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ENGLOBAL CORP  
Form 10-K  
March 16, 2007

UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549

Form 10-K

X ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES  
----- EXCHANGE ACT OF 1934

For the fiscal year ended December 31, 2006

or

----- TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES  
EXCHANGE ACT OF 1934

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission File No. 001-14217

ENGlobal Corporation

-----  
(Exact name of registrant as specified in its charter)

Nevada

88-0322261

-----  
(State or other jurisdiction of  
incorporation or organization)

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

654 North Sam Houston Parkway East, Suite 400

77060-5914

-----  
(Address of principal executive offices)

-----  
(Zip code)

Registrant's telephone number, including area code: (281) 878-1000

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

Title of each class	Name of each exchange on which registered
-----	-----
Common Stock, \$0.001 par value	American Stock Exchange

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

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act

Yes \_\_\_\_\_ No  X

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15 (d) of the Act

Yes \_\_\_\_\_ No  X

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Indicate by check mark whether the registrant: (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shortened period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes    X    No  
---    ---    -----

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of the registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

Yes    X    No  
---    ---    -----

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of "accelerated filer and large accelerated filer" in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer	Accelerated filer	X	Non-accelerated filer
-----	-----		-----

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act)

Yes                      No    X  
---                      ---    -----

The aggregate market value of the registrant's common stock held by non-affiliates of the registrant on June 30, 2006 was \$126,159,307 (based upon the closing price for shares of common stock as reported by the American Stock Exchange on that date).

The number of shares outstanding of the registrant's common stock on March 15, 2007 is as follows:

\$0.001 Par Value Common Stock	26,829,090 shares
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### DOCUMENTS INCORPORATED BY REFERENCE

Responses to Items 10, 11, 12, 13 and 14 of Part III of this report are incorporated herein by reference to certain information contained in the Company's definitive proxy statement for its 2007 Annual Meeting of Stockholders to be filed with the Securities and Exchange Commission on or before April 30, 2007.

ENGlobal Corporation  
2006 ANNUAL REPORT ON FORM 10-K

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### PART I -----

#### CAUTIONARY NOTICE REGARDING FORWARD-LOOKING STATEMENTS

This Annual Report on Form 10-K ("Report"), including "Management's Discussion and Analysis of Financial Condition and Results of Operations," as well as oral statements made by the Company and its officers, directors or employees, contains forward-looking statements within the meaning of Section 21E of the Securities Exchange Act of 1934, as amended (the "Exchange Act"). Such forward-looking statements are based on Management's beliefs, current expectations, estimates and projections about the industries that the Company and its subsidiaries serve, the economy and the Company in general. The words "expect," "anticipate," "intend," "plan," "believe," "seek," "estimate" and similar expressions are intended to identify such forward-looking statements; however, this Report also contains other forward-looking statements in addition to historical information. Although we believe that the expectations reflected in the forward-looking statements are reasonable, such forward-looking statements are not guarantees of future performance and are subject to risks, uncertainties and other factors that may cause the actual results, performance or achievements of the Company to differ materially from historical results or from any results expressed or implied by such forward-looking statements. The Company cautions readers that the following important factors and the risks described in the section of this report entitled "Risk Factors", among others, could cause the Company's actual results to differ materially from the forward-looking statements contained in this Report: (i) our ability to collect accounts receivable in a timely manner; (ii) our ability to accurately estimate costs and fees on fixed-price contracts; (iii) the effect of changes in laws and regulations with which the Company must comply, and the associated costs of compliance with such laws and regulations, either currently or in the future, as applicable; (iv) the effect of changes in accounting policies and practices as may be adopted by regulatory agencies, as well as by the Financial Accounting Standards Board; (v) the effect of changes in the Company's organization, compensation and benefit plans; (vi) the effect on the Company's competitive position within its market area of the increasing consolidation within its services industries, including the increased competition from larger regional and out-of-state engineering services organizations; (vii) the effect of increases and decreases in oil prices; (viii) the availability of parts from vendors; (ix) our ability to increase or renew our line of credit; (x) our ability to identify attractive acquisition candidates, consummate acquisitions on terms that are favorable to the Company and integrate the acquired businesses into the Company's operations; (xi) our ability to hire and retain qualified

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personnel; (xii) our ability to retain existing customers and get new customers and (xiii) the effect of changes in the business cycle and downturns in local, regional and national economies. The Company cautions that the foregoing list of important factors is not exclusive. We are under no duty and have no plans to update any of the forward-looking statements after the date of this Report to conform such statements to actual results.

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### ITEM 1. BUSINESS

#### General

ENGlobal Corporation (which may be referred to as "ENGlobal," the "Company," "we," "us" or "our") is a leading provider of engineering services and systems principally to the petroleum refining, petrochemical, pipeline, production and process industries throughout the United States and internationally. The services provided by our multi-disciplined staff span the lifecycle of a project and include feasibility studies, design, and procurement and construction management. We also supply automation, control and instrumentation systems to our clients worldwide. On May 25, 2006, the Company purchased Denver-based WRC Corporation, expanding our engineering services, by providing integrated land management, engineering, and related services.

The Company was incorporated as Industrial Data Systems Corporation in the State of Nevada in June 1994. In December 2001, we merged with Petrocon Engineering, Inc. ("Petrocon") and in June 2002, we changed the name of the Company from Industrial Data Systems Corporation to ENGlobal Corporation. Effective June 16, 2002, the Company's trading symbol for its common stock, traded on the American Stock Exchange, changed from "IDS" to "ENG".

Since the Company's merger with Petrocon, the net revenue from continuous operations has grown from \$89.1 million in 2002 to \$303.1 million in 2006, a compounded annual growth rate of approximately 35.8%. We have accomplished this growth by expanding our engineering and systems services and geographic presence through internal growth, including new initiatives and to a lesser extent, through a series of strategic acquisitions. We now have more than 2,100 full-time equivalent employees in offices strategically located in Houston, Beaumont, Clear Lake, Freeport, and Midland, Texas; Baton Rouge and Lake Charles, Louisiana; Tulsa, Cleveland and Blackwell, Oklahoma; Denver, Colorado; and Calgary, Alberta, Canada.

In December 2006, ENGlobal Engineering, Inc. began its plan to cease operations in Dallas, Texas. Some project activities previously performed in the Dallas office have been transferred to other ENGlobal offices. On February 19, 2007, the Company entered into agreements with another firm providing for the sale of the majority of Dallas assets and for the partial sublease of Dallas office space. These actions were the result of a decision to consolidate the Company's Texas-based operations while streamlining or reducing overhead costs. A small number of the Company's former Dallas personnel transferred to other ENGlobal offices and others were asked to remain with the Company through May 31, 2007, to allow for an orderly transfer of on-going projects. However, the majority of the previous Dallas employees are now employed by the firm which purchased certain of the Dallas assets, and the Company expects to utilize some on a subcontract basis for a short period of time and on a discretionary basis to complete projects. Currently the Company has no plans to sell the assets or consolidate any of its other office locations.

#### Available Information

We file annual, quarterly and current reports, proxy statements and other

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information with the Securities and Exchange Commission ("SEC"). You can read and copy any materials filed with the SEC at its Public Reference Room at 100 F. Street, N.E., Washington, D.C. 20549. You can obtain information about the operations from the SEC Public Reference Room by calling the SEC at 1-800-SEC-0330. The SEC also maintains a website, which contains information we file electronically with the SEC, which can be accessed over the Internet at [www.sec.gov](http://www.sec.gov). Our common stock is listed on the American Stock Exchange (AMEX: ENG), and you can obtain information about ENGlobal at the offices of the American Stock Exchange, 86 Trinity Place, New York, New York 10006-1872 or at their website [www.amex.com](http://www.amex.com).

### ENGlobal Website

You can find financial and other information about ENGlobal at the Company's website at the URL address [www.englobal.com](http://www.englobal.com). Copies of our annual reports on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, and amendments to those reports filed or furnished pursuant to Section 13(a) or 15(d) of the Exchange Act are provided free of charge through the Company's website and are available as soon as reasonably practicable after filing electronically or otherwise furnishing reports to the SEC.

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### ITEM 1. BUSINESS (Continued)

Information relating to corporate governance at ENGlobal, including: (i) our Code of Business Conduct and Ethics for all of our employees, including our Chief Executive Officer and Chief Financial Officer; (ii) our Code of Ethics for our Chief Executive Officer and Senior Financial Officers; (iii) information concerning our Directors, and our Board Committees, including Committee charters, and (iv) information concerning transactions in ENGlobal securities by Directors and officers, is available on our website under the Investor Relations link. Our website and the information contained therein or connected thereto are not intended to be incorporated into this Annual Report on Form 10-K. We will provide any of the foregoing information without charge upon written request to Investor Relations Officer, ENGlobal Corporation, 654 North Sam Houston Parkway East, Suite 400, Houston, Texas 77060-5914.

### Business Segments

During 2006, we operated two business segments: engineering and systems. The respective contributions to our total sales in 2006, 2005 and 2004 for the engineering and the systems segments are summarized below.

Note: Previously, within the Systems Segment, ESI provided products and services supporting the advanced automation and integrated controls fields. In January 2006, EAG assumed responsibility for these services, which resulted in a move of this division of ESI to the Engineering Segment. Revenues and expenses have been reclassified between the segments to provide comparative results. Amounts will tie in total to prior reporting, however, individual segments will vary from prior reports.

Segment	Percentage of Revenues		
	2006	2005	2004
Engineering	91.8%	93.9%	90.5%
Systems	8.2%	6.1%	9.5%

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100.0%
100.0%
100.0%  
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Revenues from the systems segment remained constant from 2004 to 2005, but increased 75.4% from 2005 to 2006 primarily as a result of the acquisition of certain assets of Analyzer Technology International, Inc. ("ATI") in January 2006. Engineering revenues increased 62.8% and 26.8%, respectively, from 2004 to 2005 and from 2005 to 2006.

### Engineering Segment \_\_\_\_\_

	2006	2005	2004
(Amounts in thousands)			
Revenues	\$ 278,157	\$ 219,426	\$ 134,778
Operating profit	\$ 9,084	\$ 18,911	\$ 10,437
Total assets	\$ 70,549	\$ 54,342	\$ 46,122

### General

Our engineering segment offers engineering consulting services to clients in the petroleum refining, petrochemical, pipeline, production and process industries for the development, management and turnkey execution of engineering projects and provides inspection services throughout the United States. The engineering segment is currently comprised of the following wholly-owned subsidiaries of ENGlobal Corporation: ENGlobal Engineering, Inc. ("EEI"), ENGlobal Construction Resources, Inc. ("ECR"), ENGlobal Technical Services, Inc. ("ETS"), ENGlobal Automation Group, Inc. ("EAG"), ENGlobal Canada ULC ("ENGlobal Canada"), WRC Corporation ("WRC") and WRC Canada. EEI focuses primarily on providing services to the downstream petroleum refining and petrochemical industry, including refineries and processing plants, upstream and midstream pipeline companies and gas processing plants. ECR primarily provides pipeline inspection services to the oil and gas, utility and pipeline industries and turnaround, asset management, and start-up services for the petrochemical industry. ETS primarily provides Automated Fuel Handling Systems and services to branches

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### ITEM 1. BUSINESS (Continued)

of the U.S. military and public sector companies. EAG and ENGlobal Canada provide engineering services relating to the implementation of process controls, instrumentation, advanced automation and information technology projects. Further expanding our services within the pipeline industry, WRC and WRC Canada primarily provide land management, right-of-way services, environmental compliance, and governmental regulatory services to pipeline, utility and telecom companies and other owner/operators of "infrastructure" facilities. The engineering segment derives revenues primarily from cost-plus fees charged for professional and technical services. We also enter into contracts providing for the execution of projects on a fixed-price basis, whereby some or all of the project activities related to engineering, material procurement and construction are performed for a lump sum amount. As a service company, we are more labor than capital intensive. Our income primarily results from our ability to generate revenues and collect cash under both cost-plus and fixed-price contracts that is in

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excess of any cost for employees, material, equipment and subcontracts and selling, general and administrative (SG&A) expenses.

As of December 31, 2006, the engineering segment had more than one hundred existing blanket service contracts pursuant to which it provides clients either with services on a time and materials basis or with services on a fixed fee, turnkey basis. Our engineering segment operates out of offices in Baton Rouge and Lake Charles, Louisiana; Beaumont, Clear Lake, Houston, Midland and Freeport, Texas; Tulsa, Cleveland and Blackwell, Oklahoma; Denver, Colorado; and Calgary, Alberta.

During 2004, the engineering segment continued its geographical expansion with new offices in Dallas and Midland, Texas and Cleveland, Oklahoma, plus an additional office in Tulsa, Oklahoma. In January, through ETS, we acquired certain assets of Engineering Design Group, Inc. ("EDGI") located in Tulsa, Oklahoma. As a result of this acquisition, ETS now provides design, installation and maintenance services for various government and public sector facilities, the most active sector being Automated Fuel Handling Systems serving the U.S. military.

In August 2005, we announced the expansion of EEI's operation in the sulfur recovery business in Dallas, Texas. In September 2005, through ECR, we acquired certain assets of AmTech Inspection located in Midland, Texas. The new division's revenues are derived primarily from providing inspectors for regional refining and pipeline operations. In October, again through ECR, we acquired certain assets of Cleveland Inspection Services, Inc. ("CIS") located in Cleveland, Oklahoma. As a result of this acquisition, we now provide inspection and construction management services in support of the oil and gas, utility and pipeline industries.

During 2005, ENGlobal Engineering formed ENGlobal Automation Group, Inc. ("EAG") to provide services relating to the implementation of process control, advance automation and information technology projects providing our clients with a full range of services, including but not limited to, front-end engineering feasibility studies and the execution of turnkey engineering, procurement, and construction projects. By focusing on large-scope projects, EAG intends to pursue distributed control systems (DCS) conversion and new installation projects by utilizing its own resources as well as resources from both ENGlobal Engineering and ENGlobal Systems. EAG will promote our proven capabilities for plant automation services and products to respond to an industry progression toward replacing obsolete technology with newer DCS. In June 2005, we formed ENGlobal Canada, based in Calgary, Alberta, Canada. ENGlobal Canada is a wholly-owned subsidiary of EAG.

In May 2006, ENGlobal Corporation purchased Denver-based WRC Corporation ("WRC") and its subsidiary WRC Canada further expanding our services within the pipeline industry. WRC provides land management, environmental compliance, and governmental regulatory services to the pipeline, utility and telecom companies and other owner/operators of "infrastructure facilities."

