was primarily due to performance related issues that reduced profit on certain task orders and to the timing of award fees received in 2006 as compared to the same period of 2007.

### Infrastructure and Information Technology Group

The following table shows consolidated revenues and income before income taxes for the Infrastructure and Information Technology Group for the three and six month periods ended June 30, 2007 (in thousands).

| Description                   | Three Months           | Six Months             |
|-------------------------------|------------------------|------------------------|
|                               | Ended June 30,<br>2007 | Ended June 30,<br>2007 |
| -----                         | -----                  | -----                  |
| Revenues                      | \$3,619                | \$3,619                |
|                               | =====                  | =====                  |
| Income before income<br>taxes | \$ 167                 | \$ 167                 |
|                               | =====                  | =====                  |
| Profit percent                | 4.6%                   | 4.6%                   |

This segment was formed as a result of the acquisition of ICRC on June 4, 2007.

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### Financial Condition

VSE's financial condition did not change materially during the six months ended June 30, 2007. The Company's largest assets are its accounts receivable. The largest liabilities are its accounts payable and accrued expenses. Accounts receivable increased by approximately \$41 million and accounts payable and accrued expenses increased by approximately \$34 million during the six months ended June 30, 2007, primarily as a result of the Company's increased revenues during this period. The acquisition of ICRC also caused increases in accounts receivable, accounts payable, and accrued expenses; and additionally resulted in a decrease in cash and cash equivalents and increases in intangible assets. The change in total stockholders' investment in this

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period was also impacted by earnings and dividend activity and the exercise of stock options.

### Liquidity and Capital Resources

#### Cash Flows

Cash and cash equivalents decreased by approximately \$7.5 million during the six months ended June 30, 2007. The decrease in cash and cash equivalents during this period resulted from cash used in investing activities of approximately \$13.9 million, cash provided by operating activities of approximately \$3.7 million, and cash provided by financing activities of approximately \$2.7 thousand. Investing activities included the acquisition of ICRC for approximately \$11.6 million, the expansion and improvement of facilities of approximately \$1.1 million and purchases of property and equipment, net of dispositions, of approximately \$1.2 million. Financing activities consisted of dividend payments and proceeds from the exercise of VSE stock options and associated excess tax benefits.

Cash and cash equivalents decreased by approximately \$7.6 million during the six months ended June 30, 2006. The decrease in cash and cash equivalents during this period resulted from cash used in operating activities of approximately \$5.9 million, cash used in investing activities of approximately \$1.7 million, and cash used in financing activities of approximately \$73 thousand. Investing activities consisted of expansion and improvement of facilities of approximately \$191 thousand and purchases of property and equipment, net of dispositions, of approximately \$1.5 million. Financing activities consisted of dividend payments and proceeds received from the issuance of VSE stock under stock incentive plans.

The difference between cash provided by operating activities of approximately \$3.7 million in 2007 as compared to cash used in operating activities of approximately \$5.9 million in 2006 is primarily due to the increase in net income and to fluctuations in operating assets and liabilities associated with increased revenues and the timing of accounts receivable collections and subcontractor and vendor payments.

Quarterly cash dividends were paid at the rate of \$.07 per share during the six months ended June 30, 2007, stated on a post-split basis to reflect the 2-for-1 stock split paid on June 28, 2007. Pursuant to its bank loan agreement, the payment of cash dividends by VSE is subject to annual rate restrictions. VSE has paid cash dividends each year since 1973.

#### Liquidity

The Company's internal sources of liquidity result primarily from operating activities, specifically from changes in the level of revenues and associated accounts receivable and accounts payable from period to period, and from profitability. Significant increases or decreases in revenue and accounts receivable and accounts payable can cause significant increases or decreases in internal liquidity.

Accounts receivable arise primarily from billings made by the Company to the government or other government prime contractors for services rendered, and

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payments received on accounts receivable represent the principal source of cash for the Company. Accounts receivable levels can be affected significantly by the timing of large materials purchases and subcontractor efforts used in performance on the Company's contracts. Accounts receivable levels are also

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affected by contract retainages, differences between the provisional billing rates authorized by the government compared to the costs actually incurred by the Company, differences between billable amounts authorized by contract terms compared to costs actually incurred by the Company, contract funding delays arising from job performance issues, and government delays in processing administrative paperwork for contract funding.

