

PARADIGM HOLDINGS, INC

FORM 10-Q (Quarterly Report)

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**UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549**

FORM 10-Q

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

For the quarterly period ended September 30, 2009

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 000-09154

PARADIGM HOLDINGS, INC.

(Exact name of registrant as specified in its charter)

WYOMING
(State or other jurisdiction
of incorporation or organization)

83-0211506
(IRS Employer
Identification No.)

9715 KEY WEST AVE., 3RD FLOOR
ROCKVILLE, MARYLAND
(Address of principal executive offices)

20850
(Zip Code)

(301) 468-1200
(Registrant's telephone number, including area code)

None
(Former name, former address, and former fiscal year,
if changed since last report)

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

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

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

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

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

Shares of common stock outstanding on November 6, 2009 were 43,868,027 .

PART I. FINANCIAL INFORMATION

Item 1.	Condensed Consolidated Financial Statements (unaudited)	3
	Condensed Consolidated Balance Sheets	3
	Condensed Consolidated Statements of Operations	4
	Condensed Consolidated Statements of Cash Flows	5
	Notes to Condensed Consolidated Financial Statements	7
Item 2.	Management's Discussion and Analysis of Financial Condition and Results of Operations	24
Item 3.	Quantitative and Qualitative Disclosures About Market Risk	33
Item 4.	Controls and Procedures	33
Item 4T.	Controls and Procedures	34

PART II. OTHER INFORMATION

Item 1.	Legal Proceedings	35
Item 1A.	Risk Factors	35
Item 2.	Unregistered Sales of Equity Securities and Use of Proceeds	35
Item 3.	Defaults Upon Senior Securities	35
Item 4.	Submission of Matters to a Vote of Security Holders	35
Item 5.	Other Information	35
Item 6.	Exhibits	36

SIGNATURES 37**CERTIFICATIONS**

EXHIBIT 31.1

EXHIBIT 31.2

EXHIBIT 32.1

EXHIBIT 32.2

PART I: FINANCIAL INFORMATION

Item 1. CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

**PARADIGM HOLDINGS, INC.
CONDENSED CONSOLIDATED BALANCE SHEETS**

	September 30, 2009	December 31, 2008
	(unaudited)	
ASSETS		
Current assets		
Cash and cash equivalents	\$ 134,719	\$ 52,257
Accounts receivable - contracts, net	5,212,932	6,920,768
Prepaid expenses	745,685	1,033,837
Prepaid corporate income taxes	—	47,092
Deferred income tax assets	34,473	60,269
Other current assets	432,869	554,610
Total current assets	6,560,678	8,668,833
Property and equipment, net	132,825	183,612
Goodwill	3,991,605	3,991,605
Intangible assets, net	984,136	1,244,591
Deferred financing costs, net	948,418	—
Deferred income tax assets, net of current portion	443,646	211,326
Other non-current assets	681,914	172,029
Total Assets	\$ 13,743,222	\$ 14,471,996
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities		
Note payable — line of credit	\$ 3,096,851	\$ 5,949,983
Note payable — promissory note	—	2,000,000
Capital leases payable, current portion	—	1,578
Accounts payable and accrued expenses	2,155,191	3,498,690
Accrued salaries and related liabilities	1,578,908	1,474,133
Corporate income tax payable	52,827	—
Mandatorily redeemable preferred stock, current portion	350,000	—
Other current liabilities	86,831	227,200
Total current liabilities	7,320,608	13,151,584
Long-term liabilities		
Other non-current liabilities	127,559	183,870
Mandatorily redeemable preferred stock - \$.01 par value, 10,000,000 shares authorized, 6,206 shares issued and outstanding as of September 30, 2009	4,483,923	—
Put warrants	1,465,082	—
Total liabilities	13,397,172	13,335,454
Commitments and contingencies		
Convertible preferred stock - \$.01 par value, 10,000,000 shares authorized, 0 and 1,800 shares issued and outstanding as of September 30, 2009 and December 31, 2008, respectively. Each share of convertible preferred stock has a liquidation preference of \$.01 per share plus all accrued but unpaid dividends	—	18
Common stock - \$.01 par value, 50,000,000 shares authorized, 41,243,027 shares and 19,148,153 shares issued and outstanding as of September 30, 2009 and December 31, 2008, respectively	412,431	191,482
Additional paid-in capital	3,344,646	3,215,400
Accumulated deficit	(3,411,027)	(2,270,358)
Total stockholders' equity	346,050	1,136,542
Total liabilities and stockholders' equity	\$ 13,743,222	\$ 14,471,996

The accompanying Notes to the Condensed Consolidated Financial Statements are an integral part of these condensed consolidated financial statements.

