

Fortress International Group, Inc.
Form 10-Q
November 14, 2008

**UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, DC 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 September 30, 2008

or

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

For the transition period from _____ to _____

Commission file number: 000-51426

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 203
Columbia, MD 21046**

(Address of principal executive offices)

21046

(Zip Code)

(410) 423-7438

(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 Exchange Act 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 the registrant is a large accelerated filer, an accelerated filer, or 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.

Edgar Filing: Fortress International Group, Inc. - Form 10-Q

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 October 31, 2008 | 12,557,669 |
|---|-------------------|

FORTRESS INTERNATIONAL GROUP, INC.
Table of Contents

| | Page |
|---|-------------|
| PART I - FINANCIAL INFORMATION | |
| Item 1. Financial Statements | |
| Consolidated Balance Sheets as of September 30, 2008 (unaudited) and as of December 31, 2007 | 1 |
| Consolidated Statements of Operations (unaudited) for the three and nine months ended September 30, 2008 and September 30, 2007 (successor) and for the period from January 1, 2007 to January 19, 2007 (predecessor) | 2 |
| Consolidated Statements of Cash Flows (unaudited) for the nine months ended September 30, 2008 and September 30, 2007 (successor) and for the period from January 1, 2007 to January 19, 2007 (predecessor) | 3 |
| Notes to Consolidated Financial Statements | 4 |
| Item 2. Management’s Discussion and Analysis of Financial Condition and Results of Operations | 14 |
| Item 3. Quantitative and Qualitative Disclosures about Market Risk | 22 |
| Item 4T. Controls and Procedures | 22 |
| PART II - OTHER INFORMATION | |
| Item 1. Legal Proceedings | 22 |
| Item 1A. Risk Factors | 22 |
| Item 2. Unregistered Sales of Equity Securities and Use of Proceeds | 22 |
| Item 3. Defaults upon Senior Securities | 23 |
| Item 4. Submission of Matters to a Vote of Security Holders | 23 |
| Item 5. Other Information | 23 |
| Item 6. Exhibits | 23 |
| SIGNATURES | 24 |

PART I - FINANCIAL INFORMATION**Item 1. Financial Statements**

FORTRESS INTERNATIONAL GROUP, INC.
CONSOLIDATED BALANCE SHEETS

| | September 30, 2008 (unaudited) | December 31, 2007 (audited) |
|--|--------------------------------------|-----------------------------------|
| <i>Current Assets</i> | | |
| Cash and cash equivalents | \$ 6,856,253 | \$ 13,172,210 |
| Contract and other receivables, net | 20,932,470 | 18,349,140 |
| Costs and estimated earnings in excess of billings on uncompleted contracts | 4,721,578 | 1,322,254 |
| Prepaid expenses and other current assets | 499,497 | 301,487 |
| Income taxes receivable | 893,322 | 893,322 |
| Total current assets | 33,903,120 | 34,038,413 |
| Property and equipment, net | 903,669 | 1,044,545 |
| Goodwill | 18,813,509 | 20,714,967 |
| Intangible assets, net | 19,838,552 | 21,089,136 |
| Other assets | 150,973 | 512,000 |
| Total assets | \$ 73,609,823 | \$ 77,399,061 |
| <i>Liabilities and Stockholders' Equity</i> | | |
| <i>Current Liabilities</i> | | |
| Notes payable, current portion | \$ 182,384 | \$ 1,650,306 |
| Accounts payable and accrued expenses | 16,266,264 | 16,121,492 |
| Billings in excess of costs and estimated earnings on uncompleted contracts | 11,145,410 | 3,880,279 |
| Total current liabilities | 27,594,058 | 21,652,077 |
| Notes payable, less current portion | 4,230,013 | 7,848,661 |
| Other liabilities | 59,960 | 44,648 |
| Total liabilities | 31,884,031 | 29,545,386 |
| Commitments and Contingencies | - | - |
| <i>Stockholders' Equity</i> | | |
| 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; 12,730,629 and 12,150,400 issued; 12,557,669 and 11,992,325 outstanding at September 30, 2008 and December 31, 2007, respectively | 1,273 | 1,214 |
| Additional paid-in capital | 60,699,980 | 55,268,012 |
| Treasury stock, 172,960 and 158,075 shares at cost at September 30, 2008 and December 31, 2007, respectively | (861,663) | (814,198) |
| Accumulated deficit | (18,113,798) | (6,601,353) |
| Total stockholders' equity | 41,725,792 | 47,853,675 |
| Total liabilities and stockholders' equity | \$ 73,609,823 | \$ 77,399,061 |

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

FORTRESS INTERNATIONAL GROUP, INC.
CONSOLIDATED STATEMENTS OF OPERATIONS

| | Successor (Fortress International Group, Inc.) | | | | Predecessor (TSS/Vortech) For the period January 1, through January 19, 2007 (audited) |
|--|---|----------------|-----------------------------------|----------------|--|
| | Three Months Ended September 30, 2008 (unaudited) | | September 30, 2007 (unaudited) | | |
| | September 30, 2008 (unaudited) | | September 30, 2007 (unaudited) | | |
| Results of Operations: | | | | | |
| Revenue | \$ 25,781,523 | \$ 12,692,772 | \$ 65,363,481 | \$ 32,232,016 | \$ 1,412,137 |
| Cost of revenue | 20,660,103 | 10,749,331 | 54,719,170 | 27,378,926 | 1,108,276 |
| Gross profit | 5,121,420 | 1,943,441 | 10,644,311 | 4,853,090 | 303,861 |
| Operating expenses: | | | | | |
| Selling, general and administrative | 4,838,291 | 3,964,468 | 15,275,116 | 10,026,448 | 555,103 |
| Depreciation | 125,716 | 137,032 | 355,810 | 289,708 | 33,660 |
| Amortization of intangibles | 702,569 | 567,109 | 2,104,067 | 1,574,671 | - |
| Impairment loss on goodwill | 2,973,000 | - | 4,190,000 | - | - |
| Total operating costs | 8,639,576 | 4,668,609 | 21,924,993 | 11,890,827 | 588,763 |
| Operating loss | (3,518,156) | (2,725,168) | (11,280,682) | (7,037,737) | (284,902) |
| Interest income (expense), net | (49,653) | 104,116 | (194,661) | 476,388 | 3,749 |
| Loss from operations before income taxes | (3,567,809) | (2,621,052) | (11,475,343) | (6,561,349) | (281,153) |
| Income tax expense (benefit) | (349,898) | - | 37,102 | (349,325) | - |
| Net loss | \$ (3,217,911) | \$ (2,621,052) | \$ (11,512,445) | \$ (6,212,024) | \$ (281,153) |
| Per Common Share (Basic and Diluted): | | | | | |
| Basic and diluted net loss | \$ (0.26) | \$ (0.22) | \$ (0.95) | \$ (0.53) | \$ - |
| Weighted average common shares outstanding-basic and diluted | 12,326,397 | 11,715,512 | 12,164,454 | 11,743,186 | - |

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

FORTRESS INTERNATIONAL GROUP, INC.
CONSOLIDATED STATEMENTS OF CASH FLOWS

| | Successor (Fortress International Group, Inc.) | | Predecessor (TSS/Vortech) |
|---|--|--------------------|---|
| | Nine Months Ended | | For the period January 1, through January 19, 2007 |
| | September 30, 2008 | September 30, 2007 | September 30, 2007 |
| Cash Flows from Operating Activities: | | | |
| Net loss | \$ (11,512,445) | \$ (6,212,024) | \$ (281,153) |
| Adjustments to reconcile net loss to net cash provided by (used in) operating activities: | | | |
| Depreciation and amortization | 355,810 | 289,708 | 33,660 |
| Amortization of intangibles | 2,491,477 | 1,891,419 | - |
| Impairment loss on goodwill | 4,190,000 | - | - |
| Allowance for doubtful accounts | 119,728 | - | - |
| Stock and warrant-based compensation | 1,469,252 | 999,196 | - |
| Benefit from income taxes | - | 490,675 | - |
| Other non-cash income, net | 15,312 | - | - |
| Changes in operating assets and liabilities, net of the effects from acquisitions: | | | |
| Contracts and other receivables | (2,315,446) | (2,293,228) | 3,698,863 |
| Costs and estimated earnings in excess of billings on uncompleted contracts | (3,399,324) | (2,443,158) | (1,078,505) |
| Prepaid expenses | (197,902) | (294,911) | (108,618) |
| Due from affiliates | - | - | 519,923 |
| Other assets | 256,571 | (1,076,125) | (42,968) |
| Accounts payable and accrued expenses | (124,199) | 3,464,210 | (1,861,306) |
| Billings in excess of costs and estimated earnings on uncompleted contracts | 6,755,014 | 151,894 | 419,676 |
| Other liabilities | - | (586,283) | (643,571) |
| Net cash provided by (used in) operating activities | (1,896,152) | (5,618,627) | 656,001 |
| Cash Flows from Investing Activities: | | | |
| Purchase of property and equipment | (214,935) | (338,547) | (127,602) |
| Sale of investments held in trust | - | 44,673,994 | - |
| Purchase of TSS/Vortech, net of cash acquired | - | (9,677,683) | - |
| Purchase of SMLB, net of cash acquired | (2,094,561) | - | - |
| Purchase of Comm Site of South Florida, Inc, net of cash acquired | - | (135,000) | - |
| Purchase of Innovative Power Solutions | - | (1,502,032) | - |
| Deferred acquisition costs | (21,785) | (1,031,472) | - |
| Net cash provided by (used in) investing activities | (2,331,281) | 31,989,260 | (127,602) |
| Cash Flows from Financing Activities: | | | |
| Payments on notes payable | (84,065) | (51,494) | (6,281) |
| Payments on Rubicon seller notes | (1,956,994) | - | - |
| Payment on promissory note payable to officer | - | (2,000,000) | - |
| Payment on shareholder advance | - | (20,000) | - |

Edgar Filing: Fortress International Group, Inc. - Form 10-Q

| | | | |
|--|--------------|---------------|--------------|
| Payment to shareholders electing to redeem their shares in connection with the TSS/Vortech acquisition | - | (4,340,013) | - |
| Repurchase of treasury stock | (47,465) | (2,036,015) | - |
| Members' distributions | - | - | (1,561,639) |
| Net cash used in financing activities | (2,088,524) | (8,447,522) | (1,567,920) |
| Net increase (decrease) in cash | (6,315,957) | 17,923,111 | (1,039,521) |
| Cash, beginning of period | 13,172,210 | 7,347 | 2,361,838 |
| Cash, end of period | \$ 6,856,253 | \$ 17,930,458 | \$ 1,322,317 |