In October 2006, ENGlobal Construction Resources acquired selected assets of Watco Management, Inc. located in Clear Lake, Texas. As a result, we now provide turnaround, asset management, and start-up services for the refining and petrochemical industry. The addition of WATCO will provide ECR



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with opportunities to expand its current services to existing WATCO clients to a complementary business, allowing expansion of current services to both existing and future clients.

In the first quarter of 2007, the Dallas office was closed with the majority of assets being sold, a major portion of the office lease obligations being assumed by others and remaining operations being transferred to other offices.

Our engineering segment offers its expertise to a broad range of industrial clients. We participate in projects involving both the modification of existing facilities and construction of new facilities. Our predominant type of contract is a blanket services contract that typically provides our clients with engineering, procurement and project management services on a time and materials basis. We also enter into contracts to complete capital projects on a fixed-price, turnkey basis. The engineering staff has the capability of developing a project from the initial planning stages through detailed design and construction management. The engineering services include:

- o conceptual studies;
- o project definition;
- o cost estimating;
- o engineering design;
- o inspection;
- o land management;
- o environmental compliance;
- o material procurement; and
- o project and construction management.

We provide services for major energy-related firms at facilities such as chemical plants, crude oil refineries, electric power generation facilities, cross-country pipelines, pipeline facilities and production processing facilities.

The engineering segment offers a wide range of services from a single source provider. The segment uses an internal virtual private network so that employees in one location can work on projects based in other offices. This "work sharing" capability allows us to provide a greater depth and breadth of expertise to our clients and helps stabilize the workload in our various offices.

### Competition

Our engineering segment competes with a large number of firms of various sizes, ranging from the industry's largest firms, which operate on a worldwide basis, to much smaller regional and local firms. Many of our competitors are larger than we are and have significantly greater financial and other resources available to them than we do.

Competition is primarily centered on performance and the ability to provide the engineering, planning and project execution skills required to complete projects in a timely and cost efficient manner. The technical expertise of our management team and technical personnel and the timeliness and quality of our support services, are key competitive factors. Larger projects, especially international work, typically include pricing alternatives designed to shift risk to the service provider, or at least to cause the service provider to share a portion of the risks associated with cost overruns in service delivery. These alternatives include fixed-price, guaranteed maximum price, incentive fee, competitive bidding and other "value based" pricing arrangements.

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### Systems Segment

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Note: Previously, within the Systems Segment, ESI provided products and services supporting the advanced automation and integrated controls fields. In January 2006, EAG assumed responsibility for these services, which resulted in a move of this division of ESI to the Engineering Segment.

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#### ITEM 1. BUSINESS (Continued)

Revenues and expenses have been reclassified between the segments to provide comparative results. Amounts will tie in total to prior reporting, however, individual segments will vary from prior reports.

	2006	2005	2004
	(Amounts in thousands)		
Revenues	\$ 24,933	\$ 14,159	\$ 14,110
Operating profit (loss)	\$ (14)	(852)	\$ 660
Total assets	\$ 16,099	\$ 6,159	\$ 7,806

#### General

Our systems segment designs, assembles, integrates and services control and instrumentation systems for specific applications in the energy and processing related industries. The systems segment currently consists of ENGlobal Systems, Inc. ("ESI"). Beginning in 2005, the operations of ENGlobal Constant Power, ENGlobal Technologies, Inc. and Senftleber & Associates, LP were merged into ESI. The systems segment derives revenues from fees on contracts for the design, assembly and servicing of control and instrumentation systems. Income from the systems segment is primarily derived from our ability to generate revenues and collect cash on fixed-price contracts in excess of our costs for labor, materials and equipment and transportation costs, plus our SG&A expenses.

ESI's control and instrumentation systems are custom designed and are typically based on electronic, programmable controls, however ESI's work also includes conventional pneumatic and hydraulic systems. Typical applications for ESI's systems include refinery, petrochemical and pipeline facility controls; analyzer packaging; fire and gas detection systems; data acquisition systems; oil and gas production safety systems; and control systems for various processing equipment. We perform all facets of control and instrumentation system design, engineering, assembly and testing in-house. Field installation and technical staff perform start-up and commissioning services, modification to existing systems, on-site training and routine maintenance procedures for client operating personnel.

ESI previously provided products and services supporting the advanced automation and environmental technology fields. Advanced automation services provided by ESI included automation technology audits, consulting, advanced process controls and process computer services, multivariable control, optimization (on-line and off-line), neural net applications, operator training simulators, expert systems and on-site support. In January 2006, EAG assumed responsibility for the provision of these services.

In January 2006, ESI acquired certain assets of Analyzer Technology International, Inc. ("ATI"), a Houston-based analyzer systems provider of

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online process analyzer systems. ATI relocated its operation to ESI's Houston facility, which the Company expects will enable ESI's clients to perform a more efficient factory adaptable test by temporarily connecting both control and analyzer systems onsite prior to delivery. The addition of ATI will provide ESI with a greater presence in the process analyzer sector, especially for larger downstream opportunities of foreign grassroots projects.

### Competition

The systems segment has been impacted by price variations attributable to cyclical conditions in the oil and gas, petroleum and processing industries. In addition, during 2006, a large percentage of ESI's revenues were derived from fabrication, which has a lower profit margin than other services. ESI's control systems and modular facilities compete with similar systems built by other companies, most of which compete primarily on the basis of pricing. We believe that pricing, technical competence and ability to provide superior service comprise the basis of competition for ESI's marketplace.

### Acquisitions and Sales

We have grown our business over the past several years through both internal initiatives and through strategic mergers and acquisitions. These mergers and acquisitions have allowed us to (i) expand our client base and the range of services that we provide to our clients; and (ii) gain access to new geographic areas. We expect to continue evaluating and assessing acquisition opportunities that will either complement our existing business

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### ITEM 1. BUSINESS (Continued)

base or that will provide the Company with additional capabilities or geographical coverage. We believe that strategic acquisitions will enable us to more efficiently serve the technical needs of national and international clients and strengthen our financial performance. The following table lists the businesses we have acquired during the three-year period ended December 31, 2006.

Name/Location/Business Unit -----	Date Acquired -----	Primary Services -----
Engineering Design Group, Inc. Tulsa, OK Operates as ETS, formerly EDG	January 2004	Automated Fuel Handling & Tank Gauging Systems
AmTech Inspection, LLC Midland, TX Operates as a Division of ECR	September 2004	Onsite Inspection and Plant Process Safety Mgt
Cleveland Inspection Services, Inc. Cleveland, OK Operates as a Division of ECR	October 2004	Onsite Pipeline Inspection
Instrument Services Company, LLC Tulsa, OK Operates as a Division of ETS	November 2004	Onsite Instrument and Electrical Technicians
InfoTech Engineering, LLC	December 2004	Advanced Automation System

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Baton Rouge, LA Operates as a Division of EAG		Design
Analyzer Technology International, Inc. Houston, TX Operates as s Division of ESI	January 2006	Process Analyzer Systems
WRC Corporation and WRC Canada Denver, CO	May 2006	Integrated Land Management
PEI Investments Beaumont, TX	May 2006	Real Estate
WATCO Management, Inc. Clearlake, TX Operates as a Division of ECR	October 2006	Turnaround Asset Management Project Commissioning Construction Management

### Business Strategy

In the past year, the Company has focused considerable attention on streamlining its organizational structure and strengthening its leadership team. It anticipates that these efforts will be ongoing in 2007. In addition, our objective is to strengthen the Company's position as a leading engineering and consulting services provider while enhancing the services we offer and expanding our geographic presence. To achieve this objective, we have developed a strategy comprised of the following key elements:

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### ITEM 1. BUSINESS (Continued)

- o Continue to Recruit and Retain Qualified Personnel. We believe recruiting and retaining qualified, skilled professionals is crucial to our success and growth. As a result, we have dedicated staff focused on recruiting personnel with experience in the energy industry. We have also used inter-company recruiting to retain key personnel.
- o Improve Utilization of Resources. We have developed a work-sharing program through the use of an internal virtual private network that gives our clients access to technical resources located in any of our offices and allows for higher utilization of our resources. We believe the work-sharing program has reduced employee turnover and provides for a more stable work environment. We are also moving toward standardization of engineering processes and procedures among our offices, which we believe will enhance our work-sharing ability and provide our clients with more consistent and higher quality services.
- o Pursue Foreign Technical Resources. Our engineering operations has partnered with several offshore technical resources to establish longer-term access to professional engineering and design work in lower cost countries such as Mexico, Venezuela, Costa Rica and the Far East. The Company has entered into an agreement with a Malaysian firm that provides for "low cost, high value" engineering and drafting services. We believe these partnerships, both formal and informal, will allow us to lower our contract bid prices and enhance our competitive position.

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- o Enhance and Strengthen Our Ability to Perform Engineering, Procurement and Construction Projects. We rely heavily on repeat business and referrals from existing customers, industry members and manufacturing representatives. One of the engineering segment's goals is to increase revenues by developing and marketing its ability to perform full service turnkey projects, also called EPC (Engineering, Procurement and Construction) projects, that is expected to emphasize a cost plus contracting strategy. The engineering segment has traditionally been responsible only for the engineering portion of its projects, which usually represents between five to fifteen percent of a project's total installed cost.
- o Maintain High Quality Service. To maintain high quality service, we focus on being responsive to our customers, working diligently and responsibly, and maintaining schedules and budgets. The Company has a quality control and assurance program to maintain standards and procedures for performance and documentation. The Company intends to audit and monitor compliance with these procedures and quality standards.
- o Expand and Enhance Technical Capabilities. We believe that it is important to develop and enhance our overall technical capabilities in the markets we serve. To achieve this objective in the area of advanced computer-aided process simulation, design and drafting, we have purchased computer hardware and software from several suppliers in order to have the latest platforms for the design of plant systems. This initiative should enhance our marketing position with many of our customers who are currently utilizing these design platforms.
- o Pursue Balanced Growth. We continue to pursue balanced growth for our business, utilizing both external acquisitions as well as internal measures as a means of future growth. The internal measures include an active business development program, together with selected initiatives to start new business operations. We also pursue acquisitions that will allow us to offer expanded engineering and control system services to a broad energy complex, increase our technical capabilities, grow our business geographically and improve our market share.
- o Continue to Increase Name Recognition. We intend to continue to present a more cohesive image and continue to increase name recognition. All of ENGlobal's operating subsidiaries have adopted "ENGlobal" as part of their name, and we anticipate that newly acquired entities will adopt ENGlobal as a part of their name within 12 to 18 months of their acquisition.

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### ITEM 1. BUSINESS (Continued)

#### Sales and Marketing

Our various subsidiaries derive revenues primarily from two sources: (1) in-house direct sales and (2) referrals from existing customers and industry members. Our in-house sales managers are assigned to industry segments and territories within the United States. Management believes that this method of selling should result in increased account penetration and enhanced customer service, which should, in turn, create and maintain the foundation for long-term customer relationships. Our growth depends in large measure on our ability to attract and retain qualified sales representatives and sales management personnel. Management believes that in-house marketing allows for more accountability and control, thus

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increasing profitability.

Products and services are also promoted through general and trade advertising, participation in trade shows and through on-line Internet communication via our corporate home page at [www.englobal.com](http://www.englobal.com). The ENGlobal site provides information about both of our operating segments. We use in-house resources to maintain and update our website and our subsidiaries' web sites on an ongoing basis. Through the ENGlobal website, we seek to provide visitors with a single point of contact for obtaining information on the services and products offered by the ENGlobal family of companies.

Our business development department focuses on building long-term relationships with customers and providing customers with product application, engineering and after-the-sale services. Additionally, we seek to capitalize on cross-selling opportunities between our various subsidiaries. Sales leads are often jointly developed and pursued by the sales personnel from a number of these subsidiaries.

Much of our business is repeat business and we are introduced to new customers in most cases by referrals from existing customers and industry members. The Company also believes that our acquisition program, although small, has provided the benefit of expanding our existing customer base.

We currently employ 25 full-time professional in-house marketers in our business development department who concentrate on both the engineering and systems segments. We have formed alliances, which include marketing activities, with other engineering and construction firms in Mexico City, Central and South America and Malaysia.

### Customers

In 2007, the Company will focus substantial attention on improving customer services in certain of its offices in order to enhance satisfaction and increase customer retention. Our customer base consists primarily of Fortune 500 companies representing a variety of industries in the United States. While we do not have continuing dependence on any single client or a limited group of clients, one or a few clients may contribute a substantial portion of our revenues in any given year or over a period of several consecutive years due to major engineering projects. We have had success undertaking new projects for prior clients and providing ongoing services to clients following the completion of the projects.

The Company believes that about two-thirds of our revenue is generated through sources such as in-plant staffing and alliance relationships that we consider longer-term in nature and that are not typically limited to one project. As an example, our In Plant Staffing division of EEI provides outsourced technical and other personnel that are assigned to work at client locations. The Company's past experience with this activity is that the term of these assignments on average spans multiple projects and multiple years.

A major long-term trend among our clients and their industry counterparts has been toward outsourcing of engineering services, and more recently, sole-sourcing. This trend has fostered the development of ongoing, longer-term alliance arrangements with clients, rather than one-time limited engagements. These arrangements vary in scope, duration and degree of commitment. While there is typically no guarantee of work that will result from these alliance agreements, often they form the basis for a longer-term relationship with our clients. Despite their variety, we believe that these partnering relationships have a stabilizing influence on our service revenues. At December 31, 2006, we maintained some form of partnering or alliance arrangement with 16 major oil and chemical companies. For example, alliance engagements may provide for:

## ITEM 1. BUSINESS (Continued)

- o a minimum number of work man-hours over a specified period;
- o the provision of at least a designated percentage of the client's requirements;
- o the designation of the Company as the client's sole source of engineering at specific locations; or
- o a non-binding preference or intent, or a general contractual framework, for what the parties expect will be an ongoing relationship.

In order to generate revenues in future years, we must continue efforts to obtain new engineering projects. Historically, we have not generated significant revenues from government clients. Also during 2006 we generated \$26 million in revenues away from the historical large "owner/operator" type Fortune 500 companies to smaller developer type entities such as smaller refiners and developers of renewable energy.

In the engineering segment, our ten largest customers, who vary from one period to the next, accounted for 71% of our total revenue for 2006, 77% of total revenue for 2005, and 80% of total revenue for 2004. Most of our projects are specific in nature and we generally have multiple projects with the same clients. If we were to lose one or more of our significant clients and were unable to replace them with other customers or other projects, our business would be materially adversely affected. Our top three clients in 2006 were ConocoPhillips, ExxonMobil and Motiva.