PARADIGM HOLDINGS, INC.
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(Unaudited)

	Three Months Ended		Nine months Ended	
	September 30, 2009	September 30, 2008	September 30, 2009	September 30, 2008
Contract Revenue				
Service contracts	\$ 5,713,956	\$ 7,079,396	\$ 17,180,060	\$ 21,388,614
Repair and maintenance contracts	2,322,972	2,485,063	7,235,964	9,593,523
Total contract revenue	<u>8,036,928</u>	<u>9,564,459</u>	<u>24,416,024</u>	<u>30,982,137</u>
Cost of revenue				
Service contracts	4,353,955	5,324,087	13,244,991	16,394,569
Repair and maintenance contracts	1,805,342	2,223,919	5,911,417	8,417,479
Total cost of revenue	<u>6,159,297</u>	<u>7,548,006</u>	<u>19,156,408</u>	<u>24,812,048</u>
Gross margin	1,877,631	2,016,453	5,259,616	6,170,089
Selling, general and administrative	1,711,850	2,115,270	5,566,304	6,319,257
Income (loss) from operations	<u>165,781</u>	<u>(98,817)</u>	<u>(306,688)</u>	<u>(149,168)</u>
Other income (expense)				
Interest income	2	65	8	2,772
Change in fair value of put warrants	1,463,910	—	463,085	—
Interest expense – mandatorily redeemable preferred stock	(418,248)	—	(950,223)	—
Interest expense	(118,697)	(230,658)	(435,475)	(736,649)
Other income (expense)	—	—	—	227
Total other income (expense)	<u>926,967</u>	<u>(230,593)</u>	<u>(922,605)</u>	<u>(733,650)</u>
Income (loss) from operations before income taxes	1,092,748	(329,410)	(1,229,293)	(882,818)
Provision (benefit) for income taxes	135,069	(105,263)	(88,624)	(255,505)
Net income (loss)	<u>\$ 957,679</u>	<u>\$ (224,147)</u>	<u>\$ (1,140,669)</u>	<u>\$ (627,313)</u>
Dividends on preferred stock	—	45,000	78,870	135,000
Net income (loss) attributable to common shareholders	<u><u>\$ 957,679</u></u>	<u><u>\$ (269,147)</u></u>	<u><u>\$ (1,219,539)</u></u>	<u><u>\$ (762,313)</u></u>
Weighted average number of common shares:				
Basic	41,243,027	19,148,153	36,299,722	19,148,153
Diluted	79,262,830	19,148,153	36,299,722	19,148,153
Basic net income (loss) per common share	\$ 0.02	\$ (0.01)	\$ (0.03)	\$ (0.04)
Diluted net loss per common share	\$ (0.01)	\$ (0.01)	\$ (0.03)	\$ (0.04)

The accompanying Notes to the Condensed Consolidated Financial Statements are an integral part of these condensed consolidated financial statements.

PARADIGM HOLDINGS, INC.
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(Unaudited)

