

Fortress International Group, Inc.  
Form 10-Q  
August 12, 2010

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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended June 30, 2010

or

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

Commission file number: 000-51426

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FORTRESS INTERNATIONAL GROUP, INC.  
(Exact name of registrant as specified in its charter)

Delaware  
(State or other jurisdiction of  
incorporation or organization)

20-2027651  
(I.R.S. Employer Identification No.)

7226 Lee DeForest Drive, Suite 209  
Columbia, Maryland  
(Address of principal executive offices)

21046  
(Zip Code)

(410) 423-7300  
(Registrant's telephone number, including area code)

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

Indicate by check mark whether each registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes  No

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

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

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

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date.

Common Stock, par value \$0.0001 per share, as of August 1, 2010 14,268,494

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## PART I - FINANCIAL INFORMATION

## Item 1. Financial Statements

FORTRESS INTERNATIONAL GROUP, INC.  
CONDENSED CONSOLIDATED BALANCE SHEETS

	(Unaudited)	
	June 30, 2010	December 31, 2009
<b>Current Assets</b>		
Cash and cash equivalents	\$ 9,545,263	\$ 2,263,146
Contract and other receivables, net	10,723,968	14,196,772
Costs and estimated earnings in excess of billings on uncompleted contracts	1,424,429	1,056,543
Prepaid expenses and other current assets	1,138,137	1,007,371
<b>Total current assets</b>	<b>22,831,797</b>	<b>18,523,832</b>
Property and equipment, net	497,457	612,569
Goodwill	3,811,127	3,811,127
Other intangible assets, net	60,000	60,000
Other assets	54,248	246,218
<b>Total assets</b>	<b>\$ 27,254,629</b>	<b>\$ 23,253,746</b>
<b>Liabilities and Stockholders' Equity</b>		
<b>Current Liabilities</b>		
Notes payable, current portion	\$ 294,646	\$ 183,679
Accounts payable and accrued expenses	9,051,957	8,038,658
Billings in excess of costs and estimated earnings on uncompleted contracts	9,203,563	6,536,752
<b>Total current liabilities</b>	<b>18,550,166</b>	<b>14,759,089</b>
Notes payable, less current portion	-	152,343
Convertible notes, less current portion	2,750,000	4,000,000
Other liabilities	165,510	186,905
<b>Total liabilities</b>	<b>21,465,676</b>	<b>19,098,337</b>
Commitments and Contingencies	-	-
<b>Stockholders' Equity</b>		
Preferred stock- \$.0001 par value; 1,000,000 shares authorized; no shares issued or outstanding	-	-
Common stock- \$.0001 par value, 100,000,000 shares authorized; 13,882,738 and 13,142,962 issued; 13,415,580 and 12,846,709 outstanding at June 30, 2010 and December 31, 2009, respectively	1,381	1,314
Additional paid-in capital	65,048,073	63,442,796
Treasury stock 467,158 and 296,253 shares at cost at June 30, 2010 and December 31, 2009, respectively	(1,076,009)	(959,971)
Accumulated deficit	(58,184,492)	(58,328,730)
<b>Total stockholders' equity</b>	<b>5,788,953</b>	<b>4,155,409</b>
<b>Total liabilities and stockholders' equity</b>	<b>\$ 27,254,629</b>	<b>\$ 23,253,746</b>

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



FORTRESS INTERNATIONAL GROUP, INC.  
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

	(Unaudited)		(Unaudited)	
	For the Three Months Ended June 30, 2010	June 30, 2009	For the Six Months Ended June 30, 2010	June 30, 2009
<b>Results of Operations:</b>				
Revenue	\$ 22,654,415	\$ 12,087,200	\$ 39,769,907	\$ 29,005,620
Cost of revenue	19,454,452	10,637,715	34,105,423	24,724,536
Gross profit	3,199,963	1,449,485	5,664,484	4,281,084
<b>Operating expenses:</b>				
Selling, general and administrative	2,649,436	4,157,981	5,269,841	7,652,131
Depreciation and amortization	92,321	103,719	187,800	205,820
Amortization of intangibles	-	455,826	-	912,902
Impairment loss on goodwill and other intangibles	-	10,254,910	-	10,254,910
Total operating costs	2,741,757	14,972,436	5,457,641	19,025,763
Operating income (loss)	458,206	(13,522,951)	206,843	(14,744,679)
Interest income (expense), net	(23,816)	(52,271)	(62,605)	(88,060)
Income (loss) from continuing operations before income taxes	434,390	(13,575,222)	144,238	(14,832,739)
Income tax expense	-	-	-	-
Net income (loss) from continuing operations	434,390	(13,575,222)	144,238	(14,832,739)
Loss from discontinued operations, net of taxes	-	(3,192,459)	-	(2,951,539)
Net income (loss)	\$ 434,390	\$ (16,767,681)	\$ 144,238	\$ (17,784,278)
<b>Per Common Share (Basic and Diluted):</b>				
Net income (loss) from continuing operations, net of tax	\$ 0.03	\$ (1.07)	\$ 0.01	\$ (1.17)
Loss from discontinued operations, net of taxes	-	(0.25)	-	(0.23)
Net income (loss)	\$ 0.03	\$ (1.32)	\$ 0.01	\$ (1.40)
<b>Weighted average common shares outstanding-basic</b>				
Basic	13,370,738	12,678,381	13,193,534	12,660,049
Diluted	14,156,784	12,678,381	14,010,302	12,660,049

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

FORTRESS INTERNATIONAL GROUP, INC.  
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

	(Unaudited)	
	For the Six Months Ended	
	June 30,	
	2010	June 30, 2009
<b>Cash Flows from Operating Activities:</b>		
Net income (loss)	\$ 144,238	\$ (17,784,278)
Adjustments to reconcile net income (loss) to net cash provided by used in operating activities:		
Depreciation and amortization	187,800	208,459
Amortization of intangibles	-	1,382,960
Impairment loss on goodwill and other intangibles	-	13,062,140
Provision for doubtful accounts	-	1,025,000
Stock and warrant-based compensation	355,344	946,740
Extinguishment of contract liabilities	-	(269,217)
Other non-cash income, net	(36,484)	2,935
Changes in operating assets and liabilities:		
Contracts and other receivables	3,472,804	7,668,648
Costs and estimated earnings in excess of billings on uncompleted contracts	(367,886)	1,441,882
Prepaid expenses and other current assets	(248,917)	(463,314)
Other assets	191,970	(42,617)
Accounts payable and accrued expenses	1,049,783	(9,193,492)
Billings in excess of costs and estimated earnings on uncompleted contracts	2,666,811	(2,235,251)
Other liabilities	(21,395)	(83,507)
Net cash provided by (used in) operating activities	7,394,068	(4,332,912)
<b>Cash Flows from Investing Activities:</b>		
Purchase of property and equipment	(72,688)	(94,897)
Proceeds from repayment of note in connection with the sale of certain assets and liabilities of Rubicon	118,151	
Payment of earnout in connection with the acquisition of Rubicon	-	(700,000)
Payment of earnout in connection with the acquisition of Innovative	-	(353,187)
Net cash provided by (used in) investing activities	45,463	(1,148,084)
<b>Cash Flows from Financing Activities:</b>		
Payments on notes payable	(4,915)	(27,511)
Payment on seller notes	(36,461)	(1,672,420)
Purchase of treasury stock	(116,038)	-
Net cash used in financing activities	(157,414)	(1,699,931)
Net increase (decrease) in cash	7,282,117	(7,180,927)
Cash, beginning of period	2,263,146	12,448,157
Cash, end of period	\$ 9,545,263	\$ 5,267,230
Less: Cash associated with discontinued operations	-	889,920
Cash, end of period from continuing operations	\$ 9,545,263	\$ 4,377,310
Supplemental disclosure of cash flow information:		
Cash paid for interest	\$ 85,950	\$ 126,444
Cash paid for taxes	-	116,411
Supplemental disclosure of non-cash financing activities:		

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Promissory notes, issued to an officer, converted to commonstock	\$ 1,250,000	\$ -
Promissory notes payable issued in connection with the acquisition of Rubicon	-	550,000

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

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FORTRESS INTERNATIONAL GROUP, INC.  
NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(1) Basis of Presentation

The unaudited condensed consolidated financial statements are for the three and six months ended June 30, 2010 and 2009 for Fortress International Group, Inc. (“Fortress” or the “Company” or “We”).

The accompanying unaudited condensed consolidated financial statements have been prepared pursuant to the rules and regulations of the Securities and Exchange Commission (“SEC”). Certain information and note disclosures normally included in the annual financial statements, prepared in accordance with accounting principles generally accepted in the United States of America (“GAAP”), have been condensed or omitted pursuant to those rules and regulations. We recommend that you read these unaudited condensed consolidated financial statements in conjunction with the audited consolidated financial statements and related notes included in our Annual Report on Form 10-K for the year ended December 31, 2009, previously filed with the SEC. We believe that the unaudited condensed consolidated financial statements in this Quarterly Report on Form 10-Q reflect all adjustments that are necessary to fairly present the financial position, results of operations and cash flows for the interim periods presented. The results of operations for such interim periods are not necessarily indicative of the results that can be expected for the full year.

Nature of Business and Organization

The Company provides a single source solution for highly technical mission-critical facilities such as data centers, operations centers, network facilities, server rooms, security operations centers, communications facilities and the infrastructure systems that are critical to their function. The Company’s services consist of technology consulting, design and engineering, construction management, systems installations and facilities management.

During the year ended December 31, 2009, the Company experienced a significant and unexpected decrease in its revenues, caused by delays in starting projects or cancellations thereof resulting in a significant loss and negative cash flows from operations. The Company has taken actions to address the liquidity concerns that this caused.

Based on an unexpected lack of closed contracts and continued customer delays experienced during 2009, management revised our financial forecast and implemented selling, general and administrative cost cutting measures with an approximate annual savings of \$2.2 million. In an effort to achieve positive cash flows from operations and align costs with forecasted revenues in the future, the Company voluntarily delisted from the NASDAQ Capital Market in March 2010 to reduce professional fees and other costs necessary to maintain a listing on the NASDAQ Capital Market.