Supplemental disclosure of cash flow information:

| | | | |
|------------------------|------------|------------|--------|
| Cash paid for interest | \$ 377,196 | \$ 416,417 | \$ 368 |
| Cash paid for taxes | 24,602 | 593,166 | - |

Supplemental disclosure of non-cash investing activities:

| | | | |
|---|---------|------------|---|
| Issuance of common stock in connection with the acquisition of SMLB | 500,000 | - | - |
| Issuance of common stock in connection with the acquisition of TSS/Vortech | - | 14,211,359 | - |
| Issuance of common stock in connection with the acquisition of Innovative | - | 150,000 | - |
| Promissory notes payable issued in connection with the acquisition of SMLB | 15,248 | - | - |
| Promissory notes payable issued in connection with the acquisition of Rubicon | 439,241 | - | - |
| Promissory notes payable issued in connection with the acquisition of TSS/Vortech | - | 10,000,000 | - |
| Promissory notes payable issued in connection with the acquisition of Innovative | - | 300,000 | - |

Supplemental disclosure of non-cash financing activities:

| | | | |
|---|-----------|---------|---|
| Promissory notes payable issued to officers converted to common stock | 3,500,000 | - | - |
| Discount received on note repayment from officer | - | 500,000 | - |

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

FORTRESS INTERNATIONAL GROUP, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(1) Basis of Presentation

The consolidated financial statements are for the three and nine months ended September 30, 2008 and 2007 for Fortress International Group, Inc. (the “Successor Company,” “Fortress” or the “Company”) and are for the period from January 1, 2007 to January 19, 2007 (the “Acquisition Date”) for VTC, L.L.C. t/a Total Site Solutions and Vortech, L.L.C. (collectively the “Predecessor Company” or “TSS/Vortech”). The results of operations attributable to each acquisition are included in the consolidated financial statements from the Acquisition Date.

Except for the balance sheet of the Company as of December 31, 2007 and the results of operations of our Predecessor Company for the period from January 1, 2007 through January 19, 2007, which are derived from audited financial statements, the accompanying consolidated financial statements are unaudited. In the opinion of management, all adjustments necessary for a fair statement of such financial position and results of operations have been included. All such adjustments are of a normal recurring nature. Interim results are not necessarily indicative of results for a full year.

The consolidated financial statements and notes are presented in accordance with instructions to Form 10-Q and Article 10 of Regulation S-X of the Securities and Exchange Commission (“SEC”) and do not contain certain information included in the Company’s annual financial statements and notes. These financial statements should be read in conjunction with the Company’s audited financial statements and the notes thereto filed with the SEC in the Company’s Annual Report on Form 10-K for the year ended December 31, 2007, as amended.

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 installation and facilities management.

The Company was incorporated in Delaware on December 20, 2004 under the name “Fortress America Acquisition Corporation” as a special purpose acquisition company 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 (“IPO”) of 7,800,000 units, including an over-allotment option of 800,000 units, with each unit consisting of one share of our common stock and two warrants (each to purchase one share of common stock at \$5.00). Of the total IPO proceeds of \$43,183,521, net of issuance costs, \$41,964,000 were placed into a trust fund (“Trust”) and the remaining \$1,219,521 were available to fund operations in the pursuit of acquiring a company.

On January 19, 2007, the Company acquired all of the outstanding interest in TSS/Vortech in exchange for a combination of cash, the Company’s common stock, and issuance of two convertible notes (See Note 10). The acquisition fundamentally transformed the Company from a firm primarily investing capital to an operating business. Concurrent with the acquisition, the Company changed its name to Fortress International Group, Inc.

After acquiring TSS/Vortech during 2007, the Company continued its expansion through the acquisitions of Comm Site of South Florida, Inc. (“Comm Site”), Innovative Power Systems, Inc. and Quality Power Systems, Inc. (“Innovative”) and Rubicon Integration, LLC. (“Rubicon”). On January 2, 2008, the Company acquired SMLB, Ltd. to continue its footprint expansion with complementary service offerings. As applicable, the Company also acquired

these companies' operating subsidiaries. The results of operations, cash flows and financial position attributable to these acquisitions are included in the consolidated financial statements from the respective dates of their acquisition (See Note 4). All intercompany transactions have been eliminated in consolidation.

Recently Issued Accounting Pronouncements

In October 2008, the FASB issued FASB Staff Position 157-3, "Determining the Fair Value of a Financial Asset When the Market of that Asset is not Active" ("FSP 157-3"). FSP 157-3 provides an example that clarifies and reiterates certain provisions of the existing fair value standard, including basing fair value on orderly transactions and usage of management and broker inputs. FSP 157-3 is effective immediately but is not expected to have a material impact on our financial position or results of operations.

In May 2008, the Financial Accounting Standards Board ("FASB") issued SFAS No. 163, "Accounting for Financial Guarantee Insurance Contracts" ("SFAS 163"). SFAS 163 requires recognition of a claim liability prior to an event of default when there is evidence that credit deterioration has occurred in an insured financial obligation. SFAS 163 clarifies how FAS 60 applies to financial guarantee insurance contracts, including the recognition and measurement to be used to account for premium revenue and claim liabilities and requires expanded disclosures about financial guarantee insurance contracts. SFAS 163 is effective January 1, 2009. The Company does not expect the adoption of SFAS 163 to have a material effect on its consolidated results of operations and financial condition.

FORTRESS INTERNATIONAL GROUP, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

In May 2008, the FASB issued SFAS No. 162, “The Hierarchy of Generally Accepted Accounting Principles” (“SFAS 162”). SFAS 162 identifies the sources of accounting principles and the framework for selecting the principles used in the preparation of financial statements of nongovernmental entities that are presented in conformity with generally accepted accounting principles (the GAAP hierarchy). SFAS No. 162 will become effective 60 days following the SEC’s approval of the Public Company Accounting Oversight Board amendments to AU Section 411, “The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles.” The Company does not expect the adoption of SFAS 162 to have a material effect on its consolidated results of operations and financial condition.

In April 2008, FASB issued a Staff Position (“FSP”) No. FAS 142-3, “Determination of the Useful Life of Intangible Assets,” (“FSP 142-3”) which amends the factors a company should consider when developing renewal assumptions used to determine the useful life of an intangible asset under SFAS 142. FSP 142-3 replaces the previous useful life criteria with a new requirement—that an entity consider its own historical experience in renewing similar arrangements. In issuing FSP 142-3, the FASB hopes to improve the consistency between the useful life of a recognized intangible asset and the period of expected cash flows used to measure the fair value of the asset. FAS 142-3 is effective January 1, 2009. The Company is currently assessing the potential impact that adoption of FAS 142-3 may have on its financial statements.

In March 2008, the FASB issued Statement of Financial Accounting Standards SFAS No. 161, “Disclosures about Derivative Instruments and Hedging Activities, an amendment of FASB Statement No. 133,” (“SFAS No. 161”) which requires additional disclosures about the objectives of the derivative instruments and hedging activities, the method of accounting for such instruments under SFAS No. 133 and its related interpretations, and a tabular disclosure of the effects of such instruments and related hedged items on our financial position, financial performance, and cash flows. SFAS No. 161 is effective beginning January 1, 2009. The Company is currently assessing the potential impact that adoption of SFAS No. 161 may have on its financial statements.

In December 2007, the FASB issued SFAS No. 160, “Noncontrolling Interests in Consolidated Financial Statements, an amendment of ARB No. 51,” (“SFAS No. 160”) which changes the accounting and reporting for minority interests. Minority interests will be recharacterized as noncontrolling interests and will be reported as a component of equity separate from the parent’s equity, and purchases or sales of equity interests that do not result in a change in control will be accounted for as equity transactions. In addition, net income attributable to the noncontrolling interest will be included in consolidated net income on the face of the income statement and, upon a loss of control, the interest sold, as well as any interest retained, will be recorded at fair value with any gain or loss recognized in earnings. SFAS No. 160 is effective for us beginning January 1, 2009 and will apply prospectively, except for the presentation and disclosure requirements, which will apply retrospectively. The Company does not expect the adoption of SFAS No. 160 to have a material effect on its consolidated results of operation of financial condition.

In December 2007, the FASB issued SFAS No. 141R, “Business Combinations,” (“SFAS No. 141R”) which replaces SFAS No. 141. The statement retains the purchase method of accounting for acquisitions, but requires a number of changes, including changes in the way assets and liabilities are recognized in the purchase accounting. It also changes the recognition of assets acquired and liabilities assumed arising from contingencies, requires the capitalization of in-process research and development at fair value, and requires the expensing of acquisition-related costs as incurred. SFAS No. 141R is effective for the Company beginning January 1, 2009 and will apply prospectively to business combinations completed on or after that date.

FORTRESS INTERNATIONAL GROUP, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(2) Accounts Receivable

During the second quarter 2008 and included in the nine months ended September 30, 2008, the Company recognized a \$0.7 million loss on customer contract due to concerns as to whether the amounts were collectible. As such, the Company has not recorded any revenue related to this contract and we will recognize revenue for this customer based on cash collections. The Company is owed \$1.3 million from this customer of which \$0.8 million will be recognized upon cash collection and the remaining \$0.5 million reduced the unsecured, promissory notes payable to the sellers of SMLB (seller note). The seller note reduction was pursuant to the working capital adjustment pursuant to terms of the SMLB purchase agreement. Contract costs totaling \$0.7 million were fully recognized in the nine months ended September 30, 2008. In the event the \$1.3 million is collected, the Company will recognize revenue of \$0.8 million and the seller note will be increased by \$0.5 million.

As of September 30, 2008, accounts receivable of \$1.4 million is due from a customer to whom the Company has offered extended payment terms. The customer has executed a promissory note in the same amount bearing interest at 8% per annum with payments of interest only due monthly and the balance in full is due on December 15, 2008. This amount was recognized as revenue during the nine months ended September 30, 2008. The Company has a history of conducting business with this customer and therefore believes collectibility is reasonably assured.