Work on the TBPS program requires the Company to acquire inventories consisting of materials, supplies, and other expenditures for which end units have not yet been completed and accepted. Although these costs are classified as inventories for accounting purposes, they are similar in nature to materials and direct supplies purchased for use in performance on the Company's other contracts in that they are solely and directly attributable to the contract and will be billed to the customer within a relatively short time. All of the inventories are expected to be liquidated, billed, and collected as vehicle protection systems are completed and accepted by the government customer. These materials and direct supplies will not be restocked to maintain any permanent inventory levels.

Accounts payable arise primarily from purchases of subcontractor services and materials used by the Company in the performance of its contract work. Payments made on accounts payable, along with payments made to satisfy employee payroll and payroll associated expenses, make up the principal cash requirements of the Company. Accounts payable levels can be affected by changes in the level of contract work performed by the Company and by the timing of large materials purchases and subcontractor efforts used in performance on the Company's contracts.

From time to time, the Company may also invest in the acquisition of another company. The acquisition of ICRC in 2007 represented a substantial use of cash. While there are no firm plans for additional acquisitions of this nature at this time, the possibility exists that future acquisitions could be made.

Other cash requirements include income tax payments, the acquisition of capital assets for shop, office and computer support, and the payment of cash dividends. The Company also invests in expansion, improvement, and maintenance of its operational and administrative facilities. The growth in the level of equipment refurbishment services provided by ELD required an increased level of investment in operational facilities in 2006 and the Company anticipates making additional investments in such facilities 2007 and future years.

VSE's external sources of liquidity consist of a revolving bank loan agreement that provides loan financing based on the Company's accounts receivable (see "Notes to Consolidated Financial Statements"). The bank financing complements the Company's internal sources of liquidity by providing increasing levels of borrowing capacity as accounts receivable levels increase. The bank loan agreement provided loan financing up to a maximum commitment of \$15 million as of June 30, 2007. The amount of this commitment is negotiable between the Company and the bank. The Company and its bank are currently in negotiation, and the Company has received a commitment letter from the bank, to increase the maximum commitment amount to \$25 million. The Company has determined that this new amount is adequate to cover known current and future liquidity requirements.

Performance of work under the Company's larger contracts that require significant amounts of subcontractor or material purchases have the potential to cause substantial requirements for working capital; however, management believes that cash flows from operations and the bank loan commitment are adequate to meet current operating cash requirements.



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### Contractual Obligations

In March 2007, the Company signed two five-year facility leases for warehouse space to begin in March 2007 for an aggregate amount of approximately \$8.4 million.

Upon the acquisition of ICRC in June 2007, the Company assumed liability for certain additional operating lease commitments. This includes five leases for office space and approximately ten equipment leases for an aggregate amount of approximately \$2.3 million.

[See "Management's Discussion and Analysis of Financial Condition and Results of Operations" contained in VSE's Annual Report on Form 10-K for the fiscal year ended December 31, 2006 for a summary of the Company's other contractual obligations.]

### Inflation and Pricing

Most of the contracts performed by VSE provide for estimates of future labor costs to be escalated for any option periods provided by the contracts, while the non-labor costs included in such contracts are normally considered reimbursable at cost. VSE property and equipment consists principally of computer systems equipment, furniture and fixtures, and land and improvements. The overall impact of inflation on replacement costs of such property and equipment is not expected to be material to VSE's future results of operations or financial condition.

### Disclosures About Market Risk

#### Interest Rates

VSE's bank loan financing provides available borrowing to the Company at variable interest rates. The Company used a significant amount of its cash reserves to pay for the ICRC acquisition in June 2007, giving rise to a situation where the Company may borrow on its bank loan from time to time in the short term future. VSE does not anticipate that such amounts borrowed will be significant, and accordingly, the Company does not believe that any movement in interest rates would have a material impact on future earnings or cash flows. If VSE were to significantly increase borrowings, future interest rate changes could potentially have a material impact.