Due to the downturn in the economy, which had an adverse impact on the Company’s existing customers, financial security and stock value, the Company suspended its strategy of growth through acquisitions in 2009. The corporate focus is centered on preserving cash, achieving positive cash flow and discontinuing or selling operations that threatened that focus. The Company engaged an investment bank to assist it in evaluating various disposition and financial alternatives, which culminated in the sale of the Rubicon division to its management and former owners on December 29, 2009. The Company is no longer actively evaluating the disposition of assets as its improved operating results and prospects based on improvements we have seen in our operating environment.

The Company further sought to restructure scheduled debt repayments with its creditors. In addition to the added liquidity from the proceeds of the sale of Rubicon, the Company eliminated scheduled debt repayments through debt forgiveness of approximately \$0.5 million to the former sellers of Rubicon. On February 28, 2010, the Company improved its net worth through the principal conversion of \$1.3 million of principal due on a seller note to Mr. Gerard

Gallagher, our Chief Operating Officer (COO). Furthermore, the principal repayment of the remaining \$2.8 million originally scheduled to begin payment on March 1, 2010 was amended to begin in the second quarter of 2012. As a result of these note restructurings, at December 31, 2009 short term debt obligations were reduced \$2.3 million and in turn our short-term liquidity substantially improved.

As a result of the cost reduction efforts to realign operations with decreased anticipated revenues, the added liquidity from the sale of Rubicon, and the financial restructuring of the \$4.0 million seller note, management believes that our current cash and cash equivalents and expected future cash generated from operations will satisfy the Company's expected working capital, capital expenditure and investment requirements through the next twelve months.

FORTRESS INTERNATIONAL GROUP, INC.  
NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

Recently Issued Accounting Pronouncements

In October 2009, Accounting Standards Update No. 2009-13, Revenue Recognition (Topic 605): Multiple-Deliverable Revenue Arrangements a consensus of the FASB Emerging Issues Task Force was issued. The objective of this Update is to address the accounting for multiple-deliverable arrangements to enable vendors to account for products or services (deliverables) separately rather than as a combined unit. Vendors often provide multiple products or services to their customers. Those deliverables often are provided at different points in time or over different time periods. Subtopic 605-25, Revenue Recognition-Multiple-Element Arrangements, establishes the accounting and reporting guidance for arrangements under which the vendor will perform multiple revenue-generating activities. Specifically, this Subtopic addresses how to separate deliverables and how to measure and allocate arrangement consideration to one or more units of accounting. The amendments in this Update will affect accounting and reporting for all vendors that enter into multiple-deliverable arrangements with their customers when those arrangements are within the scope of ASC Subtopic 605-25. The amendments in this Update significantly expand the disclosures related to a vendor's multiple-deliverable revenue arrangement. The objective of the disclosures is to provide information about the significant judgments made and changes to those judgments and about the application of the relative selling-price method affects the timing of the revenue recognition. The amendments in this Update will be effective prospectively for revenue arrangements entered into or materially modified in fiscal years beginning on or after June 15, 2010. Early adoption is permitted. The Company does not anticipate that the adoption of this standard will have any significant impact on its results of operations or financial position.

FORTRESS INTERNATIONAL GROUP, INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(2) Accounts Receivable, net

The Company had accounts receivable allowances for doubtful accounts of \$0.5 million at June 30, 2010 and December 31, 2009. Bad debt expense for the three and six months ended June 30, 2010 and 2009 was zero and \$1.0 million, respectively.

Included in accounts receivable was retainage associated with construction projects totaling \$1.9 million and \$0.5 million at June 30, 2010 and December 31, 2009, respectively.

The Company earned approximately 74% and 45% of its revenue from two customers for the three months ended June 30, 2010 and 2009, respectively. The Company earned approximately 72% and 46% of its revenue from two and three customers for the six months ended June 30, 2010 and 2009, respectively. Accounts receivable from these customers at June 30, 2010 and December 31, 2009 was \$3.2 million and \$8.1 million, respectively.

Additionally, a customer, comprising 60% and 64% of the Company's total revenue for the three and six months ended June 30, 2010, respectively, was purchased in the second quarter of 2010. We are unable to determine the effect the merger may have on continued business with our customer.

(3) Extinguishment of Liabilities

During the six months ended June 30, 2009, the Company finalized the extinguishment of approximately \$0.3 million. During 2009, pursuant to a contract assignment, two different subcontractors relieved the Company of its obligation due to these vendors which had been previously recorded by the Company. The Company's customer has not made payments under the contract and these vendors will pursue collection remedy independently and without recourse to the Company pursuant to the terms of the contract assignment. The Company recorded the extinguishment of liabilities for the amount due to these two vendors as a reduction to accounts payable and a reduction to cost of sales of \$0.3 million during the six months ended June 30, 2009.

(4) Discontinued Operations

On December 29, 2009, the Company completed the sale of substantially all of the assets and liabilities of Rubicon for total consideration of \$1.8 million consisting of \$0.8 million in cash proceeds, net of transaction costs, a \$0.6 million note receivable and \$0.4 million in forgiveness of actual obligations and potential liabilities related to 2008 and 2009 earn-outs to the former owners and management of Rubicon. The Company is in the process of reviewing the buyer's working capital calculation as outlined in the purchase agreement and received scheduled note payments through July 2010. Additionally, the Company is entitled to contingent consideration in the form of an earn-out equal to 7.5% of gross profit on designated projects during a one year period commencing on the close date. At June 30, 2010, the Company had not recorded any contingent consideration associated with this earn-out.

For all periods presented, the Company classified Rubicon, which focused on construction management and equipment integration, as discontinued operations as the Company has no ongoing involvement with the business component that has distinguishable operations and financials from the rest of the entity. We sold this business to enhance the Company's liquidity, while maintaining similar service capabilities. Associated results of operations, financial position and cash flows are separately reported for all periods presented.

Information for business components included in discontinued operations is as follows:

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	For the Three Months Ended June 30, 2009	For the Six Months Ended June 30, 2009
Revenue	\$ 2,852,222	\$ 16,005,130
Loss from operations of discontinued businesses, before taxes	(3,192,459)	(2,951,539)
Income tax expense	-	-
Loss from operations of discontinued businesses	\$ (3,192,459)	\$ (2,951,539)

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FORTRESS INTERNATIONAL GROUP, INC.  
NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

## (5) Basic and Diluted Net Loss per Share

Basic and diluted net loss per common share is computed as follows:

	Three Months Ended June 30, 2010			2009		
	Income	Shares	\$ per Share	Income	Shares	\$ per Share
<b>BASIC EARNINGS (LOSS) PER SHARE</b>						
Income (loss) from continuing operations	\$ 434,390	13,370,738	\$ 0.03	\$ (13,575,222)	12,678,381	\$ (1.07)
<b>EFFECT OF DILUTIVE SECURITIES</b>						
Unvested restricted stock	-	786,046	-	-	-	-
<b>DILUTED EARNINGS (LOSS) PER SHARE</b>						
	\$ 434,390	14,156,784	\$ 0.03	\$ (13,575,222)	12,678,381	\$ (1.07)

	Six Months Ended June 30, 2010			2009		
	Income	Shares	\$ per Share	Income	Shares	\$ per Share
<b>BASIC EARNINGS (LOSS) PER SHARE</b>						
Income (loss) from continuing operations	\$ 144,238	13,193,534	\$ 0.01	\$ (14,832,739)	12,660,049	\$ (1.17)
<b>EFFECT OF DILUTIVE SECURITIES</b>						
Unvested restricted stock	-	816,768	-	-	-	-
<b>DILUTED EARNINGS (LOSS) PER SHARE</b>						
	\$ 144,238	14,010,302	\$ 0.01	\$ (14,832,739)	12,660,049	\$ (1.17)

Unvested restricted stock units and options to purchase shares of common stock for 87,167 and 700,000 shares of common stock, respectively, that were outstanding at June 30, 2010 were not included in the computation of diluted net loss per common share for the three and six months ended June 30, 2010, as they either vest at \$3.00 per share or were out of the money. Additionally, for the three and six months ended June 30, 2010, all convertible notes were omitted from the earnings per share calculation because the effect of conversion would be anti-dilutive.

Unvested restricted stock, convertible unsecured promissory notes, options to purchase units and warrants for 715,337, 533,333, 700,000 and 15,710,300 shares of common stock, respectively, that were outstanding at June 30, 2009 were not included in the computation of diluted net loss per common share for the three and six months ended June 30, 2009, as their inclusion would be anti-dilutive.

(6) Employee Benefit Plans

Restricted Stock

For the three months ended June 30, 2010 and 2009, the Company recorded non-cash compensation expense included in selling, general and administrative expense associated with vesting awards of \$0.2 million and \$0.4 million, respectively, and in cost of revenue recorded zero and \$0.1 million, respectively.

For the six months ended June 30, 2010 and 2009, the Company recorded non-cash compensation expense included in selling, general and administrative expense associated with vesting awards of \$0.3 million and \$0.8 million, respectively, and in cost of revenue recorded \$0.1 million and \$0.2 million, respectively. For the six months ended June 30, 2010 and June 30, 2009, the Company granted 90,000 and 70,000 shares of restricted stock, respectively, and restricted stock units of zero and 20,000, respectively, under the 2006 Omnibus Incentive Compensation Plan (Stock Plan).

On June 6, 2010, shareholders approved a 950,000 increase to shares available for award under the Stock Plan. At June 30, 2010, there was approximately \$0.5 million of unrecognized stock compensation.

(7) Options to Purchase Shares of Common Stock

At June 30, 2010 and December 31, 2009, options to purchase 700,000 shares of common stock at a purchase price of \$7.50 per share were outstanding. These options have a cashless exercise feature, whereby the holder may elect to receive a net amount of shares and forego the payment of the exercise price. These options expired July 13, 2010 and subsequently the Company has no outstanding options to purchase units or warrants.