(3) Customer Concentration

The Company earned approximately 39% of its revenue from two customers for the nine months ended September 30, 2008. Accounts receivable from these customers at September 30, 2008 was \$7.9 million. For the nine months ended September 30, 2007, the Company earned approximately 30% of its revenue from two customers.

(4) Acquisitions

In 2007, the Company transitioned from a special purpose acquisition company to an operating entity with its purchase of TSS/Vortech. The Company has continued its strategy to build on to the TSS/Vortech operations through acquisitions that expand geographical reach, add complementary services and access new key customers for additional selling opportunities. All of the acquisitions have been accounted for using purchase accounting. The results of operations attributable to each acquisition are included in the consolidated financial statements from the date of acquisition. The value of the Company's common stock issued in connection with the acquisitions was determined based on the five day average closing price of the Company's common stock beginning two days before through two days after the announcement date multiplied by the number of shares issued.

2008 Acquisition

SMLB, Ltd.

On January 2, 2008, the Company acquired all of the outstanding stock of SMLB, Ltd., which provides consulting and construction management services for the mission-critical facilities in the Chicago area. The closing consideration consisted of (i) \$2,094,561 in cash, including acquisition costs of \$151,133 and net of acquired cash of \$56,573, subject to certain adjustment to be determined subsequent to the closing of the acquisition, as provided in the purchase agreement, (ii) 96,896 shares of the Company's common stock valued at approximately \$500,000, (iii) \$500,000 in unsecured promissory notes bearing interest at 6% per annum, and (iv) additional earn-out amounts up to a maximum of \$600,000, contingent upon the achievement of certain earnings targets by SMLB for each of the calendar years 2008-2009.

All of the shares issued to the selling members were placed into escrow to secure the rights of Fortress under the acquisition. These shares will be released subject to certain conditions under the agreements twelve months from the acquisition date. During the second quarter 2008, the unsecured promissory note of \$500,000 was reduced to \$15,248 based on a working capital adjustment per the purchase agreement.

The Company paid a premium (i.e., goodwill) over the fair value of the net tangible and preliminarily identified intangible assets acquired for a number of reasons, including SMLB's complementary experience, key customer relationships in an expanded market, and service offerings in the mission-critical facility industry. The Company recorded goodwill totaling \$2.7 million associated with the SMLB acquisition, which is not expected to be deductible for income tax purposes.

FORTRESS INTERNATIONAL GROUP, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

The adjusted fair values of the assets acquired and the liabilities assumed for SMLB is as follows:

| SMLB | |
|---------------------------------------|--------------|
| Cash | \$ 2,000,000 |
| Common stock | 462,775 |
| Promissory notes to sellers | 15,248 |
| Acquisition costs | 151,133 |
| Total purchase price | \$ 2,629,156 |
| | |
| Cash and equivalents | \$ 56,573 |
| Contracts and other receivables | 387,612 |
| Goodwill | 2,693,060 |
| Identifiable intangibles, net | 271,000 |
| Total assets acquired | \$ 3,408,245 |
| Liabilities | |
| Accounts payable and accrued expenses | \$ 137,309 |
| Income taxes payable | 131,662 |
| Billings in excess of costs | 510,117 |
| Total liabilities assumed | 779,089 |
| Net assets acquired | \$ 2,629,156 |

2007 Acquisitions

Rubicon Integration, LLC

During the first quarter of 2008, the Company finalized its purchase price allocation associated with Rubicon, resulting in an increase in the value of customer relationship intangibles of \$1.0 million and a corresponding decrease in goodwill.

During the second quarter of 2008, Rubicon achieved certain 2008 revenue bookings targets through June 30, 2008, which entitled the sellers under the purchase agreement to an unsecured promissory note of \$0.4 million and resulted in a corresponding increase in goodwill (see Note 10). The Company recorded indefinite lived intangibles totaling \$3.9 million associated with Rubicon transaction, of which \$2.3 million is expected to be deductible for income tax purposes.

TSS/Vortech

During the third quarter of 2008, shares issued to the selling members of TSS/Vortech were released from escrow. As of September 30, 2008, TSS/Vortech recorded indefinite lived intangibles were \$16.5 million, of which \$12.7 million is expected to be deductible for income taxes.

Purchase Price Allocation

Under business combination accounting, the purchase price for each of the acquired companies, Rubicon and SMLB, was allocated to the net tangible and identifiable intangible assets based on their estimated fair values as of the acquisition dates. The allocation of the purchase price was based upon valuations performed for each of the acquired

companies. Subject to adjustment associated with working capital requirements and contingent consideration issuable upon achievement of certain financial targets, we finalized the Rubicon valuation in the first quarter of 2008 and SMLB during the second quarter 2008.

The valuations indicated that the estimated fair value of the assets acquired was less than the total of the purchase price paid and the liabilities assumed in the transactions. As a result, the excess purchase price was assigned to goodwill for each acquisition. The Company recorded goodwill associated with its acquisitions of SMLB and Rubicon totaling \$6.1 million of which \$2.3 million is expected to be deductible for income tax purposes.

FORTRESS INTERNATIONAL GROUP, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Tangible and Other Intangible Long-Lived Assets

In performing the purchase price allocation for each acquired company, the Company considered, among other factors, the intention for future use of acquired assets, analysis of historical financial performance and estimates of future performance of each acquired company's products. The fair value of assets was based, in part, on a valuation using either a cost, income, or in some cases, market valuation approach and estimates and assumptions provided by management. The tangible assets primarily include personal property such as computers, software and service vehicles. Intangible assets consist primarily of customer relationships, order backlog and trade name.

The value of the components of intangible assets as of September 30, 2008 are as follows:

| | SMLB | Rubicon | Innovative | TSS/Vortech | Total |
|-------------------------------|-------------------|---------------------|-------------------|----------------------|----------------------|
| Intangible asset: | | | | | |
| Trade name | \$ 36,000 | \$ 460,000 | \$ 60,000 | \$ 4,930,000 | \$ 5,486,000 |
| In-place contracts | 230,000 | 50,000 | 350,000 | 406,201 | 1,036,201 |
| Customer relationships | - | 2,970,000 | 560,000 | 14,100,000 | 17,630,000 |
| Non competition agreement | 5,000 | 685,000 | 50,600 | - | 740,600 |
| Total intangible | 271,000 | 4,165,000 | 1,020,600 | 19,436,201 | 24,892,801 |
| Accumulated amortization | (152,122) | (822,131) | (382,483) | (3,697,513) | (5,054,249) |
| Intangible assets, net | \$ 118,878 | \$ 3,342,869 | \$ 638,117 | \$ 15,738,688 | \$ 19,838,552 |

Impairment

The Company has not realized the anticipated revenue from customers acquired in its acquisitions and had experienced continued operating losses during the nine months ended September 30, 2008. Based on the recurring operating losses and a revision to the Company's forecast during the second quarter of 2008, the Company conducted analyses of the operations in order to identify any impairment in the carrying value of the goodwill related to the business. During the third quarter 2008, the Company's market value declined further and we conducted additional analysis, which contemplated the market condition occurring through the third quarter. The analyses of the business using both an income approach and a market approach determined that the carrying value exceeded the current fair value of the business, resulting in goodwill impairment of \$3.0 million for the three months ended September 30, 2008 and \$4.2 million for the nine months ended September 30, 2008. At September 30, 2008, the adjusted carrying value of goodwill was \$18.8 million.

For the three months ended September 30, 2008 and September 30, 2007, amortization expense totaling \$0.8 million and \$0.7 million, respectively, has been included in the accompanying consolidated statements of operations related to the above intangibles of which \$0.2 million and \$0.1 million, respectively, is included in cost of revenue.

For the nine months ended September 30, 2008 and September 30, 2007, amortization expense totaling \$2.5 million and \$1.9 million, respectively, has been included in the accompanying consolidated statements of operations related to the above intangibles of which \$0.3 million and \$0.3 million, respectively, is included in cost of revenue.

Proforma Results

Edgar Filing: Fortress International Group, Inc. - Form 10-Q

Unaudited pro forma results of operations are as follows. The amounts are shown as if the acquisitions had occurred at the beginning of the periods presented:

| | Three Months Ended September 30, 2007 | Nine Months Ended September 30, 2007 |
|--|---|--|
| Proforma revenue | \$ 15,894,628 | \$ 44,642,765 |
| Proforma operating loss | (2,052,390) | (5,707,428) |
| Proforma pretax loss | (2,068,684) | (5,681,989) |
| Proforma net loss | (2,515,304) | (5,596,968) |
| Pro forma basic and diluted net loss per share | \$ (0.21) | \$ (0.45) |
| Weighted average common shares | 12,039,904 | 12,520,861 |

This information is not necessarily indicative of the operational results that would have occurred if the acquisition had been consummated on the dates indicated nor is it necessarily indicative of future operating results of the combined enterprise.

FORTRESS INTERNATIONAL GROUP, INC.
NOTES TO 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 | | Successor Nine Months Ended | |
|--|-----------------------|-----------------------|--------------------------------|-----------------------|
| | September 30, 2008 | September 30, 2007 | September 30, 2008 | September 30, 2007 |
| Net loss | \$ (3,217,911) | \$ (2,621,052) | \$ (11,512,445) | \$ (6,212,024) |
| Basic and diluted weighted average common shares | 12,326,397 | 11,715,512 | 12,164,454 | 11,743,186 |
| Net loss per share | \$ (0.26) | \$ (0.22) | \$ (0.95) | \$ (0.53) |

As of September 30, 2008, there were unvested restricted stock, options to purchase units and warrants outstanding to purchase a total of 18,165,634 shares of common stock and convertible unsecured promissory notes convertible into 533,333 shares of common stock. These were excluded in the computation of diluted net loss per common share for the three and nine months ended September 30, 2008, as their inclusion would be anti-dilutive.

No weighted average common shares or income (loss) per share amounts are shown for the Predecessor since the Predecessor was limited liability company whose capital structure consisted of membership interests.

(6) Employee Benefit Plans*Restricted Stock*

During the nine months ended September 30, 2008 and September 30, 2007, the Company granted 132,000 and 770,832 restricted common shares, respectively, under the 2006 Omnibus Incentive Compensation Plan ("Plan"). During the nine months ended September 30, 2008, the weighted average fair value of these grants was \$4.53 per share.

During the three months ended September 30, 2008 and September 30, 2007, non-cash compensation expense totaling \$0.5 million and \$0.3 million, respectively, has been included in the accompanying consolidated statements of operations related to vesting of awards, of which \$0.1 million and zero, respectively, is in cost of revenue.