In the systems segment, our clients include end-users and operators of facilities relating to oil and gas products, pipelines, refineries, chemical companies and processing plants. Other clients include equipment manufacturers, construction contractors and other engineering firms that incorporate our control systems into facilities and products that they design, construct and manufacture. As in the engineering segment, in any given year, a small number of clients may account for a large percentage of the systems segment's revenues for that year, depending on the number of major projects undertaken. Though the systems segment frequently receives work from repeat clients, its client list may vary significantly from year to year.

In the systems segment, our ten largest customers, who vary from one period to the next, accounted for 64% of our total revenue for 2006, 70% of total revenue for 2005, and 77% of total revenue for 2004. During 2006, foreign customers accounted for 31% of our systems segment revenue compared to less than 1% during both 2005 and 2004. The increase in revenue from foreign customers is based on the expansion of the analytical division that provides online process analyzer systems, through the acquisition of ATI. Our ability to provide analyzer systems is dependent on fundamental contracts with customers doing business in oil producing regions. The loss of business from anyone of such customers could have a material adverse effect on our systems business or results of operations, but not the company as a whole. Other factors affecting our analyzer systems business that are beyond our control include: political instability or armed conflict, the level of customer demand, the willingness of clients to make payments, and to make those payments timely.

We do not have any long-term commitments from systems segment clients and sales of products from the systems segment are typically made according to the client's specifications on a purchase order basis. Our potential

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revenues are, therefore, dependent on continuing relationships with these customers.

### Contracts

We generally enter into two principal types of contracts with our clients: time and materials contracts and fixed-price contracts. In our engineering segment, in fiscal 2006, 89% and 11% of our net revenue was derived from time and materials and fixed-price contracts, respectively, compared to 95% and 5% of net revenue from time and materials and fixed-price contract respectively in 2005. In our systems segment, in fiscal 2006, 7% and 93% of our net revenue was derived from time and materials and fixed-price contracts, respectively, compared to 3% and 97% of net revenues from time and materials and fixed-price contracts, respectively in 2005. Our clients typically determine the type of contract to be utilized for a particular engagement, with the specific terms and conditions of a contract resulting from a negotiation process between the Company and our client.

- o Time and Materials. Under our time and materials contracts, we are paid for labor at either negotiated hourly billing rates or reimbursed for allowable hourly rates and for other expenses. We are paid for material and contracted services at an agreed upon multiplier of our cost, and at times pass these non-labor services through with no profit. Profitability on these contracts is driven by billable headcount, the amount of non-labor related services, and cost control. Some of these contracts may have upper limits, referred to as "not to exceed." If our costs

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### ITEM 1. BUSINESS (Continued)

generate billings that exceed the contract ceiling or are not allowable, we will not be able to obtain reimbursement for any excess cost. Further, the continuation of each contract partially depends upon the customer's discretionary periodic assessment of our performance on that contract.

- o Fixed-Price. Under a fixed-price contract, we provide the customer a total project for an agreed-upon price, subject to project circumstances and changes in scope. Fixed-price projects vary in scope, including some engineering activities and related services, and procurement of material and construction responsibility. Fixed-price contracts carry certain inherent risks, including risks of losses from underestimating costs, delays in project completion, problems with new technologies and economic and other changes that may occur over the contract period. Another risk includes our ability to secure written change orders prior to commencing work on such orders, which may prevent our getting paid for work performed. Consequently, the profitability of fixed-price contracts may vary substantially, and we plan to limit the size and scope of fixed-price contracts that we enter into in the future due to significant losses on two fixed-price contracts.

### Backlog

Backlog represents gross revenue of all awarded contracts that have not been completed and will be recognized as revenues over the life of the project. Although backlog reflects business that we consider to be firm, cancellations or scope adjustments may occur. Further, most contracts with clients may be terminated at will, in which case the client would only be



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obligated to us for services provided through the termination date. We have adjusted backlog to reflect project cancellations, deferrals and revisions in scope and cost (both upward and downward) known at the reporting date; however, future contract modifications or cancellations may increase or reduce backlog and future revenues. As a result, no assurances can be given that the amounts included in backlog will ultimately be realized.

At December 31, 2006, our backlog was \$192.0 million compared to an estimated \$170.0 million at December 31, 2005. We expect that a majority of the \$192.0 million in backlog to be completed during 2007.

The backlog at December 31, 2006 consists of \$187.0 million with commercial customers and \$5.0 million with the United States Federal Government. Backlog on the federal programs includes only the portion of the contract award that has been funded by the U.S. Government.

Backlog includes gross revenue under two types of contracts: (1) contracts for which work authorizations have been received on a fixed-price basis and not-to-exceed projects that are well defined, and (2) time and material evergreen contracts at an assumed 12 month run-rate, where we place employees at our clients' site to perform day-to-day project efforts.

There is no assurance as to what percentage of backlog will be recognized.

### Customer Service and Support

We provide service and technical support to our customers in varying degrees depending upon the business line and on customer contractual arrangements. The Company's technical staff provides initial telephone support services for its customers. These services include isolating and verifying reported failures and authorizing repair services in support of customer requirements. We also provide on-site engineering support if a technical issue cannot be resolved over the telephone. On projects for which we have provided engineering systems, we provide worldwide start-up and commissioning services. We also provide the manufacturers' limited warranty coverage for products we re-sell.

### Dependence Upon Suppliers

Our ability to provide clients with services and systems in a timely and competitive manner depends on the availability of products and parts from our suppliers at competitive prices and on reasonable terms. Our suppliers are not obligated to have products on hand for timely delivery nor can they guarantee product availability in sufficient quantities to meet our demands. There can be no assurance that we will be able to obtain necessary supplies at prices or on terms we find acceptable. However, in an effort to maximize availability and maintain quality control, we generally procure components from multiple distributors.

## ITEM 1. BUSINESS (Continued)

For example, all of the product components used by our systems segment are fabricated using components and materials that are available from numerous domestic suppliers. There are approximately 5 principal suppliers of these components, each of whom can be replaced by an equally viable competitor. No one manufacturer or vendor provides products that account for 7% or more of our revenues. Thus, we anticipate little or no difficulty in obtaining components in sufficient quantities and in a timely manner to support our manufacturing and assembly operations. Units produced through the systems segment are normally not produced for inventory and component parts; rather, they are typically purchased on an as-needed basis.

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Despite the foregoing, some of our subsidiaries rely on certain suppliers for necessary components and there can be no assurance that these components will continue to be available on acceptable terms. If a subsidiary or one of its suppliers terminates a long-standing supply relationship, it may be difficult to obtain alternative sources of supply without a material disruption in our ability to provide products and services to our customers. While we do not believe that such a disruption is likely, if it did occur, it could have a material adverse effect on our financial condition and results of operations.

### Patents, Trademarks, Licenses

Our success depends in part upon our ability to protect our proprietary technology, which we do primarily through protection of our trade secrets and confidentiality agreements. The U.S. Patent and Trademark Office approved our application for the uses of "ENGlobal" and "Integrated Rack" in September 2004 and March 2005, respectively. In addition, we have pending trademark applications on file with the U.S. Patent and Trademark Office for the names "Engineered for Growth" and "ENGlobal CARES - Communicating Appropriate Responses in Emergency Situations", "Flare-Mon" and "Purchased Data". There can be no assurance that the protective measures we currently employ will be adequate to prevent the unauthorized use or disclosure of our technology, or the independent third party development of the same or similar technology. Although our competitive position to some extent depends on our ability to protect our proprietary and trade secret information, we believe that other factors, such as the technical expertise and knowledge base of our management and technical personnel, as well as the timeliness and quality of the support services we provide, will also help us to maintain our competitive position.

### Government Regulations

The Company and certain of our subsidiaries are subject to various foreign, federal, state, and local laws and regulations relating to our business and operations, and various health and safety regulations as established by the Occupational Safety and Health Administration. The Company and members of its professional staff are subject to a variety of state, local and foreign licensing, registration and other regulatory requirements governing the practice of engineering. Currently, we are not aware of any situation or condition relating to the regulation of the Company, its subsidiaries, or personnel that we believe is likely to have a material adverse effect on our results of operations or financial condition.

### Employees

As of December 31, 2006, the Company and its subsidiaries employed 2,100 individuals. Of these employees, 1,127 were employed in engineering and related positions; 332 were employed as inspectors; 310 were employed as project support staff; 211 were employed in technical production positions; 95 were employed in administration, finance and management information systems and 25 were employed in sales and marketing. We believe that our ability to recruit and retain highly skilled and experienced technical, sales and management personnel has been and will continue to be, critical to our ability to execute our business plan. None of our employees is represented by a labor union or is subject to a collective bargaining agreement. We believe that relations with our employees are good.

## ITEM 1A. RISK FACTORS

Set forth below and elsewhere in this Report and in other documents we file with the SEC are risks and uncertainties that could cause actual results to

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differ materially from the results contemplated by the forward-looking statements contained in this Report. You should be aware that the occurrence of any of the events described in these risk factors and elsewhere in this Report could have a material adverse effect on our business, financial condition and results of operations and that upon the occurrence of any of these events, the trading price of our common stock could decline.

Our indebtedness could limit our ability to finance future operations or engage in other business activities. As of December 31, 2006, we had \$24 million of total outstanding indebtedness against our revolving line of credit currently limited to \$30 million. Significant factors that could increase our indebtedness and/or limit our ability to finance future operations include:

- o our inability to collect accounts receivable within contractual terms;
- o client demands for extending contractual payment terms;
- o material losses and/or negative cash flows on significant projects;
- o client's ability to pay our invoices due to economic conditions; and
- o our ability to meet current credit facility financial ratios and covenants.

Although we are in compliance with all current credit facility covenants, our indebtedness could limit our ability to finance future operations or engage in other business activities.

Force majeure events such as natural disasters have negatively impacted and could further negatively impact the economy and the industries we service, which may affect our financial condition, results of operations and cash flows.

Force majeure events such as Hurricanes Katrina and Rita that affected the Gulf Coast in August and September of 2005 could negatively impact the economies in which we operate. For example, these two hurricanes caused considerable damage along the Gulf Coast not only to the refining and petrochemical industry but also the commercial segment which competes for labor, materials and equipment resources needed throughout the entire United States. We typically remain obligated to perform our services after such a natural disaster and even though our contract may contain force majeure clause. If we are not able to react quickly and/or negotiate contractual relief under a force majeure event, our operations may be affected significantly, which would have a negative impact on our financial condition, results of operation and cash flows.

Our future revenues depend on our ability to consistently bid and win new contracts and to maintain and renew existing contracts and, therefore, our failure to effectively obtain future contracts could adversely affect our profitability.

Our future revenues and overall results of operations require us to successfully bid on new contracts and renew existing contracts. Contract proposals and negotiations are complex and frequently involve a lengthy bidding and selection process, which is affected by a number of factors, such as market conditions, financing arrangements and required governmental approvals. For example, a client may require us to provide a bond or letter of credit to protect the client should we fail to perform under the terms of the contract. If negative market conditions arise, or if we fail to secure adequate financial arrangements or the required governmental approval, we may not be able to pursue particular projects, which could adversely affect our

profitability.

The failure to attract and retain key professional personnel could adversely affect the Company. Our success depends on attracting and retaining qualified personnel in a competitive environment. We are dependent upon our ability to attract and retain highly qualified managerial, technical and business development personnel. Competition for key personnel is intense. We cannot be certain that we will retain our key managerial, technical and business development personnel or that we will attract or assimilate key personnel in the future. Failure to attract and retain such personnel would materially adversely affect our businesses, financial position, results of operations and cash flows. This is a major risk factor that could materially impact our operating results.

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ITEM 1A. RISK FACTORS (Continued)

If we are not able to successfully manage internal growth initiatives, our business and results of operations may be adversely affected. Our growth strategy is to use our technical expertise in conjunction with industry trends. To support this strategy, the Company may elect to fund internal growth initiatives targeted at markets that the Company believes may have significant potential needs for the Company's services. The downside risks are that such initiatives could have a negative effect on current earnings until they reach critical mass, that industry trends have been misread or delayed or that they Company is unable to successfully execute on these initiatives. In these cases, continued funding could have a negative impact on long term earnings.

If we are not able to successfully manage our growth strategy, our business and results of operations may be adversely affected. We have grown rapidly over the last several years. Our growth presents numerous managerial, administrative, operational and other challenges. Our ability to manage the growth of our operations will require us to continue to improve our management information systems and maintain discipline in our internal systems and controls. Industry trends and our ability to manage and measure project performance will require us to strengthen our internal project and cost control systems within operations that have traditionally operated in a cost plus environment. In addition, our growth will increase our need to attract, develop, motivate and retain both our management and professional employees. The inability of our management to effectively manage our growth or the inability of our employees to achieve anticipated performance could have a material adverse effect on our business.

Liability claims could result in losses. Providing engineering and design services involves the risk of contract, professional errors and omissions and other liability claims, as well as adverse publicity. Further, many of our contracts will require us to indemnify our clients not only for our negligence, if any, but also for the concurrent negligence and in some cases, sole negligence of our clients. We currently maintain liability insurance coverage, including coverage for professional errors and omissions. However, claims outside of or exceeding our insurance coverage may be made. A significant claim could result in unexpected liabilities, take management time away from operations, and have a material adverse impact on our cash flow.

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Our business and operating results could be adversely affected by our inability to accurately estimate the overall risks, revenue or costs on a contract.

We generally enter into two principal types of contracts with our clients: time and materials contracts and fixed-price contracts. Under our fixed-price contracts, we receive a fixed-price irrespective of the actual costs we incur and, consequently, we are exposed to a number of risks. These risks include underestimation of costs, problems with new technologies, unforeseen expenditures or difficulties, delays beyond our control and economic and other changes that may occur during the contract period. Our ability to secure change orders on scope changes and our ability to invoice for such changes poses an additional risk. In fiscal 2006, approximately 17.9% of our net revenue was derived from fixed-price contracts, and we recorded losses of \$13 million on two significant fixed-price EPC projects.

Under our time and materials contracts, we are paid for labor at negotiated hourly billing rates or reimbursement at specified mark-up hourly rates and negotiated rates for other expenses. Profitability on these contracts is driven by billable headcount and cost control. Some time and materials contracts are subject to contract ceiling amounts, which may be fixed or performance-based. If our costs generate billings that exceed the contract ceiling or are not allowable under the provisions of the contract or any applicable regulations, we may not be able to obtain reimbursement for all of our costs.

Revenue recognition for a contract requires judgment relative to assessing the contract's estimated risks, revenue and costs, and technical issues. Due to the size and nature of many of our contracts, the estimation of overall risk, revenue and cost at completion is complicated and subject to many variables. Changes in underlying assumptions, circumstances or estimates may also adversely affect future period financial performance. This is a major risk factor that could materially impact our operating results.