FORTRESS INTERNATIONAL GROUP, INC.  
NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(8) Income Taxes

Deferred income taxes are provided for the temporary differences between the financial reporting and tax basis of the Company's assets and liabilities using enacted tax rates in effect for the year in which the differences are expected to reverse.

The Company is in a net operating loss carryover position. The net operating losses not utilized can be carried forward for 20 years to offset future taxable income. As of June 30, 2010 and December 31, 2009, a full valuation allowance has been recorded against the Company's deferred tax assets, as the Company has concluded that under relevant accounting standards it is more likely than not that the deferred tax assets will not be realizable.

The Company's effective tax rate is based upon the rate expected to be applicable to the full fiscal year.

The Company files a consolidated federal tax return in states that allow it, and in other states the Company files separate tax returns.

The Company's prior federal and state income tax filings since 2006 remain open under statutes of limitation. Innovative Power System Inc.'s statutes of limitation are open from the 2006 tax year forward for both federal and Commonwealth of Virginia purposes. Quality Power Systems Inc.'s statutes of limitation are open from the 2006 tax year forward for both federal and Commonwealth of Virginia purposes. SMLB, Ltd. statutes of limitation are open from the 2006 tax year forward for both federal and State of Illinois purposes.

(9) Notes Payable

	June 30, 2010	December 31, 2009
Convertible, unsecured promissory note, due 2012 (4.0%)	\$ 2,750,000	\$ 4,000,000
Unsecured promissory note, due 2010 (6.0%)	120,572	120,572
Unsecured promissory note, due 2010 (6.0%)	174,074	210,535
Vehicle notes	-	4,915
<b>Total debt</b>	<b>3,044,646</b>	<b>4,336,022</b>
Less current portion	294,646	183,679
<b>Total debt, less current portion</b>	<b>\$ 2,750,000</b>	<b>\$ 4,152,343</b>

For the six months ended June 30, 2010 and 2009, the Company made principal repayments of \$0.04 million and \$1.7 million, respectively.

On February 28, 2010, the Chief Operating Officer (COO) entered into an agreement with the Company to convert \$1.3 million of the outstanding note balance into equity at a conversion price of \$2.00 per share, resulting in the aggregate issuance of 625,000 shares of the Company's common stock. The amount of the excess of the conversion price of \$2.00 over the market price at \$0.56 on the date of conversion totaling \$0.9 million has been recorded as additional paid-in capital. The terms on the remaining principal balance of \$2.8 million were amended reducing the interest rate under the note from 6% to 4%, providing for the payment of certain amounts of accrued interest over time, providing for interest-only payments under the note until April 1, 2012, providing for eight principal payments in the amount of \$125,000 each beginning on April 1, 2012, and providing for a final payment of all remaining



amounts of principal and interest due under the note on April 1, 2014. The note amendment also provides for the acceleration of all amounts due under the note upon a change of control of the Company or the death of the COO. Based on the amended principal repayment terms, the \$4.0 million note was classified as long-term at December 31, 2009.

FORTRESS INTERNATIONAL GROUP, INC.  
NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(10) Related Party Transactions

The Company participates in transactions with the following entities affiliated through common ownership and management. The Audit Committee in accordance with its written charter reviews and approves in advance all related party transactions greater than \$25,000 and follows a pre-approved process for contracts with a related party for less than \$25,000.

S3 Integration, LLC S3 Integration LLC (S3 Integration) is 15% owned by each of the Company's Chief Executive Officer and COO. S3 Integration provides commercial security systems design and installation services as a subcontractor to the Company.

Chesapeake Systems, LLC (Chesapeake Systems) is 9% owned and significantly indebted to the Company's Chief Executive Officer. Chesapeake Systems is a manufacturers' representative and distributor of mechanical and electrical equipment.

Chesapeake Mission Critical, LLC (Chesapeake MC) is 9% owned by each of the Company's Chief Executive Officer and its COO. Additionally, it is significantly indebted to the Company's Chief Executive Officer. Chesapeake MC is a manufacturers' representative and distributor of electrical equipment.

CTS Services, LLC (CTS) is 9% owned by the Company's Chief Executive Officer. CTS is a mechanical contractor that acts as a subcontractor to the Company for certain projects. In addition, CTS utilizes the Company as a subcontractor on projects as needed. Prior to April 1, 2009, the Company's Chief Executive Officer owned 55% of CTS.

L.H. Cranston Acquisition Group, Inc . L.H. Cranston Acquisition Group, Inc. (Cranston) was 25% owned by the Company's Chief Executive Officer until the sale of his interest on February 28, 2009. Cranston is a mechanical, electrical and plumbing contractor that acts, directly or through its Subsidiary L.H. Cranston and Sons, Inc., as subcontractor to the Company on a project-by-project basis.

Telco P&C, LLC Telco P&C, LLC is 9% owned by the Company's Chief Executive Officer. Telco P&C is a specialty electrical installation company that acts as a subcontractor to the Company. The Company has also acted as a subcontractor to Telco as needed.

TPR Group Re Three, LLC TPR Group Re Three, LLC (TPR Group Re Three) is 50% owned by each of the Company's Chief Executive Officer and its COO. TPR Group Re Three leases office space to the Company under the terms of a real property lease to TSS/Vortech. The Company had an independent valuation, which determined the lease to be at fair value.

Chesapeake Tower Systems, Inc. Chesapeake Tower Systems, LLC (Chesapeake) is owned 100% by the Company's Chief Executive Officer. During the second quarter 2009 and concurrent with an expiring leased facility, the Company entered into a new lease for approximately 25,000 square feet of combined office and warehouse space from Chesapeake. The lease commitment is for five years (Initial Term) with a two-year renewal option (Renewal Term). During the Initial Term, annual rent is \$124,000, plus operating expenses. If the Company elects to extend the lease, annual rent increases by the greater of i) fair market rental as defined in the lease, or ii) 3% increase in each year of the Renewal Term. Additionally, Chesapeake provided \$150,000 for tenant improvements and relocation costs. The Company completed an independent appraisal, which determined the lease to be at fair value.



FORTRESS INTERNATIONAL GROUP, INC.  
NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

The following table sets forth transactions the Company has entered into with the above related parties for the three and six months ended June 30, 2010 and 2009. It should be noted that revenue represents amounts earned on contracts with related parties under which we provide services; and cost of revenue represents costs incurred in connection with related parties which provide services to us on contracts for our customers. As such a direct relationship to the revenue and cost of revenue information below by company should not be expected.

	Three Months Ended June 30, 2010	Three Months Ended June 30, 2009	Six Months Ended June 30, 2010	Six Months Ended June 30, 2009
<b>Revenue</b>				
Telco P&C, LLC	\$ 219,088	\$ -	\$ 465,335	\$ -
Chesapeake Mission Critical, LLC	10,202	17,385	11,500	156,658
<b>Total</b>	<b>\$ 229,290</b>	<b>\$ 17,385</b>	<b>\$ 476,835</b>	<b>\$ 156,658</b>
<b>Cost of Revenue</b>				
CTS Services, LLC	\$ 55,963	\$ 880,726	\$ 134,109	\$ 1,500,938
Chesapeake Systems, LLC	-	-	-	-
Chesapeake Mission Critical, LLC	80,967	48,250	87,767	58,280
S3 Integration, LLC	203,180	191,636	300,286	338,597
LH Cranston & Sons, Inc.	-	10,852	-	269,749
Telco P&C, LLC	36,201	59,860	37,278	72,556
<b>Total</b>	<b>\$ 376,311</b>	<b>\$ 1,191,324</b>	<b>\$ 559,440</b>	<b>\$ 2,240,120</b>
<b>Selling, general and administrative</b>				
Office rent paid on Chesapeake sublease agmt	-	54,833	-	136,538
Office rent paid on Chesapeake Tower Sytsems	45,901	10,333	75,018	10,333
Office rent paid to TPR Group Re Three, LLC	100,927	100,927	201,854	201,854
<b>Total</b>	<b>\$ 146,828</b>	<b>\$ 166,093</b>	<b>\$ 276,872</b>	<b>\$ 348,725</b>

	June 30, 2010	December 31, 2009
<b>Accounts receivable/(payable):</b>		
CTS Services, LLC	\$ 32,902	\$ 104,065
CTS Services, LLC	(114,894)	(104,528)
Chesapeake Mission Critical, LLC	-	2,000
Chesapeake Mission Critical, LLC	(9,580)	(124,425)
Chesapeake Tower Systems, Inc.	-	-
Telco P&C, LLC	150,744	39,813
Telco P&C, LLC	(53,450)	(52,373)
LH Cranston & Sons, Inc.	-	-
S3 Integration, LLC	(27,700)	(3,425)
TPR Group RE Three, LLC	-	-
<b>Total Accounts receivable</b>	<b>\$ 183,646</b>	<b>\$ 145,878</b>
<b>Total Accounts (payable)</b>	<b>\$ (205,624)</b>	<b>\$ (284,751)</b>



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

The following discussion should be read in conjunction with our Financial Statements and related Notes thereto included elsewhere in this report.

The terms "we" and "our" and the "Company" as used throughout this Quarterly Report on Form 10-Q refer to Fortress International Group, Inc. and its consolidated subsidiaries, unless otherwise indicated.

Business Formation and Overview

We were incorporated in Delaware on December 20, 2004 as a special purpose acquisition company formed under the name "Fortress America Acquisition Corporation" for the purpose of acquiring an operating business that performs services in the homeland security industry. On July 20, 2005, we closed our initial public offering of 7,800,000 units (including underwriters exercise of an over-allotment option), resulting in proceeds net of fees to us of approximately \$43.2 million.

On January 19, 2007, we acquired all of the outstanding membership interests of each of VTC, L.L.C., doing business as "Total Site Solutions" ("TSS"), and Vortech, L.L.C. ("Vortech" and, together with TSS, "TSS/Vortech") and simultaneously changed our name to "Fortress International Group, Inc." The acquisition fundamentally transformed the Company from a special purpose acquisition company to an operating business.