During the nine months ended September 30, 2008 and September 30, 2007, non-cash compensation expense totaling \$1.5 million and \$0.8 million, respectively, has been included in the accompanying consolidated statements of operations related to vesting of awards, of which \$0.3 million and zero, respectively, is in cost of revenue. There was no other restricted stock activity.

(7) Common Stock Repurchases

During the three months ended September 30, 2008, the Company repurchased 8,895 treasury shares with an aggregate value of \$20,322 associated with vesting restricted stock of an employee. During the nine months ended September 30, 2008, the Company repurchased 14,885 treasury shares with an aggregate value of \$47,465 associated with vesting restricted stock of an employee. The Company paid the employee's related taxes associated with the employee's vested stock and decreased the shares issued to the employee by a corresponding value, resulting in a share issuance net of taxes to employee. The value of the shares netted for employee taxes represents treasury stock repurchased. There were no similar repurchases during 2007.

Prior to the consummation of the acquisition of TSS/Vortech, the Company announced and implemented a common stock repurchase program under which it may purchase up to 3,000,000 shares of common stock. Currently the Board of Directors has authorized the repurchase of up to 500,000 shares under this program. During the nine months ended September 30, 2007, the Company repurchased 354,775 of the Company's common shares valued in aggregate at \$1.9 million. The plan was suspended in the third quarter of 2007; accordingly, there has been no activity under the plan in 2008.

In January 2007, the Company repurchased 756,100 shares at an aggregate value of \$4.3 million from those shareholders that voted against the acquisition of TSS/Vortech and requested that their shares be redeemed at the then per share trust value of \$5.74 per share.

FORTRESS INTERNATIONAL GROUP, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(8) Options to Purchase Units and Warrants

At September 30, 2008 and December 31, 2007, there were outstanding options to purchase units and warrants to purchase 17,810,300 of common shares. Both the option to purchase units and warrants have a cashless exercise feature, whereby the holder may elect to receive a net amount of shares and forego the payment of the strike price.

In February 2007, the Company entered into a one year agreement with an advisor in which we were obligated to issue a warrant for the purchase of 125,000 shares of our common stock, in exchange for consulting services. The fair value of these warrants was determined using the Black-Scholes model and is recognized over the term of the agreement. For the three and nine months ended September 30, 2008, the computed Black-Scholes value of the warrant remained unchanged and decreased by \$141,422, respectively, resulting in a corresponding decrease in selling, general and administrative expense for the nine months ended September 30, 2008. For the three and nine months ended September 30, 2007, the Company recognized \$213,000 in selling, general and administrative expense associated with the warrant.

(9) Income Taxes

The Company accounts for income taxes in accordance with SFAS No. 109, "Accounting for Income Taxes" ("SFAS No. 109"), APB No. 28, Interim Financial Reporting, and FASB Interpretation No. 18, "Accounting for Income Taxes in Interim Periods." 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's provision for income taxes reflects the establishment of a full valuation allowance against deferred tax assets as of September 30, 2008. SFAS No. 109 requires management to evaluate its deferred tax assets on a regular basis to reduce them to an amount that is realizable on a more likely than not basis.

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. For the year ended December 31, 2007, the Company recorded a partial valuation allowance against its deferred tax assets, as the Company concluded that under relevant accounting standards, it is more likely than not that a portion of deferred tax assets will be not be realizable.

Under SFAS No. 109, the Company evaluated available evidence to determine whether a full or partial valuation allowance of deferred tax assets should be recorded. As of September 30, 2008, cumulative losses in recent periods is evidence to support the need for a valuation allowance. Such evidence outweighs projections of future taxable income that may support the realization of deferred tax assets.

The Company is expected to record future deferred tax expense, primarily as the result of tax amortization resulting from the purchases of TSS/Vortech and Rubicon. Under SFAS No. 109, tax amortization on indefinite lived assets (goodwill and other intangibles) may not be offset by deferred tax assets that are not currently realizable, primarily deferred tax assets relating to net operating loss carryovers, because of valuation allowances.

The Company has recorded an income tax benefit of \$349,898 for the three months ended September 30, 2008 which consists of income taxes currently payable of \$37,102 net of a reduction in deferred tax liabilities of \$387,000. For the nine months ended September 30, 2008, income expense of \$37,102 has been recorded to reflect state income taxes.

The Company's effective tax rate is based upon the rate expected to be applicable to the full fiscal year. The rate differs from that used in the three months ended September 30, 2007 primarily due to changes in the valuation allowance subsequent to that date.

Effective January 1, 2007, the Company was required to adopt FASB Interpretation No. 48, "Accounting for Uncertainty in Income Taxes" ("FIN 48"). The Company evaluates its uncertain tax positions on a quarterly basis and has not identified any changes in uncertain tax positions during the reporting period.

Management is in the process of evaluating the various tax positions associated with the acquisition of SMLB and is of the opinion that any deferred tax liabilities that would ultimately result from uncertain tax positions related to this acquisition is not anticipated to be material.

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

All of the Company's prior federal and state income tax filings since inception remain open under statutes of limitation. Innovative Power System Inc.'s statutes of limitation are open from the 2002 tax year forward for both federal and Virginia purposes. Quality Power Systems Inc.'s statutes of limitation are open from the 2003 tax year forward for both federal and Virginia purposes. SMLB's statutes of limitation are open from the 2006 tax year forward for both federal and Illinois purposes.

FORTRESS INTERNATIONAL GROUP, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(10) Notes Payable

| | September 30, 2008 | December 31, 2007 |
|---|-----------------------|----------------------|
| Convertible, unsecured promissory note, due 2012 (6.0%) | \$ 4,022,356 | \$ 7,500,000 |
| Unsecured promissory note, due 2011 (6.0%) | 331,688 | 394,611 |
| Unsecured promissory note, due 2008 (6.0%) | - | 1,517,753 |
| Unsecured promissory note, due 2011 (6.0%) | 15,248 | - |
| Vehicle notes | 43,105 | 86,603 |
| Total debt | 4,412,397 | 9,498,967 |
| Less current portion | 182,384 | 1,650,306 |
| Total debt, less current portion | \$ 4,230,013 | \$ 7,848,661 |

In connection with the acquisition of TSS/Vortech, on January 19, 2007, the Company issued two convertible, unsecured promissory notes, with an aggregate value of \$10,000,000 to the sellers. During the third quarter of 2007, the Company entered into an agreement with its Chief Executive Officer (the "CEO"), one of the selling members, to retire \$2,500,000 of the note due to him by paying \$2,000,000 and the CEO used the proceeds to repurchase the Company's common stock and warrants. The prepayment discount realized of \$500,000 has been recorded as additional paid-in capital. The notes bear interest at six percent per year and have a term of five years. Interest only is payable during the first two years of each note with principal payments commencing on the second anniversary (January 19, 2009) and continuing throughout the balance of the term of the notes in equal quarterly principal installments totaling \$625,000, as adjusted for the early repayment of the CEO notes.

During the third quarter 2008, the Chief Executive Officer and Chief Operating Officer, both of the selling members, entered into an agreement with the Company to convert \$2,500,000 and \$1,000,000, respectively, of their respective notes into equity at a conversion price of \$7.50 per share, resulting in the aggregate issuance of 466,667 common shares. The conversion has been recorded as additional paid-in capital. In addition, the Chief Operating Officer agreed to postpone any principal and interest payments payable to him under his remaining \$4,000,000 promissory note until March, 2010, with such interest to be accrued to the outstanding principal. The notes are convertible at any time by the selling members at a conversion price of \$7.50 per share and are automatically convertible if the average closing price of the Company's common stock for 20 consecutive trading days equals or exceeds \$7.50 per share.

In connection with the acquisition of Innovative, on September 24, 2007, the Company issued an unsecured promissory note to the sellers in the amount of \$300,000. The note bears interest at six percent per year and has a three year term. Quarterly principal installments of \$15,000 plus interest are due commencing December 31, 2007, with a final balloon payment of \$120,000 due on December 31, 2010. Based on achieving certain earnings targets through December 31, 2007 and net of a purchase price adjustment associated with working capital, the Innovative sellers received an additional promissory note of \$64,611 at December 31, 2007. The additional unsecured promissory note is in a similar form of the unsecured promissory note issued at closing, bearing interest at six percent per year and has a three-year term. Quarterly principal installments of \$3,231 plus interest are due commencing March 31, 2008 with a final balloon payment of \$25,844 due on March 31, 2011.

In connection with the Rubicon acquisition, the Company was obligated to issue unsecured promissory notes totaling \$1.5 million and \$2.0 million contingent on Rubicon achieving certain earnings targets for the month ended December 31, 2007 and certain revenue bookings targets for 2008, respectively. Rubicon exceeded earnings targets for the month

ended December, 31 2007, resulting in the issuance of a promissory note totaling \$1.5 million which was paid in the first quarter of 2008.

Of the \$2.0 million contingent note, approximately \$0.4 million was issued at June 30, 2008 based on Rubicon's achievement of revenue bookings targets through that date. The issued note bears interest at six percent per annum from the acquisition date and was paid on July 31, 2008. At December 31, 2008, the Company may be required to issue and pay up to \$1.6 million or the balance of the note contingent on Rubicon's achievement of certain revenue booking targets in the second half of 2008. Any contingent note issuance will have earned interest at six percent per annum from the purchase date through payment. At September 30, 2008, revenue bookings were not determinable beyond a reasonable doubt and the remaining \$1.6 million contingent note has not been issued.

In connection with the acquisition of SMLB, on January 2, 2008, the Company issued unsecured promissory notes with an aggregate value of \$500,000 to the sellers. The notes bear interest at six percent per year and has a three-year term. During the three months ended June 30, 2008, the Company reduced the seller notes to \$15,248 based on a \$484,752 working capital adjustment in accordance with the terms of the purchase agreement. Principal installments net of the adjustment of \$3,050, \$3,050 and \$9,148, plus accrued interest, are due on January 2, 2009, January 2, 2010 and January 2, 2011, respectively. The Company may prepay the notes any time at its election without penalty.

FORTRESS INTERNATIONAL GROUP, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(11) Related Party Transactions

Our 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 related parties for less than \$25,000.

The Company participates in transactions with the following entities affiliated through common ownership and management.