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### ITEM 1A. RISK FACTORS (Continued)

Economic downturns could have a negative impact on our businesses. Demand for the services offered by us has been and is expected to continue to be, subject to significant fluctuations due to a variety of factors beyond our control, including demand for engineering services in the petroleum refining, petroleum chemical and pipeline industries and in other industries that we provide services to. During economic downturns in these industries, our customer's need to engage us may decline significantly. We cannot be certain that economic or political conditions will be generally favorable or that there will not be significant fluctuations adversely affecting our industry as a whole or key markets targeted by us.

Our dependence on one or a few customers could adversely affect us. One or a few clients have in the past and may in the future contribute a significant portion of our consolidated revenues in any one year or over a period of several consecutive years. In 2006, approximately 15% of our revenues were from ConocoPhillips, approximately 14% of our revenues were from ExxonMobil and another 10% were from Motiva. As our backlog frequently reflects multiple projects for individual clients, one major customer may comprise a significant percentage of our

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backlog at any point in time. Because these significant customers generally contract with us for specific projects, we may lose these customers from year to year as their projects with us are completed. If we do not replace them with other customers or other projects, our business could be materially adversely affected. Also, the majority of our contracts can be terminated at will. Additionally, we have long-standing relationships with many of our significant customers. Our contracts with these customers, however, are on a project-by-project basis and the customers may unilaterally reduce or discontinue their purchases at any time. The loss of business from any one of such customers could have a material adverse effect on our business or results of operations.

If the operating result of either segment is adversely affected, an impairment of goodwill could result in a write down. Based on factors and circumstances impacting ENGlobal and the business climate in which it operates, the Company may determine that it is necessary to re-evaluate the carrying value of its goodwill by conducting an impairment test in accordance with SFAS No. 142. The Company has assigned goodwill to its two segments based on estimates of the relative fair value of each segment. If changes in the industry, market conditions, or government regulation negatively impact either of the Company's segments resulting in lower operating income, if assets are harmed, if anticipated synergies or cost savings are not realized with newly acquired entities, or if any circumstance occurs which results in the fair value of either segment declining below its carrying value, an impairment to goodwill would be created. In accordance with SFAS No. 142, the Company would be required to write down the carrying value of goodwill.

Our backlog is subject to unexpected adjustments and cancellations and is, therefore, an uncertain indicator of our future revenues or earnings.

As of December 31, 2006, our backlog was approximately \$192 million. We cannot assure investors that the revenues projected in our backlog will be realized or, if realized, will result in profits. Projects may remain in our backlog for an extended period of time prior to project execution and, once project execution begins, it may occur unevenly over the current and multiple future periods. In addition, project terminations, suspensions or reductions in scope may occur from time to time with respect to contracts reflected in our backlog, reducing the revenue and profit we actually receive from contracts reflected in our backlog. Future project cancellations and scope adjustments could further reduce the dollar amount of our backlog and the revenues and profits that we actually earn.

Additional acquisitions may adversely affect our ability to manage our business.

Acquisitions have contributed to our growth over the past three years and we plan to continue making acquisitions in the future on terms management considers favorable to us. The successful acquisition of other companies involves an assessment of future revenue opportunities, operating costs, economies and earnings after the acquisition is complete, potential industry and business risks and liabilities beyond our control. This assessment is necessarily inexact and its accuracy is inherently uncertain. In connection with our

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assessments, we perform reviews of the subject acquisitions we believe to be generally consistent with industry practices. These reviews, however, may not reveal all existing or potential problems, nor will they permit a buyer to become sufficiently familiar with the target companies to assess fully their deficiencies and capabilities. We cannot assure you that we will identify, finance and complete additional suitable acquisitions on acceptable terms. We may not successfully integrate future acquisitions. Any acquisition may require substantial attention from our management, which may limit the amount of time that management can devote to day-to-day operations. Our inability to find additional attractive acquisition candidates or to effectively manage the integration of any businesses acquired in the future could adversely affect our ability to grow profitably or at all.

We are engaged in highly competitive businesses and must typically bid against competitors to obtain engineering and service contracts. We are engaged in highly competitive businesses in which customer contracts are typically awarded through competitive bidding processes. We compete with other general and specialty contractors, both foreign and domestic, including large international contractors and small local contractors. Some competitors have greater financial and other resources than we do, which, in some instances, gives them a competitive advantage over us.

Seasonality of our industry may cause our revenues to fluctuate. Holidays and employee vacations during our fourth quarter exert downward pressure on revenues for that quarter, which is only partially offset by the year-end efforts on the part of many clients to spend any remaining funds budgeted for engineering services or capital expenditures during the year. The annual budgeting and approval process under which these clients operate is normally not completed until after the beginning of each new-year, which can depress results for the first quarter. Principally due to these factors, our first and fourth quarters may be less robust than our second and third quarters.

Our dependence on subcontractors and equipment manufacturers could adversely affect us.

We rely on third-party subcontractors as well as third-party suppliers and manufacturers to complete our projects. To the extent that we cannot engage subcontractors or acquire supplies or materials, our ability to complete a project in a timely fashion or at a profit may be impaired. If the amount we are required to pay for these goods and services exceeds the amount we have estimated in bidding for fixed-price or cost-plus contracts, we could experience losses in the performance of these contracts. In addition, if a subcontractor or supplier is unable to deliver its services or materials according to the negotiated terms for any reason, including the deterioration of its financial condition or over-commitment of its resources, we may be required to purchase the services or materials from another source at a higher price. This may reduce the profit to be realized or result in a loss on a project for which the services or materials were needed.

A small number of stockholders own a significant portion of our outstanding common stock, thus limiting the extent to which other stockholders can effect decisions subject to stockholder vote.

A small number of stockholders own a significant portion of our outstanding common stock, thus limiting the extent to which other stockholders can effect decisions subject to stockholder vote. As of December 31, 2006, directors, executive officers and principal stockholders of ENGlobal and their affiliates, beneficially owned

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approximately 41% of our outstanding common stock on a fully diluted basis. Accordingly, these stockholders, as a group, are able to affect the outcome of stockholder votes, including votes concerning the adoption or amendment of provisions in our Articles of Incorporation or bylaws and the approval of mergers and other significant corporate transactions. The existence of these levels of ownership concentrated in a few persons makes it unlikely that any other holder of common stock will be able to affect the management or direction of the Company. These factors may also have the effect of delaying or preventing a change in management or voting control of the Company.

Our Board of Directors may authorize future sales of ENGlobal common stock, which could result in a decrease in value to existing stockholders of the shares they hold.

Our Articles of Incorporation authorize our board of directors to issue up to an additional 47,518,533 shares of common stock and an additional 2,000,000 shares of blank check preferred stock as of the date of filing. These shares may be issued without stockholder

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### ITEM 1A. RISK FACTORS (Continued)

approval unless the issuance is 20% or more of our outstanding common stock, in which case the American Stock Exchange requires stockholder approval. We may issue shares of stock in the future in connection with acquisitions or financings. In addition, we may issue options as incentives under our 1998 Incentive Option Plan or under a new equity incentive plan. Future issuances of substantial amounts of common stock, or the perception that these sales could occur, may affect the market price of our common stock. In addition, the ability of the board of directors to issue additional stock may discourage transactions involving actual or potential changes of control of the Company, including transactions that otherwise could involve payment of a premium over prevailing market prices to holders of our common stock.

### ITEM 1B. UNRESOLVED STAFF COMMENTS

Not applicable.

### ITEM 2. PROPERTIES

#### Facilities

We lease space in 23 buildings in the U.S. and Canada totaling approximately 458,600 square feet, and we own an office building in Baton Rouge, Louisiana with 27,500 square feet. The leases have remaining terms ranging from monthly to six years and are at what we consider to be commercially reasonable rental rates. On May 26, 2006, the Company entered into an exclusive agreement with a third-party, national real estate firm for tenant representation services that covers most of our facilities.

Our principal office locations are in Houston and Beaumont, Texas, and Tulsa, Oklahoma. We have other offices in Clear Lake, Freeport, and Midland, Texas; Baton Rouge and Lake Charles, Louisiana; Cleveland and Blackwell, Oklahoma; Denver, Colorado; and Calgary, Alberta Canada. Approximately 357,000 square feet of our total office space is designated for our professional, technical and administrative personnel. We believe that our office and other facilities are well maintained and adequate for existing and planned operations at each operating location.



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Our systems segment performs fabrication assembly in two shop facilities. One facility is in Houston, Texas with approximately 62,600 square feet of space and a second facility is in Beaumont, Texas with approximately 30,000 square feet of space.

On May 25, 2006, the Company, through its wholly-owned subsidiary ENGlobal Corporate Services, Inc., purchased a one-third partnership interest in PEI Investments, A Texas Joint Venture ("PEI"), from Michael L. Burrow, the Company's President and CEO, and another one-third interest from a stockholder who owns less than 1% of the Company's common stock. The partnership interests were purchased for a total of \$69,000. The remaining one-third interest was already held by the Company through its wholly-owned subsidiary EEI. PEI owns the land on which our Beaumont, Texas office building, destroyed by Hurricane Rita in September 2005, was located. The remains of the building were razed in July 2006. In September 2006, the Company acquired approximately 1.2 acres immediately adjacent to the former facility and is developing plans to construct a new facility utilizing both parcels of land.

On February 16, 2007, the Company, through its wholly-owned subsidiary, RPM Engineering, Inc. ("RPM"), entered into an agreement (the "Agreement") to sell the Company's property located in Baton Rouge, Louisiana. The purchase price is approximately \$1.9 million with 20% of the purchase price being paid at closing and the balance self-financed for a period no longer than 60 months, amortized over 180 months, payable in equal monthly installments and one irregular installment consisting of the interest and principal due at the end of the 60 months. The initial interest rate is 8.5% based on an agreed rate of NY prime plus .25%. Under certain conditions, prior to closing and up to 60 days from the last signing of the Agreement, the Purchaser is entitled to terminate the agreement and demand the return in full of any deposit held by RPM. The financed portion of the purchase price is secured by a first mortgage on the property. The Company's basis in the property, together with the building and all improvements, is approximately \$1.4 million. The Company expects to close this transaction May 31, 2007.

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### ITEM 2. PROPERTIES (Continued)

The Company has leased approximately 31,000 square feet of space in two separate facilities to house its EEI and EAG operations in Baton Rouge.

On March 2, 2007, the Company, through its wholly-owned subsidiary, ENGlobal Automation Group, Inc. ("EAG"), entered into a 39 month lease agreement for approximately 4,489 square feet of office space in Alpharetta, Georgia (a suburb of Atlanta).

### ITEM 3. LEGAL PROCEEDINGS

From time to time, we are involved in various legal proceedings arising in the ordinary course of business alleging, among other things, breach of contract or tort in connection with the performance of professional services, the outcome of which cannot be predicted with certainty. As of the date of this filing, we are party to several legal proceedings that have been reserved for or are covered by insurance, or that, if determined adversely to us individually or in the aggregate, would not have a material adverse effect on our results of operations or financial position.

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### ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

Not applicable.

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### PART II

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### ITEM 5. MARKET FOR REGISTRANT'S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES

#### Market Information and Holders

The Company's common stock has been quoted on the American Stock Exchange ("AMEX") since June 16, 1998, and is currently traded under the symbol "ENG". From its initial listing on AMEX on June 16, 1998 to June 15, 2002, the Company's stock was traded under the symbol "IDS." Newspaper stock listings identify us as "ENGlobal."

The following table sets forth the high and low sales prices of our common stock for the periods indicated.

	Fiscal Year Ended December 31			
	2006		2005	
	High	Low	High	Low
First Quarter	14.61	9.14	2.87	2.04
Second Quarter	14.70	6.91	4.03	2.01
Third Quarter	8.88	5.71	9.10	3.69
Fourth Quarter	8.15	5.92	8.75	5.87

The foregoing figures, based on information published by AMEX, do not reflect retail mark-ups or markdowns and may not represent actual trades.

In connection with our December 2001 merger with Petrocon, we issued 2,500,000 shares of Series A Preferred Stock, \$0.001 par value per share, to Equus II Incorporated. In 2002 and 2003, we issued dividends to Equus in the form of 234,833 shares of Series A Preferred Stock. Effective August 2003, the Company exercised its right to convert all outstanding Series A Preferred Stock to 1,149,089 shares of common stock. The Series A Preferred Stock had fixed terms that were specific to the 2001 merger with Petrocon. The Company's stockholders at its June, 2006 meeting approved the elimination of the 2,265,167 shares of available and unissued Series A Preferred Stock from its capital structure, and approved the authorization of a like number of "blank check" preferred stock.

The Company's stockholders, at the Company's June, 2006 meeting, approved a new class of capital stock of the Company consisting of 2,000,000 shares of Preferred Stock, par value \$0.001 per share (the "Preferred Stock"). The Preferred Stock is referred to as a "blank check" because the Board of Directors, in their discretion, will be authorized to provide for the issuance of all or any shares of the stock in one or more classes or series, specifying the terms of the shares, subject to the limitations of Nevada law. The Board of Directors would make a determination as to whether to approve the terms and issuance of any shares of Preferred Stock based on its judgment as to the best interests of the Company and its stockholders.

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As of December 31, 2006, approximately 314 stockholders of record held the Company's common stock. We do not have current information regarding the number of holders of beneficial interest holding our common stock.

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	2001	2002	2003	2004	2005	2006
	----	----	----	----	----	----
ENGlobal (ENG)	100.00	57.14	82.29	136.00	225.14	354.29
S&P 600 SmallCap Index	100.00	84.68	116.47	141.61	151.03	172.29
Amex US Index	100.00	81.74	110.63	127.83	138.33	160.48

### STOCK PERFORMANCE GRAPH Comparison of Five Year Cumulative Total Return

The following line graph compares the total returns (assuming reinvestment of dividends) of our Common Stock, the AMEX US Index and the S&P 600 SmallCap Index for the five-year period ended December 31, 2006. This comparison assumes the investment of \$100 on December 31, 2000 and the reinvestment of all dividends.

[GRAPHIC ON FILE]

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#### ITEM 5. MARKET FOR REGISTRANT'S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES (Continued)

##### Equity Compensation Plan Information

The following table sets forth certain information concerning the Company's equity compensation plans as of December 31, 2006. See Note 11 in the attached financial statements.