We provide comprehensive services for the planning, design, and development of mission-critical facilities and information infrastructure. We also provide a single source solution for highly technical mission-critical facilities such as data centers, operation centers, network facilities, server rooms, security operations centers, communications facilities and the infrastructure systems that are critical to their function. Our services include technology consulting, engineering and design management, construction management, system installations, operations management, and facilities management and maintenance.

Building on the TSS/Vortech business, management continued an acquisition strategy to expand our geographical footprint, add complementary services, and diversify and expand our customer base. After acquiring TSS/Vortech, the Company continued its expansion through the acquisitions of Comm Site of South Florida, Inc. on May 7, 2007 ("Comm Site"), Innovative Power Systems, Inc. and Quality Power Systems, Inc. (collectively, "Innovative") on September 24, 2007, Rubicon Integration, LLC ("Rubicon") on November 30, 2007 and SMLB Ltd. ("SMLB") on January 2, 2008.

Based on an unexpected lack of closed contracts and continued customer delays experienced at June 30, 2009 and through December 31, 2009, management revised our financial forecast and implemented selling, general and administrative cost cutting measures with an approximate annual savings of \$2.2 million. In an effort to attempt to achieve positive cash flows from operations and align costs with forecasted revenues in the future, the Company delisted from the NASDAQ Capital Market in March 2010 to reduce professional fees and other costs necessary to maintain a listing on the NASDAQ Capital Market.

The Company's strategic growth through acquisitions was suspended due to the downturn in the economy, the impact this had on the Company's existing customer base, and as well as the impact it had on the Company's own financial security and common stock value. The corporate focus is centered on preserving cash, achieving positive cash flow and discontinuing or selling operations that threatened that focus. The Company engaged an investment bank to assist it in evaluating various disposition and financial alternatives, which culminated in the sale of the Rubicon division to its management and former owners on December 29, 2009. The Company is no longer actively evaluating the disposition of assets as its improved operating results and prospects based on improvements we have seen in our

operating environment.

#### Competition in Current Economic Environment

Our industry has been and may be further adversely impacted by the current economic environment and tight credit conditions. We have seen larger competitors seek to expand their services offerings including a focus in the mission-critical market. These larger competitors have an infrastructure and support greater than ours and accordingly, we have experienced some price pressure as some companies are willing to take on projects at lower margins. With certain customers, we have experienced a delay in spending, or deferral of projects to an indefinite commencement date due to the economic uncertainty or lack of access to capital.

We believe there are high barriers to entry in our sector for new competitors due to our specialized technology service offerings which we deliver to our customers, our top secret clearances, and our turnkey suite of deliverables offered. We compete for business based upon our reputation, past experience, and our technical engineering knowledge of mission-critical facilities and their infrastructure. We are developing and creating long term relationships with our customers because of our excellent reputation in the industry and will continue to create facility management relationships with our customers that we expect will provide us with steadier revenue streams to improve the value of our business. Finally, we seek to further expand our energy services that focus on operational cost savings that may be used to either fund the project or increase returns to the facility operator. We believe these barriers and our technical capabilities and experience will differentiate us to compete with new entrants into the market or pricing pressures.

Although we will closely monitor our proposal pricing and the volume of the work, we have seen our margins decrease and can not be certain that our current margins will be sustained. Furthermore, given the environment, to the extent the volume of our contracts further decrease, we may have to take additional measures to reduce our operating costs through additional reductions in general, administrative and marketing costs, including potential reductions in personnel and related costs.

#### Contract Backlog

We believe an indicator of our future performance is our backlog of uncompleted projects in process or recently awarded. Our backlog represents our estimate of anticipated revenue from executed and awarded contracts that have not been completed and that we expect will be recognized as revenues over the life of the contracts. We have broken our backlog into the following three categories: (i) technology consulting consisting of services related to consulting and/or engineering design contracts, (ii) construction management, and (iii) facility management.

Backlog is not a measure defined in generally accepted accounting principles, and our methodology for determining backlog may not be comparable to the methodology of other companies in determining their backlog. Our backlog is generally recognized under two categories: (1) contracts for which work authorizations have been or are expected to be received on a fixed-price basis, guaranteed maximum price basis or time and materials basis, and (2) contracts awarded to us where some, but not all, of the work has not yet been authorized. At June 30, 2010, we had authorizations to proceed with work for approximately \$37.5 million, or 73% of our total backlog of \$51.5 million. At December 31, 2009, we had authorizations to proceed with work for approximately \$39.9 million, or 85% of our total backlog of \$47.1 million.

Approximately \$37.5 million, or 73% of our backlog, relates to two customers at June 30, 2010 and \$32.5 million, or 69%, to three customers at December 31, 2009. Additionally, a customer, who comprised 53% and 58% of our total backlog at June 30, 2010 and December 31, 2009, respectively, was purchased in the second quarter of 2010. We are unable to determine the effect of the merger may have on continued business with our customer.

As of June 30, 2010, our backlog was approximately \$51.5 million, compared to approximately \$47.1 million at December 31, 2009. We believe that approximately 58% of the backlog at June 30, 2010 will be recognized during the next six months. The following table reflects the value of our backlog in the above three categories as of June 30, 2010 and December 31, 2009, respectively.

(In millions)

	December
June 30,	31,
2010	2009



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Technology consulting	\$	11.0	\$	1.4
Construction management		29.1		33.8
Facilities management		11.4		11.9
Total	\$	51.5	\$	47.1

### Critical Accounting Policies and Estimates

Our financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America, or GAAP. The preparation of the financial statements included elsewhere in this Quarterly Report on Form 10-Q requires that management make estimates and assumptions that affect the amounts reported in the financial statements and the accompanying notes. Actual results could differ significantly from those estimates. As there have been no significant revisions, please refer to our Annual Report and Form 10-K for a description of our critical accounting policies that affect the more significant estimates and judgments used in the preparation of our financial statement.

### Recently Issued Accounting Pronouncements

In October 2009, Accounting Standards Update No. 2009-13, Revenue Recognition (Topic 605): Multiple-Deliverable Revenue Arrangements a consensus of the FASB Emerging Issues Task Force was issued. The objective of this Update is to address the accounting for multiple-deliverable arrangements to enable vendors to account for products or services (deliverables) separately rather than as a combined unit. Vendors often provide multiple products or services to their customers. Those deliverables often are provided at different points in time or over different time periods. Subtopic 605-25, Revenue Recognition-Multiple-Element Arrangements, establishes the accounting and reporting guidance for arrangements under which the vendor will perform multiple revenue-generating activities. Specifically, this Subtopic addresses how to separate deliverables and how to measure and allocate arrangement consideration to one or more units of accounting. The amendments in this Update will affect accounting and reporting for all vendors that enter into multiple-deliverable arrangements with their customers when those arrangements are within the scope of ASC Subtopic 605-25. The amendments in this Update significantly expand the disclosures related to a vendor's multiple-deliverable revenue arrangement. The objective of the disclosures is to provide information about the significant judgments made and changes to those judgments and about the application of the relative selling-price method affects the timing of the revenue recognition. The amendments in this Update will be effective prospectively for revenue arrangements entered into or materially modified in fiscal years beginning on or after June 15, 2010. Early adoption is permitted. We do not anticipate that the adoption of this standard will have any significant impact on our results of operations or financial position.

Results of operations for the three months ended June 30, 2010 compared with the three months ended June 30, 2009.

Revenue. Revenue increased \$10.6 million to \$22.7 million for the three months ended June 30, 2010 from \$12.1 million for the three months ended June 30, 2009. The increase was driven primarily by a \$9.3 million increase in construction management services attributable to two large contracts.

Cost of Revenue. Cost of revenue increased \$8.9 million to \$19.5 million for the three months ended June 30, 2010 from \$10.6 million for the three months ended June 30, 2009. The increase was driven primarily by an \$8.8 million increase in construction management services attributable to two large contracts.

Gross Margin Percentage. Gross margin percentage increased to 14.1% for the three months ended June 30, 2010 compared to 12.0% for the three months ended June 30, 2009. The increase in gross margin is attributable to primarily to improvements from our technology consulting and facilities management services, as we realigned employee related compensation as a result of pay and workforce reductions and fully vested stock grants.

Selling, general and administrative expenses. Selling, general and administrative expenses decreased \$1.6 million to \$2.6 million for the three months ended June 30, 2010 from \$4.2 million for the three months ended June 30, 2009. The decrease is primarily driven by \$0.5 million decrease in salaries and related costs of benefits and non-cash compensation due to a reduction in headcount. The remaining decline of \$0.9 million is attributable to a decrease in provision for bad debt expense. Based on the improved operating results and prospects based on improvement we have seen in our operating environment, subsequent to the quarter end we returned existing employees to their original salaries and anticipate the increase will result in an annual increase in selling, general and administrative costs of \$0.4 million. We will continue to closely monitor our bookings and anticipated revenues, and we may take future actions to reduce operating costs associated with personnel and related costs in an effort to remain profitable.

Depreciation. Depreciation remained consistent at \$0.1 million for the three months ended June 30, 2010 compared to \$0.1 million for the three months ended June 30, 2009.

Amortization of intangible assets. Amortization expense decreased \$0.5 million to zero for the three months ended June 30, 2010 from \$0.5 million for the three months ended June 30, 2009. During the three months ended June 30, 2010, there were no amortizable assets, as they were deemed impaired and reduced to zero during the three months ended June 30, 2009.

Impairment loss on goodwill and other intangibles, net. We did not record any impairment losses during the three months ended June 30, 2010. During the three months ended June 30, 2009, we had experienced continued operating losses and a decline in market value and accordingly conducted analyses of our operations in order to identify any impairment in the carrying value of the goodwill and other intangibles related to our business. Analyzing our business using both an income approach and a market approach and an evaluation of customer relation relationships, we determined that the carrying value exceeded the current fair value of our business and customer related intangibles, resulting in goodwill and other intangible impairment of \$10.3 million for the three months ended June 30, 2009.