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

Chesapeake Systems, LLC. (Chesapeake Systems) is 9% owned by, and significantly indebted to, the Company's Chief Executive Officer. Chesapeake Systems is a manufacturers' representative and distributor of mechanical and electrical equipment and purchased certain assets of Chesapeake Tower Systems, Inc. in February 2007.

Chesapeake Mission Critical, LLC. (Chesapeake MC) is 9% owned by each of the Company's Chief Executive Officer and its President. Additionally, it is significantly indebted to the Company's Chief Executive Officer. Chesapeake MC is a manufacturers' representative and distributor of electrical equipment and purchased certain assets of Chesapeake Tower Systems, Inc. in February 2007.

Chesapeake Tower Systems, Inc . Chesapeake Tower Systems, Inc. (Chesapeake) is 100% owned by the Company's Chief Executive Officer. On February 28, 2007, Chesapeake sold substantially all of its assets to Chesapeake Systems and Chesapeake MC. Except for an office space sublease agreement, Chesapeake does not engage in any business with the Company. Chesapeake was a manufacturer's representative and distributor of mechanical and electrical equipment, which Chesapeake sold to the Company.

CS Technology, Inc. CS Technology, Inc. (CST) is majority owned by a nephew of the Company's Chief Executive Officer. CST is in the Technology Consulting business and is a customer of the Company.

CTS Services, LLC (CTS) is 55% 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.

L.H. Cranston Acquisition Group, Inc . L.H. Cranston Acquisition Group, Inc. is 25% owned by the Company's Chief Executive Officer. L.H. Cranston Acquisition Group 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 (Telco) is 55% owned by the Company's Chief Executive Officer. Telco 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. CTS purchased 100% of Telco's membership interests in the first quarter of 2008.

Automotive Technologies, Inc. Automotive Technologies, Inc., is 60% owned by the Company's Chief Executive Officer and provides vehicle maintenance and repair services to the Company.

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 President. TPR Group Re Three leases office space to the Company under the terms of a real property lease to TSS/Vortech.

The following table sets forth transactions the Company has entered into with the above related parties for the Successor for the three and nine months ended September 30, 2008 and 2007 and for the Predecessor for the period from January 1, 2007 through January 19, 2007.

12

FORTRESS INTERNATIONAL GROUP, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

| | Successor | | | | Predecessor |
|----------------------------------|--------------------|--------------------|--------------------|--------------------|--|
| | Three Months | | Nine Months | | Period from |
| | Ended | Ended | Ended | Ended | January 1, 2007 through January 19, 2007 |
| | September 30, 2008 | September 30, 2007 | September 30, 2008 | September 30, 2007 | |
| Revenue | | | | | |
| CTS Services, LLC | \$ 51,298 | \$ 78,885 | \$ 163,576 | \$ 147,711 | \$ 1,800 |
| Chesapeake Systems, LLC | 2,410 | - | 2,410 | 52,716 | - |
| Chesapeake Mission Critical, LLC | 12,562 | 67,818 | 65,565 | 95,034 | - |
| CS Technology, Inc. | 40,752 | - | 116,673 | - | - |
| S3 Integration | 7,667 | - | 7,667 | - | - |
| Total | \$ 114,689 | \$ 146,703 | \$ 355,891 | \$ 295,461 | \$ 1,800 |

| | | | | | |
|----------------------------------|---------------------|---------------------|---------------------|---------------------|------------------|
| Cost of Revenue | | | | | |
| CTS Services, LLC | \$ 1,309,845 | \$ 2,292,792 | \$ 2,102,864 | \$ 2,763,184 | \$ 82,032 |
| Chesapeake Systems, LLC | - | - | 147,931 | 160,304 | - |
| Chesapeake Mission Critical, LLC | 65,082 | 41,125 | 118,399 | 78,750 | - |
| Chesapeake Tower Systems, Inc. | - | - | - | 56,501 | 8,225 |
| S3 Integration, LLC | 111,630 | - | 149,145 | 218,922 | - |
| LH Cranston & Sons, Inc. | - | 90,800 | 7,500 | 222,677 | - |
| Telco P&C, LLC | 325,089 | 18,222 | 335,158 | 29,174 | - |
| Total | \$ 1,811,646 | \$ 2,442,939 | \$ 2,860,997 | \$ 3,529,512 | \$ 90,257 |

| | | | | | |
|--|-------------------|-------------------|-------------------|-------------------|------------------|
| Selling, general and administrative | | | | | |
| Office rent paid to Chesapeake Tower Systems, Inc. | \$ 58,072 | \$ 46,841 | \$ 176,406 | \$ 131,782 | \$ 16,016 |
| Office rent paid to TPR Group Re Three, LLC | 98,131 | 94,976 | 293,513 | 286,454 | 26,472 |
| Vehicle repairs to Automotive Technologies, Inc. | - | - | - | 4,442 | 656 |
| Total | \$ 156,203 | \$ 141,817 | \$ 469,919 | \$ 422,678 | \$ 43,144 |

| | September 30, 2008 | December 31, 2007 |
|---------------------------------------|-----------------------|----------------------|
| Accounts receivable/(payable): | | |
| CTS Services, LLC | \$ 58,746 | \$ 44,821 |
| CTS Services, LLC | (861,263) | (2,969,671) |
| Chesapeake Systems, LLC | 2,410 | 611 |
| Chesapeake Systems, LLC | - | (873) |
| Chesapeake Mission Critical, LLC | 12,562 | 104,397 |
| Chesapeake Mission Critical, LLC | (47,576) | (18,950) |
| CS Technology, Inc. | 40,712 | - |
| Telco P&C, LLC | (122,274) | (8,000) |

| | | |
|----------------------------------|----------------|----------------|
| LH Cranston&Sons, Inc. | - | (11,575) |
| S3 Integration, LLC | 7,667 | - |
| S3 Integration, LLC | (31,425) | (60,556) |
| Total accounts receivable | \$ 122,097 | \$ 149,829 |
| Total accounts (payable) | \$ (1,062,538) | \$ (3,069,625) |

13

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.

This Quarterly Report on Form 10-Q, including, without limitation, Management's Discussion and Analysis of Financial Condition and Results of Operations, contains "forward-looking statements" within the meaning of Section 27A of the Securities Act, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended (the "Exchange Act"). We intend the forward-looking statements to be covered by the safe harbor for forward-looking statements in such sections of the Exchange Act. The forward-looking information is based on various factors and was derived using numerous assumptions. All statements, other than statements of historical fact, that address activities, events or developments that we intend, expect, project, believe or anticipate will or may occur in the future are forward-looking statements. Such statements are based upon certain assumptions and assessments made by our management in light of their experience and their perception of historical trends, current conditions, expected future developments and other factors they believe to be appropriate. These forward-looking statements are usually accompanied by words such as "believe," "anticipate," "plan," "seek," "expect," "intend" and similar expressions.

Forward-looking statements necessarily involve risks and uncertainties, and our actual results could differ materially from those anticipated in the forward looking statements due to a number of factors, including those set forth in Part I, Item 1A "Risk Factors" of our Annual Report on Form 10-K for the year ended December 31, 2007, as amended, and as updated and supplemented by Part II, Item 1A "Risk Factors" of our Quarterly Reports on Form 10-Q, and elsewhere in this report. These factors, as well as other cautionary statements made in this Quarterly Report on Form 10-Q, should be read and understood as being applicable to all related forward-looking statements wherever they appear herein. The forward-looking statements contained in this Quarterly Report on Form 10-Q represent our judgment as of the date hereof. We encourage you to read those descriptions carefully. We caution you not to place undue reliance on the forward-looking statements contained in this report. These statements, like all statements in this report, speak only as of the date of this report (unless an earlier date is indicated) and we undertake no obligation to update or revise the statements except as required by law.

Business Formation and Overview

We were incorporated in Delaware on December 20, 2004 as a special purpose acquisition company 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 net proceeds 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 us from a firm primarily seeking to invest capital to an operating business.

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. During 2007, we acquired substantially all of the assets of Comm Site of South Florida, Inc., 100% of the outstanding stock of Innovative Power Solutions, Inc. and Quality Power Solutions, Inc. and 100% of the membership interests of Rubicon Integration, L.L.C.

On January 2, 2008, we continued our acquisition strategy with the purchase of 100% of the outstanding stock of SMLB, Ltd., which provides consulting and construction management services for the mission-critical facilities in the Chicago area. The closing consideration consisted of (i) \$2,000,000 in cash, subject to certain adjustment to be

determined subsequent to the closing of the acquisition, as provided in the purchase agreement, (ii) 96,896 shares of our common stock valued at approximately \$500,000, (iii) \$500,000 in unsecured promissory notes bearing interest at 6% per annum (this note was adjusted to \$15,248 as SMLB has not met the working capital requirement established in the purchase agreement), and (iv) additional earn-out amounts up to a maximum of \$600,000, contingent upon the achievement of certain earnings targets by SMLB for each of the calendar years 2008-2009.

With the acquired assets, we provide comprehensive services for the planning, design, and development of mission-critical facilities and 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.

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 out 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 and time and materials basis and (2) contracts awarded to us where some, but not all, of the work have not yet been authorized.

At September 30, 2008, we have authorizations to proceed with work for approximately \$54.3 million or 25% of our total backlog of \$217.7 million. At December 31, 2007, we had authorizations to proceed with work for approximately \$32.4 million or 19% of our total backlog of \$172.9 million. Additionally, approximately \$144.9 million and \$118.0 million or 67% and 68% of our backlog relates to a single customer at September 30, 2008 and December 31, 2007, respectively.

As of September 30, 2008, our backlog was approximately \$217.7 million, compared to approximately \$172.9 million at December 31, 2007. The following table reflects the value (in millions) of our backlog in the above three categories as of September 30, 2008 and December 31, 2007, respectively.

| | September 30, 2008 | December 31, 2007 |
|-------------------------|-----------------------|----------------------|
| Technology consulting | \$ 6.8 | \$ 3.9 |
| Construction management | 195.9 | 154.1 |
| Facilities management | 15.0 | 14.9 |
| Total | \$ 217.7 | \$ 172.9 |

The backlog amounts are estimates, subject to changes or cancellations. The actual customer purchase orders to perform work may vary in scope and amount from the backlog amounts presented herein. Additionally, some of our customers may be dependent on additional funding resources, which in the current economic environment may be difficult for them to obtain. Accordingly, we can provide no assurance that we will in fact be awarded the maximum amount of such contracts or be awarded any amount at all.