	Number of Securities to be Issued Upon Exercise of Outstanding Options, Warrants and Rights (a)		Weighted-Average Exercise Price of Outstanding Options, Warrants and Rights (b)
	-----		-----
Equity compensation plans approved by security holders	1,422,494	(1)	\$5.16
	-----		

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### Dividend Policy

The Company has never declared or paid a cash dividend on its common stock. The Company intends to retain any future earnings for reinvestment in its business and does not intend to pay cash dividends in the foreseeable future. In addition, restrictions contained in our loan agreements governing our credit facility with Comerica Bank preclude us from paying any dividends on our common stock while any debt under those agreements is outstanding. The payment of dividends in the future will depend on numerous factors, including the Company's earnings, capital requirements, and operating and financial position and on general business conditions.

Dividends on outstanding shares of Series A Preferred Stock were paid on the last day of May in 2002 and 2003 in shares of stock of Series A Preferred Stock at a rate of 0.08 shares for each outstanding share of Series A Preferred Stock. The Company elected to convert all shares of preferred stock to 1,149,089 shares of common stock in August 2003. The Company's stockholders eliminated this series of preferred stock at its June, 2006 stockholders meeting.

- 
- (1) Includes options issued through our 1998 Incentive Plan. For a brief description of the material features of the Plan, see Note 11 of the Notes to the Consolidated Financial Statements. Some of these options, also granted through the 1998 Incentive Plan, were options granted as replacement options for outstanding Petrocon incentive options pursuant to the terms of the December 2001 Merger Agreement with Petrocon.

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### ITEM 6. SELECTED FINANCIAL DATA

#### Summary Selected Historical Consolidated Financial Data

The following tables set forth our selected financial data. The data for the years ended December 31, 2006, 2005, and 2004 have been derived from the audited financial statements appearing elsewhere in this document. The data as of December 31, 2003 and 2002 and for the years ended December 31, 2003 and 2002 have been derived from audited financial statements not appearing in this document. You should read the selected financial data set forth below in conjunction with our financial statements and the notes thereto included in Part II, Item 8, Part II, Item 7, "Management's Discussion and Analysis of Financial Condition and Results of Operations," and other financial information appearing elsewhere in this document.

Note: Previously, within the Systems Segment, ESI provided products and services supporting the advanced automation and integrated controls fields. In January 2006, EAG assumed responsibility for these services, which resulted in a move of this division of ESI to the Engineering Segment. This, along with the sale of Thermaire in 2003, has caused reclassification to provide comparative results. Revenues and expenses have been reclassified between the segments to provide comparative results. Amounts will tie in total to prior reporting, however, individual segments will vary from prior reports.

	Years Ended De		
	2006	2005	2004

(in thousands, except

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Statement of Operations

Revenues

Engineering  
Systems

\$ 278,157	\$ 219,426	\$ 134
24,933	14,159	14

Total revenues

303,090	233,585	148
---------	---------	-----

Costs and expenses

Engineering  
Systems  
Selling, general and administrative

254,031	192,264	118
22,795	13,048	11
29,885	19,689	13

Total costs and expenses

306,711	225,001	144
---------	---------	-----

Operating income (loss)

(3,621)	8,584	4
---------	-------	---

Interest income (expense), net

(1,312)	(800)	
---------	-------	--

Other income (expense), net

652	116	
-----	-----	--

Foreign currency gain (loss)

(19)	(2)	
------	-----	--

Income (loss) from continuing operations before

provision for income taxes

(4,300)	7,898	4
---------	-------	---

Provision for income taxes

(814)	3,116	1
-------	-------	---

Income (loss) from operations

(3,486)	4,782	2
---------	-------	---

Income (loss) from discontinued operations, net of taxes

-	-	
---	---	--

Income (loss) from disposal of discontinued operations

-	-	
---	---	--

Net income (loss)

\$ (3,486)	\$ 4,782	\$
------------	----------	----

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ITEM 6. SELECTED FINANCIAL DATA (Continued)

Years Ended De

2006	2005	2004
------	------	------

(in thousands, except

Per Share Data

Basic earnings (loss) per share

Continuing operations

\$ (0.13)	\$ 0.20	\$
-----------	---------	----

Discontinued operations

-	-	
---	---	--

Net income per share

\$ (0.13)	\$ 0.20	\$
-----------	---------	----

Weighted average common

shares outstanding - basic

26,538	24,300	2
--------	--------	---

Diluted earnings (loss) per share

Continuing operations

\$ (0.13)	\$ 0.19	\$
-----------	---------	----

Discontinued operations

-	-	
---	---	--

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Net income per share	\$	(0.13)	\$	0.19	\$
		=====		=====	=====
Weighted average common shares outstanding - diluted		26,538		25,250	2
Cash Flow Data					
Operating activities, net	\$	(8,953)	\$	(920)	\$
Investing activities, net		(9,330)		(2,417)	(
Financing activities, net		19,553		3,492	
Exchange rate changes		(26)		(4)	
		-----		-----	-----
Net change in cash and cash equivalents	\$	1,244	\$	151	\$
		=====		=====	=====
Balance Sheet Data					
Working capital	\$	35,187	\$	21,825	\$
Property and equipment, net	\$	8,725	\$	6,861	\$
Total assets	\$	106,227	\$	75,936	\$
Long-term debt, net of current portion	\$	27,162	\$	5,228	\$
Long-term capital leases, net of current portion	\$	-	\$	-	\$
Stockholders' equity	\$	40,862	\$	39,865	\$

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ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATION

The following discussion is qualified in its entirety by, and should be read in conjunction with, our Consolidated Financial Statements including the Notes thereto, included elsewhere in this Annual Report on Form 10-K. Note 18 to the Financial Statements contain segment information.

Overview

We furnish engineering consulting and control system services to the petroleum refining, petrochemical, pipeline, production and processing industries. Our business consists of two segments: engineering and systems. Our engineering segment offers engineering consulting services to clients for the development, management and turnkey execution of engineering projects, construction management, inspection services, land management and environmental compliance services. Our systems segment designs, assembles, integrates and services control and instrumentation systems for specific applications in the energy and process related industries.

The Company's revenue is composed of engineering, construction and procurement service revenue and product sales. The Company recognizes service revenue as soon as the services are performed. The majority of the Company's engineering services have historically been provided through cost-plus contracts whereas a majority of the Company's product sales are earned on fixed-price contracts.

In the course of providing our services, we routinely provide engineering, materials, and equipment and may provide construction services on a subcontractor basis. Generally, these materials, equipment and subcontractor costs are passed through to our clients and reimbursed, along with fees, which in total are at margins lower than those of our normal core business. In accordance with industry practice and generally accepted accounting principles, all costs and fees are included in revenue. The use of subcontractor services can change significantly from project to project;

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therefore, changes in revenue may not be indicative of business trends.

For analytical purposes only, we have historically segregated from our total revenue the revenues derived from material assets or companies acquired during the first 12 months following their respective dates of acquisition and referred to such revenue as "Acquisition" revenue. We also segregate gross profits and SG&A expenses derived from material assets or company acquisitions on the same basis as we segregate revenues. We analyze, for internal purposes only, the percentage of our revenue that comes from staffing services versus the percentage that comes from engineering services, as engineering services have a higher margin than staffing services.

Operating SG&A expense includes management and staff compensation, office costs such as rents and utilities, depreciation, amortization, travel and other expenses generally unrelated to specific client contracts, but directly related to the support of a segment's operation.

Corporate SG&A expense is comprised primarily of marketing costs, as well as costs related to the executive, governance/investor relations, finance, accounting, safety, human resources, project controls and information technology departments and other costs generally unrelated to specific client projects, but which can vary as costs are incurred to support corporate activities and initiatives.

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### ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATION (Continued)

#### Results of Operations

The following table sets forth, for the periods indicated, certain financial data derived from our consolidated statements of operations and indicates the percentage of total revenue for each item.

Note: Previously, within the Systems Segment, ESI provided products and services supporting the advanced automation and integrated controls fields. In January 2006, EAG assumed responsibility for these services, which resulted in a move of this division of ESI to the Engineering Segment. Revenues and expenses have been reclassified between the segments to provide comparative results. Amounts will tie in total to prior reporting, however, individual segments will vary from prior reports.

	Years Ended Dec		
	2006		2005
	Amount	%	Amount
	(in thousand)		
Revenue			
Engineering	\$ 261,389	86.3	\$ 207,368
Systems	24,933	8.2	14,159
Acquisition	16,768	5.5	12,058
Total revenue	\$ 303,090	100.0	\$ 233,585

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Gross profit			
Engineering	\$	21,737	8.3
Systems		2,138	8.6
Acquisition		2,389	14.2
		-----	-----
Total gross profit	\$	26,264	8.7
		=====	=====
Selling, general and administrative			
Non-acquisition	\$	28,211	9.9
Acquisition		1,674	10.0
		-----	-----
Total	\$	29,885	9.9
		=====	=====
Net income (loss)	\$	(3,486)	(1.2)
		=====	=====

Total revenue increased 29.8% or \$69.5 million from 2005 to 2006.

Overall gross profit decreased 7.1%, or \$2.0 million from 2005 to 2006.

Total SG&A expense increased 51.8%, or \$10.2 million from 2005 to 2006.

Income from continuing operations decreased 172.9%, or \$8.3 million from 2005 to 2006.

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ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATION (Continued)

Year Ended December 31, 2006 Compared to Year Ended December 31, 2005

Note: Previously, within the Systems Segment, ESI provided products and services supporting the advanced automation and integrated controls fields. In January 2006, EAG assumed responsibility for these services, which resulted in a move of this division of ESI to the Engineering Segment. Revenues and expenses have been reclassified between the segments to provide comparative results. Amounts will tie in total to prior reporting, however, individual segments will vary from prior reports.

Total Revenue

-----  
Engineering revenue accounted for 91.8% of our total revenue for the year, increasing \$58.8 million from \$219.4 million in 2005 to \$278.2 million in 2006.

The increase in engineering revenue was primarily brought about by increased activity in the engineering and construction markets. Refining related activity has been particularly strong, including projects to satisfy environmental mandates, expand existing facilities and utilize heavier sour crude. Capital spending in the pipeline area is also trending higher, with numerous projects in North America currently underway to deliver crude oil, natural gas, petrochemicals and refined products. Renewable energy appears to be an emerging area of activity and potential growth, with the Company currently performing a variety of services for ethanol, biodiesel, coal to liquids,



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petroleum coke to ammonia, and other biomass processes. The acquisitions of WRC in the second quarter of 2006, together with our clients' increased demand for in-plant and inspection resources, stimulated growth in our staffing services division where revenues increased 90.6%, or \$50.9 million, from \$56.2 million in 2005 to \$107.1 million in 2006.

Revenue from procurement services decreased 67.6%, or \$40.2 million, from \$59.5 million in 2005 to \$19.3 million in 2006. This significant decrease is primarily related to three projects, two of which began in 2003 and one of which began in 2005 and were materially completed in 2006. The level of procurement services is expected to vary over time depending on the volume of procurement activity our customers choose to do themselves as opposed to using our services on larger EPC contracts.

In 2005, the Company was awarded two significant fixed-price engineering, procurement and construction ("EPC") projects in the refining industry that included procurement and subcontractor activities within our scope of work. This accounts for the higher level in that year. Together these two fixed-price EPC projects accounted for approximately \$20.2 million of the engineering segment revenues during 2006 compared to approximately \$1.8 million during 2005. The current combined contract value of these two projects is approximately \$24.6 million and both are currently scheduled for completion by the end of the second quarter of 2007. As a result of revised estimates of the percentage of completion of these projects, the Company suffered a reversal of \$6.6 million in the third quarter of 2006 and \$7.1 million in the fourth quarter of 2006. Due to losses incurred in the execution of these contracts, we anticipate that we will enter into this type of contract only on a very limited basis, if at all.

The systems segment contributed 8.2% of our total revenue for the year, as its revenue increased \$10.7 million, or 75.4%, from \$14.2 million in 2005 to \$24.9 million in revenue in 2006. A general turnaround in the oil and gas industry, together with the acquisition of ATI in January 2006 has increased the demand for ESI's services. Another factor positively affecting ESI's business is that the computer-based distributed control systems equipment used for facility plant automation becomes technologically obsolete over time, which supports ongoing replacement of these systems. Backlog for ESI at December 31, 2006 reached \$10.0 million, compared to \$9.1 million at December 31, 2005.

### Gross Profit

-----

Primarily due to losses on two EPC fixed-price contracts in our engineering segment, as discussed above, total gross profit decreased \$2.0 million, or 7.1%, from \$28.3 million in 2005 to \$26.3 million in 2006 and, as a percentage of total revenue, decreased from 12.1% to 8.7% during the same period.

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## ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATION (Continued)

Due to the material financial impact of the losses on two significant fixed-price EPC projects\* during 2006, the following "non-GAAP" proforma financial is being presented to demonstrate the performance of the historical core business within the Engineering segment.

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Non-GAAP Proforma Financial Information	Years Ended December 31			
	2006		2005	
	Amount	%	Amount	%
(in thousands)				
Revenue				
Engineering - Actual	\$ 261,389		207,368	
Less fixed-price projects*	20,155		-	
Engineering - Revised	\$ 241,234	85.3	207,368	88.8
Systems	24,933	8.8	14,159	6.0
Acquisition	16,768	5.9	12,058	5.2
Total revenue	\$ 282,935	100.0	233,585	100.0
Gross profit				
Engineering - Actual	\$ 21,737		25,940	
Less fixed-price projects*	(13,740)		-	
Engineering - Revised	\$ 35,477	14.7	25,940	12.5
Systems	2,138	8.6	1,111	7.8
Acquisition	2,389	14.2	1,222	10.1
Total gross profit	\$ 40,004	14.1	28,273	12.1

\* Excluding revenues on two significant fixed-price EPC projects, our Engineering segment, exclusive of acquisition revenue, would have accounted for 85.3% of our total revenue for the year, increasing \$33.8 million from \$207.4 million in 2005 to \$241.2 million in 2006, or an increase of 16.3%.

\* Again, excluding the recorded losses on two significant fixed-price EPC projects, our Engineering segment, net of acquisition gross profit, would have reported a gross profit of \$35.5 million, an increase of \$9.6 million from \$25.9 million in 2005, or an increase year-over-year of 37.1%. As a percentage of revenue, the proforma gross profit for our Engineering segment, exclusive of gross profit from acquisitions, would have increased by 17.6%, increasing from 12.5% in 2005 to 14.7% in 2006.

\* Also, excluding the recorded losses on the two significant fixed-price EPC projects, our total gross profit would have increased \$11.7 million from \$28.3 million in 2005 to \$40.0 million in 2006, or an increase year-over-year of 41.3%. As a percentage of revenue, total gross profit, again, excluding the recorded losses on two significant fixed-price EPC projects, would have increased 16.5%, increasing from 12.1% in 2005 to 14.1% in 2006.