Interest income (expense), net. Our interest income (expense), net remained consistent at (\$0.02) million for the three months ended June 30, 2010 compared to (\$0.1) million for the three months ended June 30, 2009.

Loss from discontinued business, net of tax. We recorded loss from discontinued operations of zero for the three months ended June 30, 2010 as compared to \$3.2 million for the three months ended June 30, 2009. We sold substantially all of the assets and liabilities of Rubicon on December 29, 2009.



Results of operations for the six months ended June 30, 2010 compared with the six months ended June 30, 2009.

Revenue. Revenue increased \$10.8 million to \$39.8 million for the six months ended June 30, 2010 from \$29.0 million for the six months ended June 30, 2009. The increase in revenue was driven by a \$10.5 million increase in our construction services as we had added a significant development project and completed another during the six months ended June 30, 2010.

Cost of Revenue. Cost of revenue increased \$9.4 million to \$34.1 million for the six months ended June 30, 2010 from \$24.7 million for the six months ended June 30, 2009. The increase in revenue was driven by a \$9.3 million increase in our construction services as we had added a significant development project during the six months ended June 30, 2010. During the six months ended June 30, 2009, the Company had approximately \$0.3 million of extinguishment of contract liabilities reducing cost of sales by a corresponding amount.

Gross Margin Percentage. Gross margin percentage declined to 14.2% for the six months ended June 30, 2010 compared to 14.8% for the six months ended June 30, 2009. Excluding the \$0.3 million reduction in cost of sales for the extinguishment of contract liabilities during the six months ended June 30, 2009, gross margin increased to 14.2% for the six months ended June 30, 2010 compared to 13.8% during the six months ended June 30, 2009. The increase in gross margin is attributable to the gross margin improvements for our facilities management services as we restructured our employee- related costs through pay and headcount decreases.

Selling, general and administrative expenses. Selling, general and administrative expenses decreased \$2.4 million to \$5.3 million for the six months ended June 30, 2010 from \$7.7 million for the six months ended June 30, 2009. The decrease is primarily driven by \$1.0 million decrease in salaries and related costs of benefits and non-cash compensation due to a reduction in headcount. The remaining decline of \$1.4 million is attributable to a decrease in provision for bad debt expense and rent of \$1.0 million and \$0.2 million. Based on the improved operating results and prospects based on improvements we have seen in our operating environment, subsequent to the quarter end we returned existing employees to their original salaries and anticipate the increase will result in an annual increase in selling, general and administrative costs of \$0.4 million. We will continue to closely monitor our bookings and anticipated revenues, and we may take future actions to reduce operating costs associated with personnel and related costs in an effort to remain profitable.

Depreciation. Depreciation remained consistent at \$0.2 million for the six months ended June 30, 2010 compared to \$0.2 million for the six months ended June 30, 2009.

Amortization of intangible assets. Amortization expense decreased \$0.9 million to zero for the six months ended June 30, 2010 from \$0.9 million for the six months ended June 30, 2009. During the six months ended June 30, 2010, there were no amortizable assets, as they were deemed impaired to zero during the six months ended June 30, 2009.

Impairment loss on goodwill and other intangibles, net. We did not record any impairment losses during the six months ended June 30, 2010. During the six months ended June 30, 2009, we had experienced continued operating losses and a decline in market value and accordingly conducted analyses of our operations in order to identify any impairment in the carrying value of the goodwill and other intangibles related to our business. Analyzing our business using both an income approach and a market approach and an evaluation of customer relation relationships, we determined that the carrying value exceeded the current fair value of our business and customer related intangibles, resulting in goodwill and other intangible impairment of \$10.3 million for the six months ended June 30, 2009.

Interest income (expense), net. Our interest income (expense), net remained consistent at (\$0.1) million for the six months ended June 30, 2010 compared to (\$0.1) million for the six months ended June 30, 2009.

Income from discontinued business, net of tax. We recorded income from discontinued operations of zero for the six months ended June 30, 2010 as compared to \$3.0 million for the six months ended June 30, 2009. We sold substantially all of the assets and liabilities of Rubicon on December 29, 2009.

## EBITDA from Continuing Operations

A reconciliation of net income (loss) to EBITDA:

	(Unaudited) For the Three Months Ended June 30,		(Unaudited) For the Six Months Ended June 30,	
	2010	June 30, 2009	2010	June 30, 2009
Net income (loss) from continuing operations	\$ 434,390	\$ (13,575,222)	\$ 144,238	\$ (14,832,739)
Interest (income) expense, net	23,816	52,271	62,605	88,060
Income tax expense	-	-	-	-
Depreciation and amortization	92,321	103,719	187,800	205,820
Amortization of intangibles	-	455,826	-	912,902
EBITDA from continuing operations	\$ 550,527	\$ (12,963,406)	\$ 394,643	\$ (13,625,957)

EBITDA from continuing operations increased \$13.6 million to \$0.6 million in the three months ended June 30, 2010 from (\$13.0) million for the three months ended June 30, 2009. The increase was primarily driven by increased contracted profit and curtailment of selling, general and administrative expenses, and no impairment loss on goodwill and other intangibles was recorded for the three months ended June 30, 2010. Please refer to the preceding discussion within this “—Results of Operations” section.

EBITDA from continuing operations increased \$14.0 million to \$0.4 million in the six months ended June 30, 2010 from (\$13.6) million for the six months ended June 30, 2009. The increase was primarily driven by increased contracted profit and curtailment of selling, general and administrative expenses, and no impairment loss on goodwill and other intangibles was recorded for the six months ended June 30, 2010. Please refer to the preceding discussion within this “—Results of Operations” section.

EBITDA from continuing operations is a supplemental financial measure not defined in GAAP. We define EBITDA from continuing operations as net income from continuing operations before interest expense, income taxes, depreciation and amortization. We have presented EBITDA from continuing operations because we believe it is an important supplemental measure of operating performance. We believe that the line item on the consolidated statement of operations entitled “net income from continuing operations” is the most directly comparable GAAP financial measure to EBITDA from continuing operations. Since EBITDA from continuing operations is not a measure of performance calculated in accordance with GAAP, it should not be considered in isolation of, or as a substitute for, net income from continuing operations as an indicator of operating performance or any other GAAP financial measure. EBITDA from continuing operations, as calculated by us, may not be comparable to similarly titled measures employed by other companies. In addition, this measure does not necessarily represent funds available for discretionary use and is not necessarily a measure of our ability to fund our cash needs. As EBITDA from continuing operations excludes certain financial information that is included in net income attributable to the Company, users of this financial information should consider the type of events and transactions that are excluded. Our non-GAAP performance measure, EBITDA from continuing operations, has certain material limitations as follows:

It does not include interest expense. Because we have borrowed money to finance some of our operations, interest is a necessary and ongoing part of our costs and has assisted us in generating revenue. Therefore, any measure that excludes interest expense has material limitations;

It does not include taxes. Because the payment of taxes is a necessary and ongoing part of our operations, any measure that excludes taxes has material limitations; and

It does not include depreciation and amortization. Because we must utilize property, plant and equipment and intangible assets in order to generate revenues in our operations, depreciation and amortization are necessary and ongoing costs of our operations. Therefore, any measure that excludes depreciation and amortization has material limitations.



## Financial Condition, Liquidity and Capital Resources

For the Six Months Ended June  
30,

	2010	2009	Change
Net income (loss)	\$ 144,238	\$ (17,784,278)	\$ 17,928,516
Adjustments to reconcile net income (loss) to net cash provided by (used in) operations:			
Amortization of intangibles	-	1,382,960	(1,382,960)
Impairment loss on goodwill and other intangibles	-	13,062,140	(13,062,140)
Stock and warrant-based compensation	355,344	946,740	(591,396)
Provision for doubtful accounts	-	1,025,000	(1,025,000)
Extinguishment of contract liabilities	-	(269,217)	269,217
Other non-cash items, net	151,316	211,394	(60,078)
Net adjustments to reconcile net income for non-cash items	506,660	16,359,017	(15,852,357)
Net change in working capital	6,743,170	(2,907,651)	9,650,821
Cash provided by (used in) operations	7,394,068	(4,332,912)	11,726,980
Cash provided by (used in) investing	45,463	(1,148,084)	1,193,547
Cash used in financing	(157,414)	(1,699,931)	1,542,517
Net increase (decrease) in cash	\$ 7,282,117	\$ (7,180,927)	\$ 14,463,044

Cash and cash equivalents increased \$7.3 million to \$9.5 million at June 30, 2010 from \$2.3 million at December 31, 2009. The increase was primarily attributable to \$7.4 million provided by operating activities, offset by \$0.2 million used in repayment of notes payable.

## Operating Activity

Net cash provided by operating activities increased \$11.7 million to \$7.4 million for the six months ended June 30, 2010 from \$4.3 million used in operating activities for the six months ended June 30, 2009. The increase in operating cash flow was primarily attributable to \$9.7 million of cash generated from working capital. The cash generated from working capital was attributable primarily to an increase in billings in excess of costs and estimated earnings on uncompleted contracts as we billed ahead on projects during the six months ended June 30, 2010. For the six months ended June 30, 2010, cash generated from operations was \$7.4 million, which was primarily driven by a \$6.7 million decrease in working capital.

## Investing Activity

Net cash provided by investing activities increased \$1.2 million to \$0.05 million for the six months ended June 30, 2010 from \$1.1 million used in investing activities for the six months ended June 30, 2009. For the six months ended June 30, 2009, there were approximately \$1.1 million of acquisition related earn out payments and there were no such payments for the six months ended June 30, 2010.

## Financing Activity

Net cash used in financing decreased \$1.5 million to \$0.2 million for the six months ended June 30, 2010 from \$1.7 million for the six months ended June 30, 2009. For the six months ended June 30, 2010, financing activities consisted primarily of treasury stock repurchases associated with payment of taxes on the vesting of restricted stock held by employees as compared to \$1.7 million of scheduled seller note repayments during the six months ended June 30, 2009.