Critical Accounting Policies and Estimates

Our financial statements have been prepared in accordance with generally accepted accounting principles in the United States of America (“GAAP”). The preparation of these financial statements 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.

We believe the following critical accounting policies affect the more significant estimates and judgments used in the preparation of our financial statements.

Revenue Recognition

We recognize revenue when pervasive evidence of an arrangement exists, the contract price is fixed or determinable, services have been rendered or goods delivered and collectability is reasonably assured. Our revenue is derived from the following types of contractual arrangements: fixed-price contracts, time and material contracts and cost-plus-fee contracts (including guaranteed maximum price contracts). Our primary source of revenue is from fixed price contracts and we apply Statement of Position (SOP) 81-1, “Accounting for Performance of Construction-Type and Certain Production-Type Contracts,” recognizing revenue on the percentage-of-completion method using costs incurred

in relation to total estimated project costs.

Revenue from fixed price contracts is recognized on the percentage of completion method, measured by the percentage of total costs incurred to date to estimated total costs for each contract. This method is used because management considers costs incurred and costs to complete to be the best available measure of progress in the contracts. Contract costs include all direct materials, subcontract and labor costs and those indirect costs related to contract performance, such as indirect labor, payroll taxes, employee benefits and supplies.

Revenue on time-and-material contracts is recognized based on the actual labor hours performed at the contracted billable rates and costs incurred on behalf of the customer. Revenue on cost-plus-fee contracts is recognized to the extent of costs incurred, plus an estimate of the applicable fees earned. Fixed fees under cost-plus-fee contracts are recorded as earned in proportion to the allowable costs incurred in performance of the contract.

Contract revenue recognition inherently involves estimation. Examples of estimates include the contemplated level of effort to accomplish the tasks under the contract, the costs of the effort and an ongoing assessment of the Company's progress toward completing the contract. From time to time, as part of its standard management process, facts develop that require us to revise its estimated total costs on revenue. To the extent that a revised estimate affects contract profit or revenue previously recognized, we record the cumulative effect of the revision in the period in which the revisions becomes known. The full amount of an anticipated loss on any type of contract is recognized in the period in which it becomes probable and can reasonably be estimated.

Under certain circumstances, we may elect to work at risk prior to receiving an executed contract document. We have a formal procedure for authorizing any such at risk work to be incurred. Revenue, however, is deferred until a contract modification or vehicle is provided by the customer.

Additionally, in the event the collection of revenue is not reasonably assured, we recognize revenue when we are paid for the service. We expense any related contracted costs as they are incurred.

Allowance for Doubtful Accounts

The allowance for doubtful accounts is our best estimate of the amount of probable credit losses in our existing accounts receivable. We determine the allowance based on an analysis of our historical experience with bad debt write-offs and an aging of the accounts receivable balance. Account balances are charged off against the allowance after all means of collection have been exhausted and the potential for recovery is considered remote.

As of September 30, 2008, accounts receivable of \$1.4 million is due from a customer to whom we have offered extended payment terms. The customer has executed a promissory note in the same amount bearing interest at 8% per annum with payments of interest only due monthly and the balance in full is due on December 15, 2008. This amount was recognized as revenue in the nine months ended September 30, 2008. We have a history of conducting business with this customer and therefore believe collectibility is reasonably assured.

Non-cash Compensation

We apply the expense recognition provisions of SFAS No. 123(R), “*Accounting for Stock-Based Compensation*” (“*SFAS No. 123(R)*”), therefore, the recognition of the value of the instruments results in compensation expense in our financial statements. The expense differs from other compensation and professional expenses in that these charges, though generally permitted to be settled in cash, are typically settled through the issuance of common stock, which would have a dilutive effect upon earnings per share, if and when such warrants are exercised or restricted stock vests. The determination of the estimated fair value used to record the compensation or professional expenses associated with the equity or liability instruments issued requires management to make a number of assumptions and estimates that can change or fluctuate over time.

Goodwill and Other Purchased Intangible Assets

Goodwill represents the excess of costs over fair value of net assets of businesses acquired. Other purchased intangible assets include the fair value of items such as customer contracts, backlog and customer relationships. SFAS No. 142, “*Goodwill and Other Intangible Assets*” (“*SFAS No. 142*”), establishes financial accounting and reporting for acquired goodwill and other intangible assets. Goodwill and intangible assets acquired in a purchase business combination and determined to have an indefinite useful life are not amortized, but rather tested for impairment on an annual basis or purchased intangible assets with a definite useful life are amortized on a straight-line basis over their estimated useful lives. We have a process pursuant to which we typically retain third-party valuation experts to assist us in determining the fair market values and useful lives of identified intangible assets. Certain techniques require us to make estimates and assumptions about the future financial performance of the acquired businesses that may change in the future.

Our intangible assets consist of trade name, in-place contracts, customer relationships, and non-competition agreements with amortizable lives of 1-8 years for the finite lived intangibles. The Company annually tests for the impairment of goodwill pursuant to the requirements of SFAS No. 142 and of the other purchased intangible assets pursuant to the requirements of SFAS No. 144, “*Accounting for the Impairment or Disposal of Long-Lived Assets*.” If events or changes in circumstances indicate that an asset value might be impaired, we will test during the interim period in which those changes occur. Through the third quarter 2008, we continued to incur operating losses, revised our forecasted revenues as certain of our acquisitions have not delivered originally anticipated revenues, and

experienced a market decline in our equity value. As a result of these potential impairment indicators, we evaluated the carrying value of goodwill and other long-lived intangible assets for impairment. Utilizing a third party firm we determined the carrying value of goodwill was in excess of the fair value, resulting in an aggregate impairment on goodwill of approximately \$4.2 million.

Income Taxes

Deferred income taxes are provided for the differences between the basis of assets and liabilities for financial reporting and income tax purposes. Deferred tax assets and liabilities are measured using tax rates in effect for the year in which those temporary differences are expected to be recovered or settled. A valuation allowance is established when necessary to reduce deferred tax assets to the amount expected to be realized.

We make certain estimates and judgments in determining income tax expense for financial statement purposes. These estimates and judgments occur in the calculation of certain tax assets and liabilities, which principally arise from differences in the timing of recognition of revenue and expense for tax and financial statement purposes. We also must analyze income tax reserves, as well as determine the likelihood of recoverability of deferred tax assets and adjust any valuation allowances accordingly. Considerations with respect to the recoverability of deferred tax assets include the period of expiration of the tax asset, planned use of the tax asset and historical and projected taxable income, as well as tax liabilities for the tax jurisdiction to which the tax asset relates. Valuation allowances are evaluated periodically and will be subject to change in each future reporting period as a result of changes in one or more of these factors.

Effective January 1, 2007, we were required to adopt FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes ("FIN 48"). FIN 48 prescribes a more-likely-than-not threshold of financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. This interpretation also provides guidance on de-recognition of income tax assets and liabilities, classification of current and deferred tax assets and liabilities, accounting for interest and penalties associated with tax positions, accounting for income taxes in interim periods and income tax disclosures. Since inception and through January 1, 2007, the adoption date of this standard, we were in essence a "special purpose acquisition" company with no substantive operations. Management concluded that the adoption of FIN 48 had no material effect on our financial position or results of operations. As of September 30, 2008, we do not have any material gross unrecognized tax benefit liabilities. However, management is still in the process of evaluating the various tax positions associated with the acquisition of SMLB and is of the opinion that any deferred tax liabilities that would ultimately result from uncertain tax positions related to these entities may be covered by indemnification provisions provided in the acquisition agreement or may result in an adjustment to goodwill.

Use of Estimates

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenue and expenses during the reporting period. The most critical estimates and assumptions are made in determining the allowance for doubtful accounts, revenue recognition, recovery of long-lived assets, useful lives of long-lived assets, accruals for estimated tax and stock compensation expense. Actual results could differ from those estimates and assumptions.

Recently Issued Accounting Pronouncements

In October 2008, the FASB issued FASB Staff Position 157-3, "Determining the Fair Value of a Financial Asset When the Market of that Asset is not Active" ("FSP 157-3"). FSP 157-3 provides an example that clarifies and reiterates certain provisions of the existing fair value standard, including basing fair value on orderly transactions and usage of management and broker inputs. FSP 157-3 is effective immediately but is not expected to have a material impact on our financial position or results of operations.

In May 2008, the FASB issued SFAS No. 163, "Accounting for Financial Guarantee Insurance Contracts" ("SFAS 163"), SFAS 163 requires recognition of a claim liability prior to an event of default when there is evidence that credit

deterioration has occurred in an insured financial obligation. SFAS 163 clarifies how FAS 60 applies to financial guarantee insurance contracts, including the recognition and measurement to be used to account for premium revenue and claim liabilities and requires expanded disclosures about financial guarantee insurance contracts. SFAS 163 is effective for us January 1, 2009. The Company does not expect the adoption of SFAS 163 to have a material effect on our consolidated results of operations and financial condition.

In May 2008, the FASB issued SFAS No. 162, “The Hierarchy of Generally Accepted Accounting Principles” (“SFAS 162”). SFAS 162 identifies the sources of accounting principles and the framework for selecting the principles used in the preparation of financial statements of nongovernmental entities that are presented in conformity with generally accepted accounting principles (the GAAP hierarchy). SFAS No. 162 will become effective 60 days following the SEC’s approval of the Public Company Accounting Oversight Board amendments to AU Section 411, “The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles.” We do not expect the adoption of SFAS 162 to have a material effect on our consolidated results of operations and financial condition.

In April 2008, FASB issued a Staff Position (FSP) No. FAS 142-3, “Determination of the Useful Life of Intangible Assets,” (“FSP 142-3”) which amends the factors a Company should consider when developing renewal assumptions used to determine the useful life of an intangible asset under SFAS 142. FSP 142-3 replaces the previous useful life criteria with a new requirement-that an entity consider its own historical experience in renewing similar arrangements. In issuing FSP 142-3, the FASB hopes to improve the consistency between the useful life of a recognized intangible asset and the period of expected cash flows used to measure the fair value of the asset. FAS 142-3 is effective January 1, 2009. We are currently assessing the potential impact that adoption of FAS 142-3 may have on our financial statements.