	Nine Months Ended September 30,	
	2009	2008
CASH FLOWS FROM OPERATING ACTIVITIES		
Net loss	\$ (1,140,669)	\$ (627,313)
Adjustments to reconcile net loss to net cash used in operating activities:		
Share-based compensation	487,175	420,095
Depreciation and amortization	329,082	468,824
Bad debt recovery	(1,748)	(25,468)
Amortization of deferred financing costs	226,660	—
Interest expense for accretion of warrant discount	251,279	—
Accretion of preferred stock	283,370	—
Change in fair value of put warrants	(463,085)	—
Loss on disposal of property and equipment	22,841	—
Deferred income taxes	(206,524)	(291,200)
(Increase) Decrease in		
Accounts receivable - contracts, net	1,709,584	717,249
Prepaid expenses	283,152	256,813
Prepaid corporate income taxes	47,092	(16,242)
Other current assets	121,741	5,776
Other non-current assets	(544,885)	15,892
(Decrease) Increase in		
Accounts payable and accrued expenses	(1,308,604)	(187,286)
Accrued salaries and related liabilities	104,775	953
Corporate income tax payable	52,827	—
Other current liabilities	(140,369)	379,028
Other non-current liabilities	(56,311)	(75,278)
Net cash provided by operating activities	57,383	1,041,843
CASH FLOWS FROM INVESTING ACTIVITIES		
Cash paid for business acquisitions, net of cash assumed	—	(80,116)
Purchase of property and equipment	(30,574)	(27,968)
Net cash used in investing activities	(30,574)	(108,084)
CASH FLOWS FROM FINANCING ACTIVITIES		
Bank overdraft	—	(1,181,997)
Payments on capital leases	(1,578)	(23,968)
Payment on notes payable	(2,000,000)	(18,228)
Proceeds from mandatorily redeemable preferred stock	6,206,000	—
Preferred stock issuance costs	(1,113,637)	—
Dividends paid on Series A Preferred Stock	(75,000)	(135,000)
Repurchase of Series A Preferred Stock	(107,000)	—
Proceeds from line of credit	34,705,476	47,178,821
Payments on line of credit	(37,558,608)	(46,759,146)
Net cash provided by (used in) financing activities	55,653	(939,518)
Net increase (decrease) in cash and cash equivalents	82,462	(5,759)
Cash and equivalents, beginning of period	52,257	7,771
Cash and cash equivalents, end of period	\$ 134,719	\$ 2,012

For the nine months ended September 30,	2009	2008
SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION		
Cash paid during the year:		
Cash paid for income taxes	\$ 17,984	\$ 55,101
Cash paid for interest	\$ 644,927	\$ 775,257
Non-cash financing activities:		
Conversion of Series A preferred stock to common stock	\$ 1,191,771	\$ —
Dividends declared but not paid	\$ —	\$ 45,000

The accompanying Notes to the Condensed Consolidated Financial Statements are an integral part of these condensed consolidated financial statements.

PARADIGM HOLDINGS, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Unaudited)

1. ORGANIZATION AND SIGNIFICANT ACCOUNTING POLICIES

Basis of Presentation

Paradigm Holdings, Inc. (the “Company”) is the parent of the wholly owned subsidiaries, Paradigm Solutions Corp., Trinity IMS, Inc. (“Trinity”) and Caldwell Technology Solutions, LLC (“CTS”). Reference is made to the Annual Report on Form 10-K for the Company for the year ended December 31, 2008 filed with the Securities and Exchange Commission (the “SEC”) for additional information on our corporate structure.

The interim condensed consolidated financial statements have been prepared pursuant to the rules and regulations of the SEC. Therefore, certain financial information and footnote disclosures accompanying annual financial statements prepared in accordance with generally accepted accounting principles in the United States of America (“GAAP”) are omitted in this interim report. The interim condensed consolidated financial statements and notes thereto should be read in conjunction with the Annual Report on Form 10-K for the Company for the year ended December 31, 2008.

The accompanying unaudited condensed consolidated financial statements for the Company reflect all normal recurring adjustments that are necessary, in the opinion of management, to present fairly the results of operations in accordance with GAAP. All significant intercompany accounts and transactions have been eliminated in consolidation. The results for the interim periods are not necessarily indicative of the results to be expected for the fiscal year.

Liquidity

As of September 30, 2009, the Company had an accumulated deficit of approximately \$3.4 million and working capital deficit of \$0.8 million. Additionally, the Company is dependent on a line-of-credit financing arrangement. Although there can be no assurances, the Company believes that cash flow from operations, together with borrowings available from our credit facility with Silicon Valley Bank (“SVB”) and the combination of in-process cost reductions will be adequate to meet future liquidity needs for the next twelve months.

For a description of the Company’s accounting policies, refer to Note 1 of the Notes to Consolidated Financial Statements of the Annual Report on Form 10-K for Paradigm Holdings, Inc. for the year ended December 31, 2008.

Revenue Recognition

Substantially all of the Company's revenue is derived from service and solutions provided to the federal government by Company employees and subcontractors.

The Company generates its revenue from three different types of contractual arrangements: (i) time and materials contracts, (ii) cost-plus reimbursement contracts, and (iii) fixed price contracts.

Time and Materials (“T&M”). For T&M contracts, revenue is recognized based on direct labor hours expended in the performance of the contract by the contract billing rates and adding other billable direct costs.