Non-Cash Financing Activity

On February 28, 2010, we entered into an agreement with our Chief Operating Officer (COO) to convert \$1.3 million of the outstanding note balance into equity at a conversion price of \$2.00 per share, resulting in the aggregate issuance of 625,000 shares of our common stock. The amount of the excess of the conversion price of \$2.00 over the market price at \$0.56 on the date of conversion totaling \$0.9 million has been recorded as additional paid-in capital. The terms on the remaining principal balance of \$2.8 million were amended reducing the interest rate under the note to 4%, providing for the payment of certain amounts of accrued interest over time, providing for interest-only payments under the note until April 1, 2012, providing for eight principal payments in the amount of \$125,000 each beginning on April 1, 2012, and providing for a final payment of all remaining amounts of principal and interest due under the note on April 1, 2014. The note amendment also provides for the acceleration of all amounts due under the note upon a change of control of the Company or the death of the COO. Based on the amended principal repayment terms, the \$4.0 million note was classified as long-term at December 31, 2009.

During the six months ended June 30, 2009, in connection with the purchase of Rubicon, we issued to the sellers \$0.6 million of unsecured promissory notes bearing interest at 6% per annum and repayable over a one-year term. The notes were issued in association with the achievement of certain profit targets, as defined in the purchase agreement, for the year ended December 31, 2008.

## Liquidity and Capital Resources

We had \$9.5 million and \$2.3 million of unrestricted cash and cash equivalents at June 30, 2010 and December 31, 2009, respectively. During the six months ended June 30, 2010, we have financed our operations primarily with operating cash flows driven by a decrease in working capital and cash on hand.

Based on an unexpected lack of closed contracts and continued customer delays during 2009, we revised our financial forecast and implemented selling, general and administrative cost cutting measures with an approximate annual savings of \$2.2 million. In an effort to attempt to achieve positive cash flows from operations and align costs with forecasted revenues in the future, the Company voluntarily delisted from the NASDAQ Capital Market in March 2010 to reduce professional fees and other costs necessary to maintain a listing on the NASDAQ Capital Market.

Due to the downturn in the economy, which had an adverse impact on our existing customers, our own financial security and stock value, we suspended our strategy of growth through acquisitions in 2009. Our corporate focus became centered on preserving cash, achieving positive cash flow and discontinuing or selling operations that threatened that focus. We engaged an investment bank to assist us in evaluating various disposition and financial alternatives, which culminated in the sale of the Rubicon division to its management and former owners on December 29, 2009.

We further sought to restructure scheduled debt repayments with our creditors. In addition to the added liquidity from the proceeds of the sale of Rubicon, we eliminated scheduled debt repayments through debt forgiveness of approximately \$0.6 million owed to the former sellers. On February 28, 2010, we improved our net worth through the principal conversion of \$1.3 million of principal due on a seller note to our COO. Furthermore, the principal repayment of the remaining \$2.7 million was amended to begin in the second quarter of 2012. As a result of note restructuring, at December 31, 2009 short term debt obligations were reduced \$2.3 million and in turn our short-term liquidity substantially improved.

During the three months ended June 30, 2010, our operating results have improved as we generated \$0.4 million in net income. Additionally, we have seen some improvement in our operating environment and as a result have returned our employees to their original salaries in an effort to retain them. We will continue to closely monitor our bookings and anticipated revenues, and we may take future actions to reduce operating costs associated with personnel and related costs in an effort to remain profitable.

As a result of the overall cost reduction efforts to realign operations with decreased anticipated revenues, the added liquidity from the sale of Rubicon, and the financial restructuring of the \$4.0 million note to our COO, we believe that our current cash and cash equivalents and expected future cash generated from operations will satisfy our expected working capital, capital expenditure and investment requirements through the next twelve months. If we experience an increase in revenue, we will attempt to maximize a fixed operating structure and attempt to take a measured approach in any increase to selling, general and administrative costs to support that additional revenue. We may elect to secure additional capital in the future, at acceptable terms, to improve our liquidity or fund acquisitions. The amounts involved in any such transaction, individually or in the aggregate, may be material. To the extent that we raise additional capital through the sale of equity securities, the issuance of such securities could result in dilution to our existing stockholders. If we raise additional funds through the issuance of debt securities, the terms of such debt could impose additional restrictions on our operations. Although we believe that our current cash and cash equivalents and expected future cash generated from operations will satisfy our expected working capital, capital expenditure and investment requirements through the next twelve months, failure to obtain additional financing, if necessary, could have a material adverse impact our business, financial condition and earnings.

## Off Balance Sheet Arrangements

As of June 30, 2010, we do not have any off balance sheet arrangements.

Item 3. Quantitative and Qualitative Disclosures about Market Risk.

The information called for by this item is not required as we are a smaller reporting company.

Item 4. Controls and Procedures.

Our management performed an evaluation under the supervision and with the participation of our Chief Executive Officer (principal executive officer) and our Chief Financial Officer (principal financial officer) of the effectiveness of our disclosure controls and procedures (as defined in Rule 13a-15(e) or 15d-15(e) of the Securities Exchange Act of 1934, as amended) as of June 30, 2010. Based upon that evaluation, our Chief Executive Officer and Chief Financial Officer have concluded that as of June 30, 2010, our disclosure controls and procedures were ineffective.

### Changes in Internal Control over Financial Reporting

During the three months ended June 30, 2010, the Company developed a remediation plan with the objective of remediating material weaknesses previously disclosed at December 31, 2009. The Company is finalizing formal documentation of policies and procedures and has begun to automate various controls related to revenue recognition.

## PART II - OTHER INFORMATION

### Item 1. Legal Proceedings.

We are not a party to any material litigation in any court, and management is not aware of any contemplated proceeding by any governmental authority against us. From time to time, we are involved in various legal matters and proceedings concerning matters arising in the ordinary course of business. We currently believe that any ultimate liability arising out of these matters and proceedings will not have a material adverse effect on our financial position, results of operations or cash flows.

### Item 1A. Risk Factors.

In addition to the other information set forth in this Form 10-Q, you should carefully consider the factors discussed in Part I, "Item 1A: Risk Factors" in our Annual Report on Form 10-K for the year ended December 31, 2009, which could materially affect our business, financial condition or future results. The risks described in our Annual Report on Form 10-K are not the only risks that we face. Additional risks and uncertainties not currently known to us or that we currently deem to be immaterial also may materially adversely affect our business, financial condition and/or operating results.

## SPECIAL NOTE REGARDING FORWARD-LOOKING STATEMENTS

This Quarterly Report on Form 10-Q and, in particular, our Management's Discussion and Analysis of Financial Condition and Results of Operations set forth in Part I—Item 2 contain or incorporate a number of forward-looking statements. These forward-looking statements can be identified by the use of forward-looking terminology, including the words "believes," "anticipates," "plans," "expects" and similar expressions that are intended to identify forward-looking statements. You should read such statements carefully because they discuss our future expectations, contain projections of our future results of operations or of our financial position, or state other forward-looking information. There are a number of factors that could cause actual events or results to differ materially from those indicated by such forward-looking statements, many of which are beyond our control, including the factors set forth under "Item 1A. Risk Factors" of our 2009 Annual Report on Form 10-K

Any or all of our forward-looking statements in this Quarterly Report on Form 10-Q may turn out to be wrong. They can be affected by inaccurate assumptions we might make or by known or unknown risks and uncertainties. Many factors mentioned in our discussion in this Quarterly Report on Form 10-Q will be important in determining future results. Consequently, no forward-looking statement can be guaranteed. Actual future results may vary materially. In addition, the forward-looking statements contained herein represent our estimate only as of the date of this filing and should not be relied upon as representing our estimate as of any subsequent date. While we may elect to update these forward-looking statements at some point in the future, we specifically disclaim any obligation to do so to reflect actual results, changes in assumptions or changes in other factors affecting such forward-looking statements.

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

Total Shares    Approximate Dollar

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Monthly Period During the Three Months Ended June 30, 2010	Total Shares Purchased (a)	Average Price Paid per Share	Purchased as Part of Publicly Announced Plans	Amount of Shares Yet To Be Purchased Under Plans
April 1, 2010-April 30, 2010		\$ -	-	-
May 1, 2010- May 31, 2010	5,092	1.83	-	-
June 1, 2010-June 30, 2010	-	-	-	-
Total	5,092	\$ 1.83	-	-

(a) All of these shares were acquired from associates to satisfy tax withholding requirements upon the vesting of restricted stock.

Item 3. Defaults upon Senior Securities.

Not applicable.

Item 4. (Removed and Reserved).

Item 5. Other Information.

Not applicable.

Item 6. Exhibits.

- 10.1 Fortress America Acquisition Corporation 2006 Omnibus Incentive Compensation Plan (previously filed with the Commission as Annex A to the Proxy Statement for the 2010 Annual Meeting of Stockholders filed on April 30, 2010, and incorporated herein by reference).
- 31.1\* Certification of Fortress International Group, Inc. Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 31.2\* Certification of Fortress International Group, Inc. Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 32.1‡ Certification of Fortress International Group, Inc. Chief Executive Officer and Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

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\* Filed herewith.

‡ Furnished herewith.





Provisions for loan losses. The allowance is maintained at a level sufficient to provide for estimated probable losses in the loan portfolio at each reporting date. At least quarterly, management performs an analysis to identify the inherent risk of loss in the Company's loan portfolio. This analysis includes a qualitative evaluation of concentrations of credit, past loss experience, current economic conditions, amount and composition of the loan portfolio (including loans being specifically monitored by management), estimated fair value of underlying collateral, delinquencies, and other factors.