In March 2008, the FASB issued SFAS No. 161, “Disclosures about Derivative Instruments and Hedging Activities, an amendment of FASB Statement No. 133,” (“SFAS No. 161”) which requires additional disclosures about the objectives of the derivative instruments and hedging activities, the method of accounting for such instruments under SFAS No. 133 and its related interpretations, and a tabular disclosure of the effects of such instruments and related hedged items on our financial position, financial performance, and cash flows. SFAS No. 161 is effective beginning January 1, 2009. We are currently assessing the potential impact that adoption of SFAS No. 161 may have on our financial statements.

In December 2007, the FASB issued SFAS No. 160, “Noncontrolling Interests in Consolidated Financial Statements, an amendment of ARB No. 51” (“SFAS No. 160”), which changes the accounting and reporting for minority interests. Minority interests will be recharacterized as noncontrolling interests and will be reported as a component of equity separate from the parent’s equity, and purchases or sales of equity interests that do not result in a change in control will be accounted for as equity transactions. In addition, net income attributable to the noncontrolling interest will be included in consolidated net income on the face of the income statement and, upon a loss of control, the interest sold, as well as any interest retained, will be recorded at fair value with any gain or loss recognized in earnings. SFAS No. 160 is effective beginning July 1, 2009 and will apply prospectively, except for the presentation and disclosure requirements, which will apply retrospectively. We do not expect the adoption of SFAS No. 160 to have a material effect on our consolidated results of operation of financial.

In December 2007, the FASB issued SFAS No. 141R, “Business Combinations,” (“SFAS No. 141(R)”) which replaces SFAS No. 141. The statement retains the purchase method of accounting for acquisitions, but requires a number of changes, including changes in the way assets and liabilities are recognized in the purchase accounting. It also changes the recognition of assets acquired and liabilities assumed arising from contingencies, requires the capitalization of in-process research and development at fair value, and requires the expensing of acquisition-related costs as incurred. SFAS No. 141R is effective beginning January 1, 2009 and will apply prospectively to business combinations completed on or after that date.

Consolidated Statements of Operations

| | Successor (Fortress International Group, Inc.) | | | | Predecessor (TSS/Vortech) For the period January 1, through January 19, 2007 |
|-------------------------------------|--|--------------------|--------------------|--------------------|---|
| | Three Months Ended | | Nine Months Ended | | |
| | September 30, 2008 | September 30, 2007 | September 30, 2008 | September 30, 2007 | January 19, 2007 |
| | (unaudited) | (unaudited) | (unaudited) | (unaudited) | (audited) |
| Results of Operations: | | | | | |
| Revenue | \$ 25,781,523 | \$ 12,692,772 | \$ 65,363,481 | \$ 32,232,016 | \$ 1,412,137 |
| Cost of revenue | 20,660,103 | 10,749,331 | 54,719,170 | 27,378,926 | 1,108,276 |
| Gross profit | 5,121,420 | 1,943,441 | 10,644,311 | 4,853,090 | 303,861 |
| Operating expenses: | | | | | |
| Selling, general and administrative | 4,838,291 | 3,964,468 | 15,275,116 | 10,026,448 | 555,103 |
| Depreciation | 125,716 | 137,032 | 355,810 | 289,708 | 33,660 |
| Amortization of intangibles | 702,569 | 567,109 | 2,104,067 | 1,574,671 | - |
| Impairment loss on goodwill | 2,973,000 | - | 4,190,000 | - | - |
| Total operating costs | 8,639,576 | 4,668,609 | 21,924,993 | 11,890,827 | 588,763 |
| Operating loss | (3,518,156) | (2,725,168) | (11,280,682) | (7,037,737) | (284,902) |
| Interest income (expense), net | (49,653) | 104,116 | (194,661) | 476,388 | 3,749 |
| | (3,567,809) | (2,621,052) | (11,475,343) | (6,561,349) | (281,153) |

| | | | | | |
|--|----------------|----------------|-----------------|----------------|--------------|
| Loss from operations before income taxes | | | | | |
| Income tax expense (benefit) | (349,898) | - | 37,102 | (349,325) | - |
| Net loss | \$ (3,217,911) | \$ (2,621,052) | \$ (11,512,445) | \$ (6,212,024) | \$ (281,153) |

Results of operations for the Successor company for the three months ended September 30, 2008 compared with the three months ended September 30, 2007.

Revenue. Revenue increased \$13.1 million to \$25.8 million for the three months ended September 30, 2008 from \$12.7 million for the three months ended September 30, 2007. The increase was primarily driven by a \$12.3 million increase in our construction management services and the inclusion of \$1.9 million of revenue associated with the acquisitions of Innovative, Rubicon and SMLB.

Cost of Revenue. Cost of revenue increased \$10.0 million to \$20.7 million for the three months ended September 30, 2008 from \$10.7 million for the three months ended September 30, 2007. The increase was primarily driven by a volume increase in our construction management services and the inclusion of \$1.2 million of cost of revenue associated with the acquisitions of Innovative, Rubicon, and SMLB.

Gross Margin Percentage. Gross margin percentage increased by 4.6% to 19.9% for the three months ended September 30, 2008 compared to 15.3 % for the three months ended September 30, 2007. Excluding the effect of gross margin contribution associated with the acquisitions of Innovative, Rubicon and SMLB, gross margin percentage increased to 18.9% for the three months ended September 30, 2008 from 15.3% for the three months ended September 30, 2007. The overall increase in gross profit was primarily attributable improved profitability on our construction management contracts; however, we expect our total gross margin percentage to approximate 16.0%.

Selling, general and administrative expenses . Selling, general and administrative expenses increased \$0.8 million to \$4.8 million for the three months ended September 30, 2008 from \$4.0 million for the three months ended September 30, 2007. The increase was primarily driven by professional fees of approximately \$0.5 million that we expensed associated with abandoned acquisitions and the inclusion of \$0.6 million of selling, general and administrative expenses associated with the acquisitions of Innovative, Rubicon, and SMLB.

As we have experienced delays in the timing of revenues associated with certain customers, we began implementing a plan to restructure expenses to align with current operating revenues. The plan seeks to reduce operating costs associated with personnel and related costs, professional fees, and sales and marketing, which we anticipate will result in lower total selling, general and administrative costs.

Depreciation. Depreciation remained consistent at \$0.1 million for the three months ended September 30, 2008 compared to \$0.1 million for the three months ended September 30, 2007.

Amortization of intangible assets. Amortization expense increased \$0.1 million to \$0.7 million for the three months ended September 30, 2008 compared to \$0.6 million for the three months ended September 30, 2007. The increase is attributable to an increase in amortizable intangible assets as a result of our acquisitions of Innovative, Rubicon and SMLB.

Impairment loss on intangibles. We have experienced continued operating losses and had a decline in our equity market value during the three months ended September 30, 2008. Based on these potential impairment indicators, we conducted analyses of the 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, we determined that the carrying value exceeded the current fair value of our business, resulting in goodwill impairment of \$3.0 million for the three months ended September 30, 2008. At September 30, 2008, the adjusted carrying value of goodwill was \$18.8 million.

Interest income (expense), net. Our interest income (expense), net, decreased \$0.2 million to (\$0.1) million for the three months ended September 30, 2008 from \$0.1 million for the three months ended September 30, 2007. The decrease in interest income was due primarily to a lower average invested balance in the three months ended September 30, 2008 compared to the three months ended September 30, 2007.

Income tax expense (benefit). Income tax (benefit) increased \$0.4 million to (\$0.4) million for the three months ended September 30, 2008 from zero for the three months ended September 30, 2007. The tax benefit was associated with the decrease in our deferred tax liability associated with a decrease in our tax deductible goodwill.

Results of operations for the Successor company for the nine months ended September 30, 2008 compared with the nine months ended September 30, 2007.

Revenue. Revenue increased \$33.2 million to \$65.4 million for the nine months ended September 30, 2008 from \$32.2 million for the nine months ended September 30, 2007. The increase was primarily driven by a \$24.1 million increase in our construction management services and the inclusion of \$10.5 million of revenue associated with the acquisitions of Innovative, Rubicon, and SMLB.

Cost of Revenue. Cost of revenue increased \$27.3 million to \$54.7 million for the nine months ended September 30, 2008 from \$27.4 million for the nine months ended September 30, 2007. The increase was driven by the increase in revenue primarily from our construction management services and the inclusion of \$8.3 million of cost of revenue associated with the acquisitions of Innovative, Rubicon, and SMLB.

Gross Margin Percentage. Gross margin percentage increased 1.2% to 16.3% for the nine months ended September 30, 2008 compared to 15.1% for the nine months ended September 30, 2007. The increase in gross profit was primarily attributable to improved profitability on our construction management contracts.

Selling, general and administrative expenses. Selling, general and administrative expenses increased \$5.3 million to \$15.3 million for the nine months ended September 30, 2008 from \$10.0 million for the nine months ended September 30, 2007. The increase was primarily driven by \$2.2 million of selling, general and administrative expenses associated

with the acquisitions of Innovative, Rubicon and SMLB, and \$1.2 million that we expensed associated with abandoned acquisitions.

As we have experienced delays in the timing of revenues associated with certain customers and margins have contracted, we began implementing a plan to restructure expenses to align with current operating revenues. The plan seeks to reduce operating costs associated with personnel and related costs, professional fees, and sales and marketing, which we anticipate will result in lower total selling, general and administrative costs.

Depreciation. Depreciation remained consistent at \$0.4 million for the nine months ended September 30, 2008 compared to \$0.3 million for the nine months ended September 30, 2007.

Amortization of intangible assets. Amortization expense increased \$0.5 million to \$2.1 million for the nine months ended September 30, 2008 from \$1.6 million for the nine months ended September 30, 2007. The increase is attributable to an increase in the amortizable intangible assets as a result of our acquisitions of Innovative, Rubicon and SMLB.

Impairment loss on intangibles. Through the third quarter 2008, we continued to incur operating losses, revised our forecasted revenues as certain of our acquisitions have not delivered originally anticipated revenues, and experienced a market decline in our equity value. Based on these potential impairment indicators, we conducted an analyses of the 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, we determined that the carrying value exceeded the current fair value of our business, resulting in goodwill impairment of \$4.2 million for the nine months ended September 30, 2008. At September 30, 2008, the adjusted carrying value of goodwill was \$18.8 million.

Interest income (expense), net. Our interest income (expense), net, decreased \$0.7 million to (\$0.2) million for the nine months ended September 30, 2008 from \$0.5 million for the nine months ended September 30, 2007. The decrease in interest income was due primarily to a lower average invested balance in the nine months ended September 30, 2008 compared to nine months ended September 30, 2007.