#### Foreign Currency

While a significant amount of the Company's business results from the services provided by BAV related to the transfer of ships to foreign governments, the BAV contract payments are made by the U.S. Government in U.S. dollars. Additionally, most funding requirements to support work performed or services purchased in foreign countries are made in U.S. dollars, and the infrequent disbursements that are made in foreign currencies are reimbursable to BAV in post conversion dollars. Foreign currency transactions of other VSE divisions or subsidiaries are minimal. Accordingly, the Company does not believe that it is exposed to any material foreign currency risk.

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### Item 3. Quantitative and Qualitative Disclosures About Market Risks

See "Disclosures About Market Risk" in Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations.

### Item 4. Controls and Procedures

As of the end of the period covered by this report, based on management's evaluation, with the participation of VSE's Chief Executive Officer and Chief Financial Officer, of the effectiveness of the disclosure controls and procedures (as defined in Rules 13a-15(e) or 15d - 15(e) under the Securities Exchange Act of 1934, as amended) our Chief Executive Officer and Chief Financial Officer have concluded that our disclosure controls and procedures are effective in ensuring that information required to be disclosed by us in reports filed or submitted under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission's rules and forms, and that information required to be disclosed by us in the reports that we file or submit under the Exchange Act is accumulated and communicated to our management, including our principal executive and principal financial officers, or persons performing similar functions, as appropriate to allow timely decisions regarding required disclosure.

There was no change in our internal control over financial reporting during our second quarter of fiscal 2007 that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

## PART II. Other Information

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

The Registrant did not purchase any of its equity securities during the period covered by this report.

Under the Registrant's bank loan agreement dividends may be paid in an annual aggregate amount of \$.60 per share, provided there is no default under the loan agreement.

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

The 2007 annual meeting of the Company's stockholders was held on May 1, 2007, for the following purposes:

1. To elect seven directors to serve until the next annual meeting of stockholders and until their successors are duly elected and qualified;
2. To ratify the appointment of Ernst & Young LLP as VSE's independent certified public accountants for the fiscal year ending December 31, 2007.

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All of the Company's seven nominees were elected as directors, and the appointment of Ernst & Young LLP as VSE's independent certified public accountants for the year ending December 31, 2007, was ratified. Voting results were as follows:

Shares Voted

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|    |                                  | For       | Against | Withhold/<br>Abstain | Broker<br>Non-Votes |
|----|----------------------------------|-----------|---------|----------------------|---------------------|
| 1. | Nominee                          |           |         |                      |                     |
|    | Donald M. Ervine                 | 4,179,454 | --      | 89,348               | 186,986             |
|    | Clifford M. Kendall              | 4,144,640 | --      | 123,582              | 186,986             |
|    | Calvin S. Koonce                 | 4,140,624 | --      | 128,198              | 186,986             |
|    | James F. Lafond                  | 4,177,974 | --      | 90,848               | 186,986             |
|    | David M. Osnos                   | 3,916,740 | --      | 352,082              | 186,986             |
|    | Jimmy D. Ross                    | 4,179,474 | --      | 89,348               | 186,986             |
|    | Bonnie K. Wachtel                | 4,141,324 | --      | 127,498              | 186,986             |
| 4. | Ernst & Young LLP<br>appointment | 4,216,250 | 2,946   | 1,206                | 186,986             |

Item 6. Exhibits

(a) Exhibits.

Exhibit No.

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- 10.1 Employment Agreement dated as of May 31, 2007, by and between VSE Corporation and James W. Lexo, Jr.
  - 31.1 Section 302 CEO Certification
  - 31.2 Section 302 CFO and PAO Certification
  - 32.1 Section 906 CEO Certification
  - 32.2 Section 906 CFO and PAO Certification

Pursuant to the requirements of the Securities Exchange Act of 1934, the Registrant has omitted all other items contained in "Part II. Other Information" because such other items are not applicable or are not required if the answer is negative or because the information required to be reported therein has been previously reported.

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VSE CORPORATION AND SUBSIDIARIES

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.

VSE CORPORATION

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Date: August 1, 2007

/s/ D. M. Ervine

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D. M. Ervine  
Chairman, President,  
Chief Executive Officer and  
Chief Operating Officer

Date: August 1, 2007

/s/ T. R. Loftus

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T. R. Loftus  
Executive Vice President and  
Chief Financial Officer  
(Principal Accounting Officer)