Due to the significant losses on these two projects the Company plans to limit the size and scope of fixed-price EPC contracts in the future. Both of the significant fixed-price EPC projects are scheduled for

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completion by the end of the second quarter of 2007.

Also during the past year, the Company has shifted a portion of its services to developer type work for customers that are typically smaller than its historical customer base. The viability of these projects and the creditworthiness of these types of customers must be carefully analyzed to assure profitable results. In the future, the Company intends to analyze these projects much more carefully before accepting them.

The Company has also engaged in a number of entrepreneurial ventures over the past several years, not all of which have been profitable. In the future, the Company intends to scrutinize these projects much more carefully before engaging in them and exit them more quickly if they are not successful.

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### ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATION (Continued)

Gross profit from engineering, including the breakout of acquisitions, decreased \$3.1 million, or 11.4%, from \$27.2 million in 2005 to \$24.1 million in 2006 and, as a percentage of revenue, decreased from 12.4% in 2005 to 8.7% in 2006 primarily due to estimated losses of approximately \$13.7 million on two EPC fixed-price contracts. Both projects are currently scheduled for completion by the end of the second quarter of 2007.

The staffing services division, consisting of our in-plant staffing, land management and inspection operations, increased gross profit \$7.4 million, or 113.8%, from \$6.5 million in 2005 to \$13.9 million in 2006.

We earn a lower margin on procurement services as compared to the margin we earn on our core engineering services. As an example, procurement services for 2005 produced a 1.7% gross profit margin. Comparably, in 2006 gross profit margin on core engineering services was 8.3%. Our level of procurement revenue has recently trended down, from \$59.5 million or 25.5% of total revenue for 2005 to \$19.3 million or 6.4% of total revenue for 2006.

Any shift from engineering only to EPC projects that include material procurement and construction responsibility will negatively impact engineering gross profit as a percentage of revenue. In this case, lower gross profit will occur because higher historical cost plus margins on engineering labor recognized during the period in which it was earned will now be combined with the lower margins on procurement services and construction subcontractor charges and recorded throughout the over

**Gross  
profit**

12,189,019

10,479,553

23,563,455

20,185,688

**Costs  
and expenses**

Research and development

1,687,140

1,345,067

3,073,728

2,691,396

Selling, general and administrative

6,853,228

5,605,591

13,446,914

11,197,664

8,540,368

6,950,658

16,520,642

13,889,060

**Operating  
income**

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3,648,651

3,528,895

7,042,813

6,296,628

**Other  
income (expense)**

Interest income

438,104

124,484

815,582

236,231

Other

(342,912

)

(34,980

)

(311,453

)

(71,013



)

95,192

89,504

504,129

165,218

**Income  
before income taxes**

3,743,843

3,618,399

7,546,942

6,461,846

**Income  
taxes**

852,681

1,226,381

2,259,828

2,164,719

**Net  
income**

\$

2,891,162

\$

2,392,018

\$

5,287,114

\$

4,297,127

**Earnings  
per common share**

Basic

\$

0.28

\$

0.23

\$

0.51

\$

0.42

Diluted

\$

0.27

\$

0.22

\$

0.49

\$

0.40

**Weighted  
average number of common shares  
outstanding**

Basic

10,451,351

10,331,963

10,451,374

10,301,560

Diluted

10,779,798

10,771,375

10,812,319

10,716,031

**COMPREHENSIVE  
INCOME**

**Net  
income**

\$

2,891,162

\$

2,392,018

\$

5,287,114

\$

4,297,127



**Other  
comprehensive loss**

Foreign currency translation adjustment

(202,038

)

(3,897

)

(264,510

)

(30,206

)

**Comprehensive  
income**

\$

2,689,124

\$

2,388,121

\$

5,022,604

\$

4,266,921



**STRATASYS, INC.**  
**CONSOLIDATED STATEMENTS OF CASH FLOWS**

	<b>Six Months Ended June 30,</b>	
	<b>2005</b>	<b>2004</b>
	<b>(unaudited)</b>	<b>(unaudited)</b>
<b>Cash flows from operating activities</b>		
Net income	\$ 5,287,114	\$ 4,297,127
Adjustments to reconcile net income to net cash provided by operating activities:		
Deferred income taxes	105,195	369,107
Depreciation	1,077,428	814,463
Amortization	381,525	434,950
Loss on disposal of assets	43,081	16,011
Increase (decrease) in cash attributable to changes in operating assets and liabilities:		
Accounts receivable	(4,223,185)	(2,620,040)
Inventories	(3,703,665)	(1,701,810)
Net investments in sales-type leases	(94,088)	(1,100,657)
Prepaid expenses	(780,347)	1,035,916
Other assets	109,015	195,215
Accounts payable and other current liabilities	3,120,001	2,694,442
Unearned maintenance revenue	300,279	830,237
<b>Net cash provided by operating activities</b>	<b>1,622,353</b>	<b>5,264,961</b>
<b>Cash flows from investing activities</b>		
Proceeds from (purchase of) investments	12,630,660	(9,982,530)
Acquisition of property and equipment	(952,611)	(3,635,033)
Payments for intangible assets	(716,905)	(636,584)
<b>Net cash provided by (used in) investing activities</b>	<b>10,961,144</b>	<b>(14,254,147)</b>
<b>Cash flows from financing activities</b>		
Purchase of treasury stock	(690,362)	(25,346)
Net proceeds from exercise of stock options	183,099	542,158
<b>Net cash provided by (used in) financing activities</b>	<b>(507,263)</b>	<b>516,812</b>
<b>Effect of exchange rate changes on cash</b>	<b>(264,510)</b>	<b>(30,206)</b>
<b>Net increase (decrease) in cash and cash equivalents</b>	<b>11,811,724</b>	<b>(8,502,580)</b>
<b>Cash and cash equivalents, beginning of period</b>	<b>20,624,845</b>	<b>23,744,341</b>
<b>Cash and cash equivalents, end of period</b>	<b>\$ 32,436,569</b>	<b>\$ 15,241,761</b>



**STRATASYS, INC.**

**CONSOLIDATED STATEMENTS OF CASH FLOWS (CONTINUED)**

	<b>Six Months Ended June 30,</b>	
	<b>2005</b>	<b>2004</b>
	<b>(unaudited)</b>	<b>(unaudited)</b>
<b>Supplemental disclosures of cash flow information,</b>		
Cash paid during the period for income taxes:	\$ 1,517,617	\$ 7,000
<b>Supplemental disclosures of noncash investing and financing activities:</b>		
Machinery and equipment transferred to inventory	\$ 121,050	\$ 1,075,666
Inventory transferred to machinery and equipment	\$ 1,178,119	\$ 60,108

**Notes to Consolidated Financial Statements**Note 1 <sup>3</sup>/<sub>4</sub> Basis of Presentation

The financial information herein is unaudited; however, such information reflects all adjustments (consisting of normal, recurring adjustments) which are, in the opinion of management, necessary for a fair statement of results for the interim period. The results of operations for the three and six months ended June 30, 2005, are not necessarily indicative of the results to be expected for the full year. Certain financial information and footnote disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States of America have been condensed or omitted. The reader is referred to the audited financial statements and notes thereto for the year ended December 31, 2004, filed as part of the Company's Annual Report on Form 10-K for such year.

Note 2 <sup>3</sup>/<sub>4</sub> Inventories

Inventories consisted of the following at June 30, and December 31, respectively:

	<b>2005</b>	<b>2004</b>
Raw Materials	\$ 3,819,571	\$ 4,057,327
Finished Goods	\$ 6,347,447	3,463,095
<b>Totals</b>	<b>\$ 10,167,018</b>	<b>\$ 7,520,422</b>

Note 3 <sup>3</sup>/<sub>4</sub> Material Commitments

The Company has signed material commitments with several vendors for fixed delivery of selected inventory expected to be supplied in the ensuing twelve-month period. These commitments amount to approximately \$9,100,000, some of which contain non-cancellation clauses.

## Note 4—Income per common share

The difference between the number of shares used to compute basic income per share and diluted income per share relates to additional shares to be issued upon the assumed exercise of stock options and warrants, net of shares hypothetically repurchased at the average market price with the proceeds of exercise. For the six months ended June 30, 2005 and 2004, the additional shares amounted to 360,945 and 414,471, respectively. For the three months ended June 30, 2005 and 2004, the additional shares amounted to 328,447 and 439,412, respectively.

Note 5 <sup>3</sup>/<sub>4</sub> Stock-based compensation

The Company has various stock-based compensation plans that have been approved by the stockholders. The Company accounts for those plans under the recognition and measurement principles of Accounting Principles Board No. 25, "Accounting for Stock Issued to Employees" ("APB 25"), and related interpretations. No stock-based employee compensation is reflected in the net income for the three and six months ended June 30, 2005 and 2004, as all options granted under those plans had an exercise price equal to the market value of the underlying common stock on the date of grant. The Company follows the disclosure-only provisions of SFAS No. 123 "Accounting for Stock-Based Compensation." The following table illustrates the effect on net income and earnings per share if the Company had applied the fair value recognition provisions of SFAS No. 123 "Accounting for Stock-Based Compensation," to stock-based employee compensation:

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	Six months ended June 30,		Three months ended June 30,	
	2005	2004	2005	2004
Net income as reported	\$ 5,287,114	\$ 4,297,127	2,891,162	\$ 2,392,018
Effect of stock-based compensation accounted for under the fair value recognition provisions, net of tax	(4,320,000)	(666,000)	(288,000)	(339,250)
Pro forma net income	967,114	3,631,127	2,603,162	2,052,768
Earnings per share:				
Basic, as reported	0.51	0.42	0.28	0.23
Basic, pro forma	0.09	0.35	0.25	0.20
Diluted, as reported	0.49	0.40	0.27	0.22
Diluted, pro forma	0.09	0.34	0.24	0.19



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

### General

We develop, manufacture, and market a family of rapid prototyping ("RP") devices, which include our 3D printing systems, that enable engineers and designers to create physical models, tooling and prototypes out of plastic and other materials directly from a computer aided design ("CAD") workstation. In the quarter ended June 30, 2005, our revenues increased to \$20,784,945, a 20% increase over the \$17,315,648 that we reported in the second quarter of 2004. The number of units that we shipped in the quarter increased by approximately 25% to 351 units as compared with 281 units shipped in the second quarter of 2004. The higher shipment level was due to a continuing strong interest in our Dimension systems and strong backlog of Dimension SST systems at the beginning of the quarter. Based on industry reports, we believe that we shipped more total RP systems than any other company in the world since 2002. Revenues derived from our consumable products increased significantly in the quarter ended June 30, 2005, as compared with the quarter ended June 30, 2004. We believe that the growth rate of our consumable sales should increase in future quarters due to the significant expansion of our active installed base over the past several years.

We have continued to successfully implement our strategy to address the needs of both the high-performance RP and 3D printing ends of the market. Our sales growth in the second quarter of 2005 was derived from a number of industries, including consumer products, government agencies, educational institutions, electronics, general manufacturing, medical, automotive, and aerospace. Our strategy in 2005 will be to continue to expand our position in the 3D printing market through increased sales of Dimension BST and Dimension SST, our low-cost 3D printers. We believe that the 3D printer market demand is elastic relative to its price. We reduced the list price of the Dimension SST in February 2005 from \$34,900 to \$29,900 while maintaining the list price on Dimension BST at \$24,900. We believe that Dimension BST at \$24,900 is among the lowest priced systems in the RP market. We believe that the 3D printing market continues to represent a significant growth area and that Dimension BST and Dimension SST will continue to have a significant positive impact on our results in 2005 and beyond.

With the introduction of the Dimension SST in February 2004, we initiated a highly successful distributor program involving the reseller's purchasing demonstration systems with extended payment terms on both the Dimension SST and Dimension BST. While the program impacted our accounts receivable days sales outstanding (DSO) during a portion of 2004, it proved an effective tool in promoting and selling our systems. Given the success of the program in 2004, we offered a similar program in February 2005. Again, this program adversely impacted our DSO in the second quarter of 2005, and we believe that it will adversely impact our DSO in the third quarter of 2005 as well. However, we believe our distributor program is an integral part of our strategy to expand the RP market.

Our strategy also includes the expansion of our position in the RP market through the growth of our high performance systems, represented principally by our Titan, Vantage, and Maxum systems as well as the Eden PolyJet systems that we distribute for another company. In the second quarter of 2005, the unit revenue growth rate of our high performance systems was 15% and the revenue growth rate was 3%.

As our installed base has increased, we have derived an increasing amount of revenue from the sales of consumables, maintenance contracts, and other services. These represent recurring revenue for us. We expect that this trend will continue.

Gross profits, as a percentage of sales, declined in the second quarter of 2005 to 59% compared with 61% in the second quarter of 2004. The decline was primarily due to a shift in our product mix weighted toward our Dimension systems and the Eden PolyJet systems, which have a lower gross profit than our high end systems or consumables business. Gross profit was also adversely impacted by a 23% decline in our paid parts business in the second quarter of 2005 compared to 2004. Our paid parts business is a high gross profit business as we manufacture the machine as

well as the materials used to create the parts.

Our 2005 strategy is also based on the expectation that we will expand revenues faster than our operating expenses, with the intent to improve our operating margins as compared with those recorded in 2004. While our total revenues in the second quarter of 2005 increased by 20% to \$20,784,945 from \$17,315,648 in 2004, our operating expenses grew by 23%, or \$1,589,710, as we continue to invest in developing new products and creating market awareness. As a result, operating margins declined in the second quarter of 2005 compared with the 2004 period to approximately 18% compared with 20% in the same year-ago period due to the aforementioned decline in gross profits. We will continue to focus on our operating expenses in 2005, with the intent to improve our operating profits beyond those reported in 2004. We cannot, however, ensure that we will be successful.

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In 2005, we expect that our research and development (“R&D”) expenses will track higher than comparative 2004 quarters, but should decline as a percentage of revenue. R&D projects primarily involve development of new systems and materials, better throughput, and software enhancements. The R&D group and a cross-functional team of other disciplines were responsible for also reducing the material and labor costs of the Dimension BST and Dimension SST in 2004, with further cost reductions on this platform expected in the latter part of 2005. R&D expenses in the second quarter of 2005 increased by \$342,073, or 25%, to \$1,687,140 representing 8.1% of sales compared with 7.8% in the second quarter of 2004.

Our balance sheet continues to be strong. As of June 30, 2005, our cash and investment position was approximately \$55.7 million, with no debt. In the first six-months of 2005, our cash flow from operations amounted to more than \$1.6 million. In short, we continue to have a very strong balance sheet and liquidity to fund our 2005 growth strategy.