Our methodology for assessing the adequacy of the allowance establishes both specific and general pooled allocations of the allowance. To determine the adequacy of the allowance and the need for potential changes to the allowance, we conduct a formal analysis quarterly to assess the risk within the loan portfolio. This assessment includes analyses of historical performance, past due trends, the level of nonperforming loans, reviews of certain impaired loans, loan activity since the last quarter, consideration of current economic conditions, and other pertinent information. Loans are assigned ratings, either individually for larger credits or in homogeneous pools, based on an internally developed grading system. The resulting conclusions are reviewed and approved by senior management.

The Company established a provision for loan losses of \$135,000 for the quarter ended December 31, 2009, compared to \$313,000 for the comparable quarter in 2008. The larger provision for the 2008 period primarily related to a 40-unit condominium project, in which another bank acted as the lead lender, that had experienced payment delinquencies and the estimated net realizable value of the collateral was less than the loan balance. The loan was subsequently transferred to real estate owned during the second fiscal quarter of 2009. At December 31, 2009, the Company's non-performing assets totaled \$6.8 million or 1.3% of total assets. The non-performing assets consisted of one construction loan totaling \$640,000, three commercial real estate loans totaling \$790,000, 11 one-to four-family residential mortgage loans totaling \$1.4 million and four real estate owned properties totaling \$4.1 million. The allowance for loan losses totaled \$2.9 million, or 1.1% of total loans and 103.4% of non-performing loans at December 31, 2009.

Non-interest income (loss). Non-interest income amounted to \$19,000 for the three months ended December 31, 2009, compared with a loss of \$2.0 million for the same period in 2008. The loss experienced in the 2008 period was due to OTTI charges arising from the Company's investment in a mutual fund and the subsequent redemption in kind of such investment. The decline in the amount of losses recognized between the 2008 and 2009 periods reflected the decline in the amount of the OTTI charges from \$2.2 million for the three months ended December 31, 2008 to \$204,000 during the three months ended December 31, 2009 related to the non-agency mortgage-backed securities acquired as part of the June 2008 redemption in kind of the investment in the mutual fund.

Non-interest expenses. For the quarter ended December 31, 2009, non-interest expense increased \$99,000 compared to the same period in 2008. The increase for the three month period was primarily due to expenses of \$154,000 related to stock benefit plans which were not incurred in the 2008 period and pension contributions of \$66,000 in excess of the amount recognized in the comparable period in 2008. These increases were partially offset by a decrease of \$75,000 in professional services expenses in December 31, 2009 from the comparable period in 2008.

Income tax expense. The Company recognized income tax expense for the quarter ended December 31, 2009 of \$622,000 compared to income tax expense of \$44,000 for the three months ended December 31, 2008. The increase in income tax expense was primarily attributable to the recognition of income before taxes during the three months ended December 31, 2009 as compared to a loss before taxes in the comparable period in 2008. Also contributing to the increase was a \$108,000 increase in the valuation allowance for a deferred tax asset related to a capital loss carryforward.

## LIQUIDITY AND CAPITAL RESOURCES

The Company's liquidity, represented by cash and cash equivalents, is a product of its operating, investing and financing activities. Our primary sources of funds are from deposits, scheduled principal and interest payments on loans, loan prepayments and the maturity of loans, mortgage-backed securities and other investments, and other funds provided from operations. While scheduled payments from the amortization of loans and mortgage-backed securities and maturing investment securities are relatively predictable sources of funds, deposit flows and loan and securities prepayments can be greatly influenced by market rates of interest, economic conditions and competition. We also maintain excess funds in short-term, interest-bearing assets that provide additional liquidity. At December 31, 2009, our cash and cash equivalents amounted to \$11.9 million. In addition, our available for sale investment and mortgage-backed securities amounted to an aggregate of \$65.1 million at such date.

We use our liquidity to fund existing and future loan commitments, to fund maturing certificates of deposit and demand deposit withdrawals, to invest in other interest-earning assets, and to meet operating expenses. At December 31, 2009, the Company had \$10.6 million in outstanding commitments to originate fixed and variable-rate loans, not including loans in process. The Company also had commitments under unused lines of credit of \$7.2 million and letters of credit outstanding of \$621,000 at December 31, 2009. Certificates of deposit at December 31, 2009 maturing in one year or less totaled \$151.2 million. Based upon historical experience, we anticipate that a significant portion of the maturing certificates of deposit will be redeposited with us.

In addition to cash flows from loan and securities payments and prepayments as well as from sales of available for sale securities, we have significant borrowing capacity available to fund liquidity needs should the need arise. Our borrowings consist solely of advances from the Federal Home Loan Bank of Pittsburgh, of which we are a member. Under terms of the collateral agreement with the Federal Home Loan Bank, we pledge residential mortgage loans and mortgage-backed securities as well as our stock in the Federal Home Loan Bank as collateral for such advances. However, use of FHLB advances has been modest. At December 31, 2009, we had \$23.6 million in outstanding FHLB advances and had the ability to obtain an additional \$132.4 million in FHLB advances.

We anticipate that we will continue to have sufficient funds and alternative funding sources to meet our current commitments.

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The following table summarizes the Company's and Bank's regulatory capital ratios as of December 31, 2009 and September 30, 2009 and compares them to current regulatory guidelines.

	Actual Ratio	Required for Capital Adequacy Purposes	To Be Well Capitalized Under Prompt Corrective Action Provisions
December 31, 2009:			
Tier 1 capital (to average assets)			
The Company	11.14%	4.0%	N/A
The Bank	10.15%	4.0%	5.0%
Tier 1 capital (to risk weighted assets)			
The Company	24.68%	4.0%	N/A
The Bank	22.49%	4.0%	6.0%
Total capital (to risk weighted assets)			
The Company	25.93%	8.0%	N/A
The Bank	23.74%	8.0%	10.0%
September 30, 2009:			
Tier 1 capital (to average assets)			
The Company	10.86%	4.0%	N/A
The Bank	9.99%	4.0%	5.0%
Tier 1 capital (to risk weighted assets)			
The Company	24.59%	4.0%	N/A
The Bank	22.61%	4.0%	6.0%
Total capital (to risk weighted assets)			
The Company	25.79%	8.0%	N/A
The Bank	23.81%	8.0%	10.0%

#### IMPACT OF INFLATION AND CHANGING PRICES

The financial statements, accompanying notes, and related financial data of the Company presented herein have been prepared in accordance with generally accepted accounting principles which require the measurement of financial position and operating results in terms of historical dollars, without considering changes in the relative purchasing power of money over time due to inflation.

Unlike most industrial companies, substantially all of the assets and liabilities of a financial institution are monetary in nature. As a result, interest rates have a more significant impact on a financial institution's performance than the effects of general levels of inflation. Interest rates do not necessarily move in the same direction or in the same magnitude as

the price of goods and services, since such prices are affected by inflation to a larger extent than interest rates. In the current interest rate environment, liquidity and the maturity structure of the Company's assets and liabilities are critical to the maintenance of acceptable performance levels.

**How We Manage Market Risk.** Market risk is the risk of loss from adverse changes in market prices and rates. Our market risk arises primarily from the interest rate risk which is inherent in our lending, investment and deposit gathering activities. To that end, management actively monitors and manages interest rate risk exposure. In addition to market risk, our primary risk is credit risk on our loan portfolio. We attempt to manage credit risk through our loan underwriting and oversight policies.

The principal objective of our interest rate risk management function is to evaluate the interest rate risk embedded in certain balance sheet accounts, determine the level of risk appropriate given our business strategy, operating environment, capital and liquidity requirements and performance objectives, and manage the risk consistent with approved guidelines. We seek to manage our exposure to risks from changes in interest rates while at the same time trying to improve our net interest spread. We monitor interest rate risk as such risk relates to our operating strategies. We have established an Asset/Liability Committee which is comprised of our President and Chief Executive Officer, Chief Financial Officer, Chief Lending Officer, Treasurer and Controller. The Asset/Liability Committee meets on a regular basis and is responsible for reviewing our asset/liability policies and interest rate risk position. Both the extent and direction of shifts in interest rates are uncertainties that could have a negative impact on future earnings.

In recent years, we primarily have reduced our exposure in callable agency bonds and increased our portfolio of agency issued mortgage-backed securities. However, notwithstanding the foregoing steps, we remain subject to a significant level of interest rate risk in a low interest rate environment due to the high proportion of our loan portfolio that consists of fixed-rate loans as well as our decision to invest a significant amount of our assets in long-term, fixed-rate investment and mortgage-backed securities.

**Gap Analysis.** The matching of assets and liabilities may be analyzed by examining the extent to which such assets and liabilities are “interest rate sensitive” and by monitoring a Company’s interest rate sensitivity “gap.” An asset or liability is said to be interest rate sensitive within a specific time period if it will mature or reprice within that time period. The interest rate sensitivity gap is defined as the difference between the amount of interest-earning assets maturing or repricing within a specific time period and the amount of interest-bearing liabilities maturing or repricing within that same time period. A gap is considered positive when the amount of interest rate sensitive assets exceeds the amount of interest rate sensitive liabilities. A gap is considered negative when the amount of interest rate sensitive liabilities exceeds the amount of interest rate sensitive assets. During a period of rising interest rates, a negative gap would tend to affect adversely net interest income while a positive gap would tend to result in an increase in net interest income. Conversely, during a period of falling interest rates, a negative gap would tend to result in an increase in net interest income while a positive gap would tend to affect adversely net interest income.

The following table sets forth the amounts of our interest-earning assets and interest-bearing liabilities outstanding at December 31, 2009, which we expect, based upon certain assumptions, to reprice or mature in each of the future time periods shown (the “GAP Table”). Except as stated below, the amounts of assets and liabilities shown which reprice or mature during a particular period were determined in accordance with the earlier of term to repricing or the contractual maturity of the asset or liability. The table sets forth an approximation of the projected repricing of assets and liabilities at December 31, 2009, on the basis of contractual maturities, anticipated prepayments, and scheduled rate adjustments within a three-month period and subsequent selected time intervals. The loan amounts in the table reflect principal balances expected to be redeployed and/or repriced as a result of contractual amortization and anticipated prepayments of adjustable-rate loans and fixed-rate loans, and as a result of contractual rate adjustments on adjustable-rate loans. Annual prepayment rates for adjustable-rate and fixed-rate single-family and multi-family residential and commercial mortgage loans are assumed to range from 8.1% to 27.0%. The annual prepayment rate for mortgage-backed securities is assumed to range from 0.5% to 79.5%. Money market deposit accounts, savings accounts and interest-bearing checking accounts are assumed to have annual rates of withdrawal, or “decay rates,” based on information from the FDIC. For savings accounts and checking accounts, the decay rates are 60% in one to three years, 20% in three to five years and 20% in five to 10 years. For money market accounts, the decay rates are 50% in

three to 12 months and 50% in 13 to 36 months.