Income tax expense (benefit). Income tax expense (benefit) decreased \$0.3 million to zero for the nine months ended September 30, 2008 from (\$0.3) million for the nine months ended September 30, 2007. For the nine months ended September 30, 2007, income tax benefit was \$0.3 million reflecting the value of a NOL carryback to prior periods at an effective federal rate of 34%, net of a valuation allowance on deferred tax assets.

Financial Condition, Liquidity and Capital Resources

We have historically incurred net losses and have used our cash and investments to fund our operating and investing activities. We believe that operational improvements, strategic investments and complementary acquisitions will improve the cash flows of our business. Our efforts are continuing and may include further acquisitions and realignment of our sales, general and administrative expenses. We cannot be sure, however, as to the amount and timing of the associated financial impact. Summary cash flows for the nine months ended September 30, 2008 and 2007 and for the period January 1, through January 19, 2007 (Predecessor) are as follows:

| | Successor (Fortress International Group, Inc.) | | Predecessor (TSS/Vortech) |
|---|--|--|---|
| | For the nine months ended September 30, 2008 | For the nine months ended September 30, 2007 | For the period January 1, through January 19, 2007 |
| Net cash provided by (used in) operating activities | \$ (1,896,152) | \$ (5,618,627) | \$ 656,001 |
| Net cash provided by (used in) investing activities | (2,331,281) | 31,989,260 | (127,602) |
| Net cash provided by (used in) financing activities | (2,088,524) | (8,447,522) | (1,567,920) |
| Net increase (decrease) in cash | \$ (6,315,957) | \$ 17,923,111 | \$ (1,039,521) |

Cash and cash equivalents decreased \$6.3 million to \$6.9 million at September 30, 2008 from \$13.2 million at December 31, 2007. The decrease was primarily attributable to \$1.9 million from operating activities, \$2.1 million for the purchase of SMLB and \$2.0 million for the repayment of promissory notes issued in connection with the Rubicon acquisition.

Operating Activity

Net cash used in operations decreased \$3.7 million to \$1.9 million for the nine months ended September 30, 2008 from \$5.6 million used in operations for the nine months ended September 30, 2007. The decline in cash used in operating cash flows is primarily attributable to working capital as follows:

Increase in net loss. Net loss increased \$5.3 million to \$11.5 million for the nine months ended September 30, 2008 from \$6.2 million for the nine months ended September 30, 2007. The increase in net loss was primarily attributable to a \$5.0 million increase in non-cash items consisting of the impairment loss on goodwill, amortization of intangibles and equity-based compensation expense.

Increase in working capital. Net changes in operating assets and liabilities decreased approximately \$4.1 million primarily due to trade receivables and payables, which accounts for the improvement or decline in cash used by operating activities. The decrease is primarily attributable to managing our trade accounts receivable and corresponding payables.

Investing Activity

Net cash used in investing increased \$34.3 million to \$2.3 million used in investing activities for the nine months ended September 30, 2008 from \$32.0 million provided by investing activities for the nine months ended September 30, 2007. The increase was primarily attributable to our transition to an operating Company in the first quarter of 2007 and the release of investments held in trust for general operating purposes.

Sale of investments held in Trust. Upon the approval of the TSS/Vortech acquisition, we had a cash inflow from the sale of approximately \$44.7 million in trust investments, which funded the cash portion of the acquisition and repurchase of common stock from dissenting shareholders electing to receive their IPO proceeds back and provided cash for future ongoing operations.

Acquisitions. Net cash used to acquire businesses decreased \$10.2 million to \$2.1 million for the nine months ended September 30, 2008 from \$12.3 million for the nine months ended September 30, 2007. In the first quarter of 2008, we acquired SMLB, Ltd. which had a significantly lower enterprise value and in turn lower cash purchase price component as compared to TSS/Vortech acquisition, which occurred in the first quarter of 2007.

Financing Activity

Net cash used in financing decreased \$6.3 million to \$2.1 million for the nine months ended September 30, 2008 from \$8.4 million for the nine months ended September 30, 2007. The decrease in cash used in financing activities was attributable fundamentally to different activity as described in the following:

- *Repayment of seller notes.* During the nine months ended September 30, 2008, we repaid \$2.0 million of unsecured promissory notes that were issued to the Rubicon sellers upon achievement of certain financial targets at December 31, 2007 and June 30, 2008.
- *Repurchase of common stock.* During the first quarter of 2007, we used \$6.2 million to repurchase our common stock associated with the election of conversion rights by our dissenting shareholders in connection with our acquisition of TSS/Vortech and \$1.3 million in a share buyback program. The share buyback program was suspended in the third quarter of 2007; however, during 2008 we repurchased 14,885 shares at an average price of \$3.19 per share for employee taxes associated with net issuance of vesting restricted stock.

Non-Cash Activities

During the nine months ended September 30, 2008, we issued total unsecured promissory notes totaling \$0.5 million as purchase consideration. In connection with the acquisitions of SMLB, we initially issued \$0.5 million of unsecured promissory notes that were reduced in the second quarter 2008 to \$15,248 pursuant to the working capital requirements per the original purchase agreement. Consistent with the Rubicon purchase agreement in exchange for achieving specified financial targets through June 30, 2008, we issued an additional \$0.4 million of unsecured promissory notes.

During the third quarter 2008, the Chief Executive Officer and Chief Operating Officer, both of the selling members of TSS/Vortech, entered into an agreement with the Company to convert \$2,500,000 and \$1,000,000, respectively, of their respective notes into common stock at a conversion price of \$7.50 per share, resulting in the aggregate issuance of 466,667 common shares. The conversion has been recorded as an increase to additional paid-in capital. In addition, the Chief Operating Officer agreed to postpone any principal and interest payments payable to him under his remaining \$4,000,000 promissory note until March, 2010, with such interest to be accrued to the outstanding principal. At September 30, 2008, \$4,000,000 of the seller notes remains outstanding, which are convertible at \$7.50 per shares to 533,333 shares of the Company's common stock.

For a discussion of our acquisitions, see Note 3 of the Notes to Consolidated Financial Statements-Acquisitions.

Liquidity

In the third quarter of 2008, we initiated a plan to restructure expenses to realign them with the current operating revenues and gross margins as certain customers have delayed their spending. Our plan seeks to reduce operating costs associated with professional fees, sales and marketing, and personnel and related costs.

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. We

may elect to secure additional capital in the future, if available and 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 and differ in structure relative to past acquisitions. 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 shareholders. If we raise additional funds through the issuance of debt securities, the terms of such debt could impose additional restrictions on our operations. Additional capital, if required, may not be available on acceptable terms, if at all. If we are unable to obtain additional financing, we may be required to reduce the scope of acquisition plans, which could impact our business, financial condition and earnings.

Off Balance Sheet Arrangements

At September 30, 2008, we do not have any off balance sheet arrangements.

Item 3. Quantitative and Qualitative Disclosures about Market Risk.

Refer to our annual report on Form 10-K for the year ended December 31, 2007, as amended, for a complete discussion of our market risk. There have been no material changes to the market risk information included in our Annual Report on form 10-K, as amended, for the year ended December 31, 2007.

Item 4T. 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 September 30, 2008. Based upon that evaluation, our Chief Executive Officer and Chief Financial Officer have concluded that as of September 30, 2008, our disclosure controls and procedures were ineffective.

Changes in Internal Control over Financial Reporting

There were no other changes in the Company's internal control over financial reporting for the third quarter of 2008 that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting as such term is defined in Rule 13a-15 and 15d-15 of the Exchange Act.

PART II - OTHER INFORMATION**Item 1. Legal Proceedings.**

We are not currently subject to any material legal proceedings, nor, to our knowledge, is any material legal proceeding threatened against us.

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, 2007 and subsequent quarterly reports, 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 as well as adversely affect the value of an investment in our common stock.

There have been no material updates to the risk factors previously disclosed in our Form 10-K for the year ended December 31, 2007.

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

The table set forth below shows all repurchases of securities by us during the quarter ended September 30, 2008:

| Monthly Period During the Quarter Ended September 30, 2008 | Total Shares Purchased | Average Price Paid per Share | Total Shares Purchased as Part of Publically Announced Plans | Approximate Dollar Amount of Shares Yet To Be Purchased Under Plans |
|--|------------------------|------------------------------|--|---|
| July 1, 2008-July 31, 2008 | 8,028 | \$ 2.27 | - | - |

Edgar Filing: Fortress International Group, Inc. - Form 10-Q

| | | | | |
|---------------------------------------|-------|----|------|---|
| August, 1 2008-August 31, 2008 | - | \$ | | |
| September 1, 2008- September 30, 2008 | 867 | \$ | 1.31 | - |
| Total | 8,895 | \$ | 2.18 | |

The Company repurchased 8,895 shares for employee taxes associated with net issuance of vesting restricted stock.

22

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

| Number | Description |
|--------|--|
| 10.1 | Amendment to Employment Agreement between Fortress International Group, Inc. and Thomas P. Rosato, dated August 26, 2008. |
| 10.2 | Amendment to Employment Agreement between Fortress International Group, Inc. and Gerard G. Gallagher, dated August 26, 2008. |
| 10.3 | Amendment to Employment Agreement between Fortress International Group, Inc. and Harvey L. Weiss, dated August 26, 2008. |
| 10.4 | Amendment to Employment Agreement between Fortress International Group, Inc. and Timothy C. Dec, dated August 26, 2008. |
| 10.5 | Amendment to Consulting Agreement between Fortress International Group, Inc. and Washington Capital Advisors, Inc. , dated August 26, 2008. |
| 31.1 | Certificate of Fortress International Group, Inc. Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002. |
| 31.2 | Certificate of Fortress International Group, Inc. Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002. |
| 32.1‡ | Certificate of Fortress International Group, Inc. Chief Executive Officer and Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. |

‡ Furnished herewith.

23

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.

FORTRESS INTERNATIONAL GROUP, INC.

Date: November 14, 2008

By: /s/ Thomas P. Rosato
Thomas P. Rosato
*Chief Executive Officer (Authorized
Officer and Principal Executive Office)*

Date: November 14, 2008

By: /s/ Timothy C. Dec
Timothy C. Dec
*Chief Financial Officer (Authorized Officer and
Principal Financial and Accounting Officer)*