Our current and future growth is largely dependent upon our ability to penetrate new markets and develop and market new rapid prototyping and 3D printing systems, materials, applications, and services that meet the needs of our current and prospective customers. Our expense levels are based in part on our expectations of future revenues. While we have adjusted, and will continue to adjust, our expense levels based on both actual and anticipated revenues, fluctuations in revenues in a particular period could adversely impact our operating results. Our ability to implement our strategy for 2005 is subject to numerous uncertainties, many of which are described in this “Management’s Discussion and Analysis of Financial Condition and Results of Operations” and in the section below captioned “Forward Looking Statements and Factors That May Affect Future Results of Operations.” We cannot ensure that our efforts will be successful.

## Results of Operations

### Three months ended June 30, 2005 compared with three months ended June 30, 2004

The following table sets forth certain statement of operations data as a percentage of net sales for the periods indicated. All items are included in or derived from our statement of operations.

	For the three months ended June 30,	
	2005	2004
Net sales	100.0%	100.0%
Cost of sales	41.4%	39.5%
Gross profit	58.6%	60.5%
Selling, general, and administrative expenses	33.0%	32.3%
Research & development expense	8.1%	7.8%
Operating income	17.6%	20.4%
Other income	.4%	.5%
Income before taxes	18.0%	20.9%
Income taxes	4.1%	7.1%
Net income	13.9%	13.8%

### Net Sales

Net sales for the three months ended June 30, 2005, were \$20,784,945, compared with net sales of \$17,315,648 for the three months ended June 30, 2004. This represents an increase of \$3,469,297, or 20%. The number of systems sold increased by 25%. The growth in unit volume was greater than the sales increase as the growth in our Dimension systems was 26% and these have a lower average selling price than our high-end systems. Revenues from consumables increased 65% while our paid parts business declined 23% in the three months ended June 30, 2005 as compared with the same 2004 period. Consumable revenue was enhanced by the larger installed base of systems.



North American sales, which include Canada and Mexico, accounted for approximately 59% of total revenue in the three months ended June 30, 2005, as compared with approximately 63% in the three months ended June 30, 2004. Total North American sales, which include systems, services, and consumables, grew by approximately 13% as compared with international sales growth of approximately 31%. Internationally, our Asia Pacific region, which comprises Japan, China, India, and Southeast Asia countries, were extremely strong and recorded revenues that amounted to approximately 16% of total sales. Europe accounted for approximately 20% of total revenue for the three months ended June 30, 2005. High-end system sales were weak in Europe in the second quarter of 2005.

Whereas we expect to report higher revenues and profits in 2005 over the results achieved in 2004, declining economic conditions in any of these regions could adversely impact our future sales and profitability.

### **Gross Profit**

Gross profit improved to \$12,189,019, or 59% of sales, in the three months ended June 30, 2005, compared with \$10,479,553 or 61% of sales, in the comparable period of 2004. This represents an increase of \$1,709,466, or 16%. Gross profit increased due to higher revenues. As a percentage of revenues, the decline to 59% was principally due to the mix of products and services that we sold, which included a higher percentage sales of our Dimension systems and the Eden PolyJet systems that we distribute as well as a lower percentage of sales from our paid parts business.

### **Operating Expenses**

SG&A expenses increased to \$6,853,228 for the three months ended June 30, 2005, from \$5,605,591 for the comparable period of 2004. This represents an increase of \$1,247,637, or 22%. We incurred significant expenses in the second quarter of 2005 for promotional, marketing, and channel development activities related to all our products. Variable commissions, incentives, and travel expenses were higher in the 2005 period as a result of significantly higher revenues. Higher expenses were also incurred for additional investor relations and customer support activities.

R&D expenses increased to \$1,687,140 for the three months ended June 30, 2005 from \$1,345,067 for the three months ended June 30, 2004. This amounted to an increase of \$342,073, or 25%. On higher revenues, R&D expenses increased as a percentage of sales to 8.1% in the three months ended June 30, 2005, from 7.8% in the 2004 period. Higher contract labor and salary and benefit expenses accounted for much of the increased costs. While we remain committed to maintaining R&D to design new products and materials, to reduce costs on existing products, and to improve the quality and reliability of all of our platforms, we have had an on-going objective to control spending levels. As such, R&D expenses for all of 2005 should increase at a lower rate than that of our revenue growth, which should have the effect of reducing R&D expenses as a percentage of revenue.

### **Operating Income**

For the reasons cited above, our operating income for the three months ended June 30, 2005, amounted to \$3,648,651, or 17.6% of sales, compared with operating income of \$3,528,895, or 20.4% of sales, for the three months ended June 30, 2004. This represents an increase of \$119,756, or approximately 3.4%.

### **Other Income**

Other income netted to \$95,192 in the three months ended June 30, 2005 compared with other income of \$89,504 in the comparable 2004 period. Net interest income increased to \$438,104 in the current three-month period, compared with \$124,484 in the three-month period of 2004. The increase in interest income was primarily due to significantly higher average cash and investment balances as well as higher interest rates. In the three months ended June 30, 2005, we recognized a loss from foreign currency transactions related to the euro of approximately \$246,000 which

compared with a loss of \$98,000 in the same period of 2004.

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## Income Taxes

Income tax expense amounted to \$852,681, or 4.1% of sales, in the three months ended June 30, 2005, compared with \$1,226,381, or 7.1% of sales, for the three months ended June 30, 2004. The effective tax rate for the second quarter of 2005 amounted to 23% compared with 34% in the prior year. The decrease in the effective tax rate resulted from a greater-than-expected annual U. S. federal income tax benefit from our foreign income and manufacturers deductions for income taxes purposes. In addition, we recognized a \$325,000 benefit in the second quarter of 2005 resulting from adjustments to prior years' tax benefits from research activities and foreign sales income.

## Net Income

For the reasons cited above, our net income for the three months ended June 30, 2005, amounted to \$2,891,162 or 13.9% of sales, compared with net income of \$2,392,018, or 13.8% of sales, in the comparable 2004 period. This resulted in earnings per diluted common share of \$.27 on 10,779,798 weighted shares outstanding in the three months ended June 30, 2005, compared with earnings per diluted common share of \$.22 on 10,771,375 weighted shares outstanding for the comparable period ended June 30, 2004.

## Six months ended June 30, 2005 compared with six months ended June 30, 2004

The following table sets forth certain statement of operations data as a percentage of net sales for the periods indicated. All items are included in or derived from our statement of operations.

	For the six months ended June 30,	
	2005	2004
Net sales	100.0%	100.0%
Cost of sales	40.6%	39.1%
Gross profit	59.4%	60.9%
Selling, general, and administrative expenses	33.9%	33.8%
Research & development expense	7.8%	8.1%
Operating income	17.8%	19.0%
Other income	1.2%	0.5%
Income before taxes	19.0%	19.5%
Income taxes	5.7%	6.5%
Net income	13.3%	13.0%

## Net Sales

Net sales for the six months ended June 30, 2005, were \$39,647,764, compared with net sales of \$33,161,823 for the six months ended June 30, 2004. This represents an increase of \$6,485,941, or 19.6%. Sales of the Dimension SST, Maxum and Eden systems were strong in the six-month period. We shipped 628 total systems in the first six months of 2005 as compared with 572 total systems in the comparable 2004 period, a growth rate of about 10%. Revenues from consumables increased 53% and maintenance by 22% in the six months ended June 30, 2005 as compared with the same 2004 period. The larger installed base of systems enhanced consumable and maintenance revenues.

North American sales, which include Canada and Mexico, accounted for approximately 60% of total revenue in both the six months ended June 30, 2005 and 2004. Internationally, our Asia Pacific region, which comprises Japan, China, the Far East and India, grew 20% year-over-year for the six months ended June 30, 2005 and represented approximately 20% of total sales, an increase from the 19% reported in the six months ended June 30, 2004. Sales into our European region accounted for approximately 20% of total revenue for the six months ended June 30, 2005 compared with 21% for the six months ended June 30, 2004. Systems sales to Europe were down 5% year-over-year for the six months. Whereas we expect to report higher revenues and profits in 2005 over the results achieved in 2004,

declining economic conditions in any of these regions could adversely impact our future sales and profitability.



## **Gross Profit**

Gross profit improved to \$23,563,455, or 59.4% of sales, in the six months ended June 30, 2005, compared with \$20,185,688, or 60.9% of sales, in the comparable period of 2004. This represents an increase of \$3,377,767, or 16.7%. Gross profit increased due to higher revenues and control over our manufacturing overhead and direct labor expenses. The decline in gross profit as a percentage of sales to 59.4% was principally due to the mix of products that we sold, which was heavily weighted to Dimension SST and Eden systems that have lower margins than many of our other systems.

## **Operating Expenses**

SG&A expenses increased to \$13,446,914 for the three months ended June 30, 2005, from \$11,197,664 for the comparable period of 2004. This represents an increase of \$2,249,250, or 20.1%. We incurred higher expenses for promotional, marketing, and channel development activities in our continuing efforts to increase product awareness. Variable commissions, incentives, and travel expenses were higher in the 2005 period as a result of significantly higher revenues. We have also incurred higher medical insurance, investor relations and customer support expenses.

R&D expenses increased to \$3,073,728 for the six months ended June 30, 2005 from \$2,691,396 for the six months ended June 30, 2004. This amounted to an increase of \$382,332, or 14.2%. On higher revenues, R&D expenses declined as a percentage of sales to 7.8% in the six months ended June 30, 2005, from 8.1% in the 2004 period. Higher salary and benefit expenses accounted for much of the increase.

## **Operating Income**

For the reasons cited above, our operating income for the six months ended June 30, 2005, amounted to \$7,042,813, or 17.8% of sales, compared with operating income of \$6,296,628, or 19.0% of sales, for the six months ended June 30, 2004. This represents an increase of \$746,185, or 11.9%.

## **Other Income**

Other income netted to \$504,129 in the six months ended June 30, 2005 compared with other income of \$165,218 in the comparable 2004 period. Interest income increased to \$815,582 in the current six-month period, compared with \$236,231 in the six-month period of 2004. The increase in interest income was primarily due to significantly higher average cash balances and a rise in interest rates. In the six months ended June 30, 2005, we recognized a loss from foreign currency transactions related to the euro of approximately \$331,000 compared with \$185,000 in the same period of 2004.

## **Income Taxes**

Income tax expense amounted to \$2,259,828, or 5.7% of sales, in the six months ended June 30, 2005, compared with \$2,164,719, or 6.5% of sales, for the six months ended June 30, 2004. The effective tax rate for the six months of 2005 amounted to 29.9%, including a discrete tax benefit of \$325,000 from adjustments to the prior years research activities credit and extraterritorial income exclusion benefit. Excluding these discrete items the effective rate for the six-months ended June 30, 2005 was 34.25% compared with 33.5% in the same period of 2004.

## **Net Income**

For the reasons cited above, our net income for the six months ended June 30, 2005, amounted to \$5,287,114, or 13.3% of sales, compared with net income of \$4,297,127, or 13.0% of sales, in the comparable 2004 period. This resulted in earnings per diluted common share of \$.49 on 10,812,319 weighted shares outstanding in the six months

ended June 30, 2005, compared with earnings per diluted common share of \$.40 on 10,716,031 weighted shares outstanding for the comparable period ended June 30, 2004.

## Liquidity and Capital Resources

We decreased our short-term cash, cash equivalents and investment balances to \$52,436,569 at June 30, 2005, from \$55,849,845 at December 31, 2004. We increased our long-term investments, consisting principally of municipal bonds, to \$3,314,340 compared with \$720,000 at December 31, 2004.

In the three months ended June 30, 2005, net cash provided by our operating activities amounted to \$1,622,353, compared with \$5,264,961 in the comparable 2004 period. The principal source of cash from our operating activities has been our net income, as adjusted to exclude the effects of non-cash charges, and changes in working capital, primarily inventories and accounts receivable, and in the 2004 period, a large reduction in our prepaid expenses. These increases are partially offset by increases in accounts payable and other accrued liabilities. Our net accounts receivable balance increased to \$19,174,535 in the second quarter of 2005 from \$14,951,350 as of December 31, 2004, which was principally due to an increase in net sales and some impact from our extended terms on our sales demo program. Throughout the last three years, we introduced tighter controls in our credit and collections areas. Some of our international distributors, however, have continued to carry high balances, some of which have exceeded our normal terms. As several of these international distributors have significantly improved their position with us since 2003, we believe we have made adequate allowances against these balances.

For the six months ended June 30, 2005, our inventory balances have increased to \$10,167,018 from \$7,520,422 at December 31, 2004. We have instituted better inventory management, but recognize that we continue to have opportunities to make considerably more improvement to reduce overall inventory and improve turns. Inventory turns have improved to 3.3 times in the quarter ended June 30, 2005, from about 3.2 times in the comparable 2004 period. The increase in inventory in the current period is principally due to expected higher future sales volume as well as a slight change in product mix in the quarter resulting in higher inventory of certain products. A significant portion of our inventory is dedicated to fulfill our service contract and warranty obligations. As we have introduced several new products over the last several quarters, there are many more platforms and models to service than in the past, which increases the requirements to maintain spare parts inventory. With the introduction of these new products, older products have been discontinued. However, inventory for these discontinued products is still required to fulfill our service contracts. Our procedures for dealing with this inventory are more fully explained in the section below captioned "Critical Accounting Policies."

Our investing activities, which consist primarily of buying and selling auction-rate securities, provided cash of \$12,630,660 compared to using cash of \$9,982,530 in the six months ended June 30, 2005 and 2004, respectively. This was partially offset by fixed asset additions of \$952,611 and payments for intangibles of \$716,905. Much of the capital expenditures in 2005 were for equipment required by the growing components of our business, including consumable manufacturing and paid parts. Net cash used for payments of intangible assets included patents and capitalized software.

Our financing activities provided cash of \$10,961,144 compared to using cash of \$14,254,147 in the six months ended June 30, 2005 and 2004, respectively. In the six-months ended June 30, 2005, we used \$690,362 to repurchase 26,903 shares of Company stock. This was partially offset by the receipt of \$183,099 from the exercise of stock options.

For the remainder of 2005, we expect to use our cash for the following purposes:

- the continuation of our leasing program;
- the expansion of our paid parts business;
  - working capital;
- improvements and upgrades to our existing manufacturing facility;
  - new product and materials development;
  - sustaining engineering;

- the acquisition of equipment, including production equipment, tooling, and computers;
  - the purchase or development of intangible assets, including patents;
- increased selling and marketing activities, especially as they relate to the continued Dimension market and channel development as well as the Eden market development;
  - acquisitions and/or strategic alliances; and
  - our common stock buyback program.