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	3 Months or Less	More than 3 Months to 1 Year	More than 1 Year to 3 Years	More than 3 Years to 5 Years	More than 5 Years	Total Amount
(Dollars in Thousands)						
Interest-earning assets(1):						
Investment and mortgage-backed securities(2)	\$ 11,077	\$ 20,607	\$ 22,936	\$ 14,301	\$ 145,494	\$ 214,415
Loans receivable(3)	30,931	59,365	81,994	42,964	42,974	258,228
Other interest-earning assets(4)	8,661					8,661
Total interest-earning assets	\$ 50,669	\$ 79,972	\$ 104,930	\$ 57,265	\$ 188,468	\$ 481,304
Interest-bearing liabilities:						
Savings accounts	\$ 133	\$ 145	\$ 41,661	\$ 13,887	\$ 13,887	\$ 69,713
Money market deposit and NOW accounts		39,508	56,758	5,750	5,750	107,766
Certificates of deposit	60,076	91,078	66,772	23,454		241,380
Advances from Federal Home Loan Bank	10,028	13,085	195		340	23,648
Advances from borrowers for taxes and insurance	1,810	-	-	-	-	1,810
Total interest-bearing liabilities	\$ 72,047	\$ 143,816	\$ 165,386	\$ 43,091	\$ 19,977	\$ 444,317
Interest-earning assets less interest-bearing liabilities	(\$ 21,378)	(\$ 63,844)	(\$ 60,456)	\$ 14,174	\$ 168,491	\$ 36,987
Cumulative interest-rate sensitivity gap (5)	(\$ 21,378)	(\$ 85,222)	(\$ 145,678)	(\$ 131,504)	\$ 36,987	
Cumulative interest-rate gap as a percentage of total assets at December 31, 2009	-4.15%	-16.56%	-28.30%	-25.55%	7.19%	
Cumulative interest-earning assets as a percentage of cumulative interest-bearing	70.33%	60.52%	61.79%	69.01%	108.32%	

liabilities at December  
31, 2009

- (1) Interest-earning assets are included in the period in which the balances are expected to be redeployed and/or repriced as a result of anticipated prepayments, scheduled rate adjustments and contractual maturities.
- (2) For purposes of the gap analysis, investment securities are stated at amortized cost.
- (3) For purposes of the gap analysis, loans receivable includes non-performing loans and is gross of the allowance for loan losses and unamortized deferred loan fees, but net of the undisbursed portion of loans-in-process.
- (4) Includes FHLB stock.
- (5) Cumulative interest-rate sensitivity gap represents the difference between interest-earning assets and interest-bearing liabilities.

Certain shortcomings are inherent in the method of analysis presented in the foregoing table. For example, although certain assets and liabilities may have similar maturities or periods to repricing, they may react in different degrees to changes in market interest rates. Also, the interest rates on certain types of assets and liabilities may fluctuate in advance of changes in market interest rates, while interest rates on other types may lag behind changes in market rates. Additionally, certain assets, such as adjustable-rate loans, have features which restrict changes in interest rates both on a short-term basis and over the life of the asset. Further, in the event of a change in interest rates, prepayment and early withdrawal levels would likely deviate significantly from those assumed in calculating the table. Finally, the ability of many borrowers to service their adjustable-rate loans may be adversely affected in the event of an interest rate increase.



Net Portfolio Value Analysis. Our interest rate sensitivity also is monitored by management through the use of a model which generates estimates of the changes in our net portfolio value (“NPV”) over a range of interest rate scenarios. NPV is the present value of expected cash flows from assets, liabilities and off-balance sheet contracts. The NPV ratio, under any interest rate scenario, is defined as the NPV in that scenario divided by the market value of assets in the same scenario. The “Sensitivity Measure” is the decline in the NPV ratio, in basis points, caused by a 2% increase or decrease in rates, whichever produces a larger decline. The following table sets forth our NPV as of December 31, 2009 and reflects the changes to NPV as a result of immediate and sustained changes in interest rates as indicated.

Change in Interest Rates In Basis Points (Rate Shock)	Net Portfolio Value			NPV as % of Portfolio Value of Assets	
	Amount	\$ Change	% Change	NPV Ratio	Change
(Dollars in Thousands)					
300	\$ 10,840	\$ (50,619)	(82.36)%	2.45%	(9.58)%
200	25,995	(35,464)	(57.70)%	5.61%	(6.42)%
100	43,698	(17,761)	(28.90)%	8.97%	(3.06)%
Static	61,459	-	-	12.03%	-
(100)	68,945	7,486	12.18%	13.14%	1.11%
(200)	69,656	8,197	13.34%	13.15%	1.12%
(300)	72,603	11,144	18.13%	13.59%	1.56%

At December 31, 2009, the Company’s NPV was \$61.5 million or 12.03% of the market value of assets. Following a 200 basis point increase in interest rates, the Company’s “post shock” NPV would be \$26.0 million or 5.61% of the market value of assets. The change in the NPV ratio or Company’s sensitivity measure was a decline of 642 basis points.

At September 30, 2009, the Company’s NPV was \$62.1 million or 11.90% of the market value of assets. Following a 200 basis point increase in interest rates, the Company’s “post shock” NPV would be \$27.2 million or 5.72% of the market value of assets. The change in the NPV ratio or Company’s sensitivity measure was a decline of 618 basis points.

As is the case with the GAP Table, certain shortcomings are inherent in the methodology used in the above interest rate risk measurements. Modeling changes in NPV requires the making of certain assumptions which may or may not reflect the manner in which actual yields and costs respond to changes in market interest rates. In this regard, the models presented assume that the composition of our interest sensitive assets and liabilities existing at the beginning of a period remains constant over the period being measured and also assumes that a particular change in interest rates is reflected uniformly across the yield curve regardless of the duration to maturity or repricing of specific assets and liabilities. Accordingly, although the NPV model provides an indication of interest rate risk exposure at a particular point in time, such model is not intended to and does not provide a precise forecast of the effect of changes in market interest rates on net interest income and will differ from actual results.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Not applicable.

ITEM 4T. CONTROLS AND PROCEDURES

Our management evaluated, with the participation of our Chief Executive Officer and Chief Financial Officer, the effectiveness of our disclosure controls and procedures (as defined in Rule 13a-15(e) or 15d-15(e) under the Securities Exchange Act of 1934) as of the end of the period covered by this report. Based on such evaluation, our Chief Executive Officer and Chief Financial Officer have concluded that our disclosure controls and procedures are designed to ensure that information required to be disclosed by us in the reports that we file or submit under the Securities Exchange Act of 1934 is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and regulations and are operating in an effective manner.

No change in our internal control over financial reporting (as defined in Rule 13a-15(f) or 15d-15(f) under the Securities Exchange Act of 1934) occurred during the most recent fiscal quarter that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

## PART II

## Item 1. Legal Proceedings

No material changes in the matters previously disclosed in Item 3 of the Company's Annual Report on Form 10-K for the year ended September 30, 2009 has occurred.

The Company is involved in various legal proceedings occurring in the ordinary course of business. Management of the Company, based on discussions with litigation counsel, does not believe that such proceedings will have a material adverse effect on the financial condition or operations of the Company. There can be no assurance that any of the outstanding legal proceedings to which the Company is a party will not be decided adversely to the Company's interests and have a material adverse effect on the financial condition and operations of the Company.

## Item 1A. Risk Factors

Not applicable

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

(a) Not applicable

(b) Not applicable

(c) There were no repurchases of common stock by the Company during the quarter ended December 31, 2009.

The MHC's purchases of the Company's common stock made during the quarter are set forth in the following table:

Period	Total Number of Shares Purchased as Part of	Average Price Paid per Share	Publicly Announced Plans or Programs	Maximum Number of Shares that May Yet be Purchased Under the Plan or Programs
October 1 – October 31, 2009	8,500	\$ 10.12	8,500	64,648
November 1 – November 30, 2009	6,400	10.02	6,400	58,248
December 1 - December 31, 2009	17,048	9.83	17,048	41,200
Total	31,948	\$ 9.94	31,948	41,200

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Notes to the table:

- (1) On January 21, 2009, the MHC announced its second stock purchase plan (“Second Plan”) to purchase up to 198,000 shares of the Company’s common stock, or approximately 5% of the Company’s common stock held by shareholders other than the MHC.
- (2) The Second Plan was completed on December 2, 2009.
- (3) The MHC announced on December 16, 2009 that its Board of Directors approved its third stock purchase plan to purchase up to 50,000 shares of the Company’s common stock

Item 3. Defaults Upon Senior Securities

Not applicable

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

Not applicable

Item 5. Other Information

Not applicable

Item 6. Exhibits

Exhibit No.	Description
31.1	Rule 13a-14(a)/15d-14(a) Certification of Chief Executive Officer
31.2	Rule 13a-14(a)/15d-14(a) Certification of Chief Financial Officer
32.0	Section 1350 Certifications

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SIGNATURES

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

PRUDENTIAL BANCORP, INC. OF PENNSYLVANIA

Date: February 16, 2010

By: /s/ Thomas A.  
Vento  
Thomas A. Vento  
President and Chief Executive Officer

Date: February 16, 2010

By: /s/ Joseph R.  
Corrato  
Joseph R. Corrato  
Executive Vice President and Chief  
Financial Officer