While we believe that the primary source of liquidity during 2005 will be derived from current cash balances and cash flows from operations, we have maintained a line of credit for the lesser of \$4,000,000 or a defined borrowing base. To date, we have not borrowed against this credit facility.

As of June 30, 2005, we had gross accounts receivable of \$20,637,065 less an allowance of \$1,462,530 for returns and doubtful accounts. Over our history, bad debt expense has generally been small as a percentage of sales. However, at June 30, 2005, large balances were concentrated with certain international distributors and some of these balances exceed our payment terms. Default by one or more of these distributors could result in a significant charge against our current reported earnings. We have reviewed our policies that govern credit and collections, and will continue to monitor them in light of current payment status and economic conditions. While we can give no assurances, we believe that most, if not all, of the accounts receivable balances will ultimately be collected. For further information, see the section below captioned "Critical Accounting Policies."

Our total current assets amounted to \$86,324,724 at June 30, 2005, most of which consisted of cash and cash equivalents, investments, inventories and accounts receivable. Total current liabilities amounted to \$17,732,262. We have no debt. We believe we have adequate resources to fund our foreseeable future growth.

### **Inflation**

We believe that inflation has not had a material effect on our operations or on our financial condition during the three most recent fiscal years.

### **Foreign Currency Transactions**

We invoice sales to certain European distributors in euros. Our reported results are therefore subject to fluctuations based upon changes in the exchange rates of that currency in relation to the United States dollar. In the quarters ended June 30, 2005 and 2004, the net loss on foreign currency translations amounted to approximately \$246,000 and \$98,000, respectively. In the quarter ended June 30, 2005, we hedged approximately €1,000,000 of our accounts receivable that were denominated in euros. The hedge resulted in a currency translation gain of approximately \$73,000 for that period. Effective at the end of the second quarter of 2005, we have implemented a strategy to more fully hedge our euro denominated accounts receivable position throughout the remainder of 2005. We will continue to monitor our exposure to currency fluctuations. Instruments to hedge our risks may include foreign currency forward, swap, and option contracts. These instruments will be used to selectively manage risks, but there can be no assurances that we will be fully protected against material foreign currency fluctuations. We expect to continue to derive most of our revenue from regions where the transactions are negotiated, invoiced, and paid in US dollars. Fluctuations in the currency exchange rates in these other countries may therefore reduce the demand for our products by increasing the price of our products in the currency of countries in which the local currency has declined in value.

### **Critical Accounting Policies**

We have prepared our financial statements and related disclosures in conformity with accounting principles generally accepted in the United States of America. This has required us to make estimates, judgments, and assumptions that affected the amounts we reported. Note 1 of Notes to Consolidated Financial Statements contains the significant accounting principles that we used to prepare our consolidated financial statements.

We have identified several critical accounting policies that required us to make assumptions about matters that were uncertain at the time of our estimates. Had we used different estimates and assumptions, the amounts we recorded could have been significantly different. Additionally, if we had used different assumptions or different conditions existed, our financial condition or results of operations could have been materially different. The critical accounting policies that were affected by the estimates, assumptions, and judgments used in the preparation of our financial

statements are listed below.

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### ***Revenue Recognition***

We recognize revenue when 1) persuasive evidence of a final agreement exists, 2) delivery has occurred or services have been rendered, 3) the selling price is fixed or determinable, and 4) collectability is reasonably assured. Revenue from system sales is primarily recognized at the time of shipment if the shipment conforms to the terms and conditions of the purchase agreement. Revenue from sales-type leases is recognized at the time of lessee acceptance, which follows installation. Revenue from maintenance contracts is recognized ratably over the term of the contract, usually one year. On certain sales that require a one-year warranty rather than our standard 90-day warranty, a percentage of the selling price that represents the extended warranty is deferred and recognized ratably over the period of the extended warranty as an implied maintenance contract.

We assess collectability as part of the revenue recognition process. We evaluate a number of factors to assess collectability, including an evaluation of the credit worthiness of the customer, past payment history, and current economic conditions. If it is determined that collectability cannot be reasonably assured, we would decline shipment, request a down payment, or defer recognition of revenue until ultimate collectability is more determinable.

We also record a provision for estimated product returns and allowances in the period in which the related revenue is recorded. This provision against current gross revenue is based principally on historical rates of sales returns, but also factors in changes in the customer base, geographic economic conditions, and changes in the financial conditions of our customers. If past trends were to change, we would potentially have to increase or decrease the amount of the provision for these returns. We have limited history as to potential returns under our lease programs. We will monitor our lease sales in the future, and if necessary will record a provision for returns on leased systems.

### ***Allowance for Doubtful Accounts***

While we evaluate the collectability of a sale as part of our revenue recognition process, we must also make judgments regarding the ultimate realization of our receivable balances. A considerable amount of judgment is required in assessing the realization of these receivables, including the aging of the receivables and the creditworthiness of each customer. If a customer's financial condition should suddenly deteriorate, calling into question our ability to collect the receivable, our estimates of the realization of our receivables could be adversely affected. We might then have to record additional allowances for doubtful accounts, which could have an adverse effect on our results of operations in the period affected.

Our allowance for doubtful accounts is adjusted quarterly using two methods. First, our overall reserves are based on a percentage applied to certain aged receivable categories that are predominately based on historical bad debt write-off experience. Then, we make an additional evaluation of overdue customer accounts, for which we specifically reserve. In our evaluation we use a variety of factors, such as past payment history, the current financial condition of the customer, and current economic conditions. We also evaluate our overall concentration risk, which assesses the total amount owed by each customer, regardless of its current status. Certain of our international distributors have carried large balances that have become overdue. While these distributors have paid down their balances and are still considered performing, we have either converted certain of these accounts receivable to notes receivables (some of which are collateralized) or placed distributors on payment plans that strictly limit the amount of new orders that we will honor unless they adhere to the payment plans. A default by one or more of these distributors could have a material effect, ranging from \$300,000 to \$800,000, on our reported operating results in the period affected.

### ***Inventories***

Our inventories are recorded at the lower of cost or market, with cost determined on a first-in, first-out basis. We periodically assess this inventory for obsolescence and potential excess by reducing the difference between our cost and the estimated market value of the inventory based on assumptions about future demand and historical sales

patterns. Our inventories consist of materials and products that are subject to technological obsolescence and competitive market conditions. If market conditions or future demand are less favorable than our current expectations, additional inventory write downs or reserves may be required, which could have an adverse effect on our reported results in the period the adjustments are made. Additionally, engineering or field change orders (“ECO” and “FCO”, respectively) introduced by our engineering group could suddenly create extensive obsolete and/or excess inventory. Although our engineering group considers the estimated effect that an ECO or FCO would have on our inventories, a mandated ECO or FCO could have an immediate adverse affect on our reported financial condition if they required the use of different materials in either new production or our service inventory.



Some of our inventory is returned to us by our customers and refurbished. This refurbished inventory, once fully repaired and tested, is functionally equivalent to new production and is utilized to satisfy many of our requirements under our warranty and service contracts. Upon receipt of the returned material, this inventory is recorded at a discount from original cost, and further reduced by estimated future refurbishment expense. While we evaluate this service material in the same way as our stock inventory (*i.e.*, we periodically test for obsolescence and excess), this inventory is subject to changes in demand that may not be immediately apparent. Adjustments to this service inventory, following an obsolescence or excess review, could have an adverse effect on our reported financial condition in the period when the adjustments are made. In 2003, we began to review the requirements for service inventory for discontinued products using the number of active maintenance contracts per product line as the key determinant for inventory levels and composition. A sudden decline in the number of customers renewing service agreements in a particular period could lead to an unanticipated write down of this service inventory for a particular product line.

### ***Income Taxes***

We comply with SFAS No. 109, "Accounting for Income Taxes," which requires that deferred tax assets and liabilities be recognized using enacted tax rates for the effect of temporary differences between the book and tax bases of recorded assets and liabilities. SFAS 109 also requires a valuation allowance if it is more likely than not that a portion of the deferred tax asset will not be realized. We have determined that it is more likely than not that our future taxable income will be sufficient to realize our deferred tax assets.

Our provision for income taxes is based on our effective income tax rate. The effective rate is highly dependent upon a number of factors, including our total earnings, the geographic location of sales, the availability of tax credits, and the effectiveness of our tax planning strategies. We monitor the effects of these variables throughout the year and adjust our income tax rate accordingly. However, if our actual results differ from our estimates, we could be required to adjust our effective tax rate or record a valuation adjustment on our deferred tax assets. This could have an adverse effect on our financial condition and results of operations.

### **Forward-looking Statements and Factors That May Affect Future Results of Operations**

All statements herein that are not historical facts or that include such words as "expect", "anticipate", "project", "estimate" or "believe" or other similar words are forward-looking statements that we deem to be covered by and to qualify for the safe harbor protection covered by the Private Securities Litigation Reform Act of 1995 (the "1995 Act"). Investors and prospective investors in our Company should understand that several factors govern whether any forward-looking statement herein will be or can be achieved. Any one of these factors could cause actual results to differ materially from those projected herein.

These forward-looking statements include the expected increases in net sales of RP and 3D printing systems, services and consumables, and our ability to maintain our gross margins on these sales. The forward-looking statements include our assumptions about the size of the RP and 3D printing markets, and our ability to penetrate, compete, and successfully sell our products in these markets. They include our plans and objectives to introduce new products, to control expenses, to improve the quality and reliability of our systems, to respond to new or existing competitive products, and to improve profitability. The forward-looking statements included herein are based on current expectations that involve a number of risks and uncertainties. These forward-looking statements are based on assumptions, among others, that we will be able to:

- continue to introduce new RP and 3D printing systems and materials acceptable to the market, and to continue to improve our existing technology and software in our current product offerings;
- successfully develop the 3D printing market with our Dimension BST and Dimension SST products, and that the market will accept these products;
  - maintain our revenues and gross margins on our present products;
  - control our operating expenses;
- expand our manufacturing capabilities to meet the expected demand generated by our Dimension BST and Dimension SST systems, our paid parts business, and our consumable products;
- successfully and profitably distribute and service the Eden product line that is governed by our distributor agreement with Objet Geometries;
- successfully commercialize polyphenylsulfone (“PPSF”) and other new materials, and that the market will accept these new materials; and
  - retain and recruit employees with the necessary skills to produce, develop, market, and sell our products.

Assumptions relating to the foregoing involve judgments with respect to, among other things, future economic, geo-political, competitive, market and technological conditions, and future business decisions, all of which are difficult or impossible to predict accurately and many of which are beyond our control. Although we believe that the assumptions underlying the forward-looking statements contained herein are reasonable, any of those assumptions could prove inaccurate, and therefore there is and can be no assurance that the results contemplated in any such forward-looking statement will be realized. The impact of actual experience and business developments may cause us to alter our marketing plans, our capital expenditure budgets, or our engineering, selling, manufacturing or other budgets, which may in turn affect our results of operations or the success of our new product development and introduction. We may not be able to alter our plans or budgets in a timely manner, resulting in reduced profitability or losses.

Due to the factors noted above and elsewhere in this Management’s Discussion and Analysis of Financial Condition and Results of Operations, our future earnings and stock price may be subject to significant volatility, particularly on a quarterly basis. Additionally, we may not learn of revenue or earnings shortfalls until late in a fiscal quarter, since we frequently receive a significant number of orders very late in a quarter. This could result in an immediate and adverse effect on the trading price of our common stock. Past financial performance should not be considered a reliable indicator of future performance, and investors should not use historical trends to anticipate results or trends in future periods.

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

#### **Interest Rate Risk**

Our cash and cash equivalent investments are exclusively in short-term money market funds, auction rate certificates, and sweep instruments with maturities of less than 90 days. These are subject to limited interest rate risk. A 10% change in interest rates would not have a material effect on our financial condition or results of operations. Our short- and long-term investments are invested in certificates of deposit that bear interest at fixed rates. An immediate 10% change in interest rates would have no material effect on our financial condition or results of operations.

#### **Foreign Currency Exchange Rate Risk**

We have not historically hedged sales from or expenses incurred by our European operations that are conducted in euros. Therefore, a hypothetical 10% change in the exchange rates between the U.S. dollar and the euro could increase or decrease our earnings before taxes by less than \$150,000 for the continued maintenance of our European facility. Throughout 2004 and through the first six months of 2005, we hedged €1,000,000 of our accounts receivable balances that were denominated in euros. We estimate a hypothetical 10% change in the exchange rates between the US dollar

and the euro could increase or decrease earnings before taxes by between \$100,000 and \$300,000.

**Item 4. Controls and Procedures**

*Disclosure Controls and Procedures.* We carried out an evaluation, under the supervision and with the participation of the our management, including our Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Exchange Act of 1934, as amended (the “Exchange Act”). Based on such evaluation, our Chief Executive Officer and Chief Financial Officer concluded that, as of the end of the period, our disclosure controls and procedures were effective in recording, processing, summarizing and reporting on a timely basis, information required to be disclosed by us in the reports that we file or submit under the Exchange Act.

*Internal Controls over Financial Reporting.* There have not been any changes in our internal control over financial reporting (as defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act) that during the fiscal quarter to which this report relates, that have materially affected, or are reasonably likely to affect, our internal control over financial reporting.

**PART II****OTHER INFORMATION****Item 4. Submission of Matters to a Vote of Security Holders.**

We held our Annual Meeting of Stockholders on May 5, 2005. The following directors, constituting all of our directors, were elected at the meeting to serve until their respective successors are duly elected and qualified. The directors elected at the Annual Meeting received the number of votes set forth opposite their respective names:

	For Election	Withheld Authority
S. Scott Crump	9,508,376	216,296
Ralph E. Crump	9,494,226	230,446
Edward J. Fierko	9,508,086	216,586
Clifford H. Schwieter	9,508,086	216,586
Arnold J. Wasserman	9,506,472	218,200
Gregory L. Wilson	9,468,685	255,987

**Item 6. Exhibits**

(a) Exhibits.

31.1 Certification of the Chief Executive Officer required by Rule 13a-14(a) or Rule 15d-14(a).

31.2 Certification of the Chief Financial Officer required by Rule 13a-14(a) or Rule 15d-14(a).

32.1 Certification of the Chief Executive Officer required by Rule 13a-14(b) or Rule 15d-14(b) and 18 U.S.C. 1350.

32.2 Certification of the Chief Financial Officer required by Rule 13a-14(b) or Rule 15d-14(b) and 18 U.S.C. 1350.

**SIGNATURES**

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

Date: August 9, 2005

**Stratasys, Inc.**

By: /s/ Robert F. Gallagher

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Robert F. Gallagher  
Chief Financial Officer  
(Principal Financial Officer)