Cost-Plus Reimbursement (“CP”). Under CP contracts, revenue is recognized as costs are incurred and include an estimate of applicable fees earned. For award based fees under CP contracts, the Company recognizes the relevant portion of the expected fee to be awarded by the client at the time such fee can be reasonably estimated and collection is reasonably assured based on factors such as prior award experience and communications with the client regarding performance.

Fixed Price (“FP”). The Company has two basic categories of FP contracts: (i) fixed price-level of effort (“FP-LOE”) and (ii) firm fixed price (“FFP”).

- Under FP-LOE contracts, revenue is recognized based upon the number of units of labor actually delivered multiplied by the agreed rate for each unit of labor. Revenue on fixed unit price contracts, where specific units of output under service agreements are delivered, is recognized as units are delivered based on the specific price per unit. For FP maintenance contracts, revenue is recognized on a pro-rata basis over the life of the contract.
- Under FFP contracts, revenue is generally recognized subject to the provision of the SEC Staff Accounting Bulletin (“SAB”) No. 104, “Revenue Recognition.” For those contracts that are within the scope of Accounting Standards Codification (“ASC”) 605-35, “Revenue Recognition; Construction-Type and Production-Type Contracts,” revenue is recognized on the percentage-of-completion method using costs incurred in relation to total estimated costs.

In certain arrangements, the Company enters into contracts that include the delivery of a combination of two or more of its service offerings. Such contracts are divided into separate units of accounting. Revenue is recognized separately in accordance with the Company's revenue recognition policy for each element. Further, if an arrangement requires the delivery or performance of multiple deliveries or elements under a bundled sale, the Company determines whether the individual elements represent "separate units of accounting" under the requirements of ASC 605-25, “Revenue Recognition; Multiple Element Arrangements,” and allocates revenue to each element based on relative fair value.

Software revenue recognition for sales of OpsPlanner is in accordance with ASC 985-605, “Software Revenue Recognition.” Since the Company has not yet established vendor specific objective evidence of fair value for the multiple elements typically contained within an OpsPlanner sale, revenue from the sale of OpsPlanner is recognized ratably over the term of the contract. The OpsPlanner software was sold as part of the sale of the commercial business on February 28, 2007. Effective March 1, 2007, the Company became the exclusive reseller of the OpsPlanner software to the federal government.

In certain contracts, revenue includes third-party hardware and software purchased on behalf of clients. The level of hardware and software purchases made for clients may vary from period to period depending on specific contract and client requirements. The Company recognizes the gross revenue under ASC 605-45, “Revenue Recognition; Principal Agent Considerations,” for certain of its contracts which contain third-party products and services, because in those contracts, the Company is contractually bound to provide a complete solution which includes labor and additional services in which the Company maintains contractual, technical and delivery risks for all services and agreements provided to the customers, and the Company may be subject to financial penalties for non-delivery.

The Company is subject to audits from federal government agencies. The Company has reviewed its contracts and believes there is no material risk of any significant financial adjustments due to government audit. To date, the Company has not had any adjustments as a result of a government audit of its contracts.

Revenue recognized on contracts for which billings have not yet been presented to customers is included in unbilled receivables.

Deferred revenue relates to contracts for which customers pay in advance for services to be performed at a future date. The Company recognizes deferred revenue attributable to its software and maintenance contracts over the related service periods.

Cost of Revenue

Cost of revenue for service contracts consists primarily of labor, consultant, subcontract, materials, travel expenses and an allocation of indirect costs attributable to the performance of the contract.

Cost of revenue for repair and maintenance contracts consist primarily of labor, consultant, subcontract, materials, travel expenses and an allocation of indirect costs attributable to the performance of the contract. Certain costs are deferred based on the recognition of revenue for the associated contracts.

Goodwill and Intangible Assets

Goodwill represents the excess of cost over the fair value of net assets acquired in business combinations. Pursuant to ASC 350, "Intangibles-Goodwill and Other," goodwill and intangible assets with indefinite lives are not amortized, but instead are tested for impairment at least annually. ASC 350-30 also requires that identifiable intangible assets with estimable useful lives be amortized over their estimated useful lives, and reviewed for impairment in accordance with ASC 360-10, "Property, Plant, and Equipment."

The Company conducts a review for impairment of goodwill and indefinite lived intangible assets annually in the fourth quarter. Additionally, on an interim basis, the Company assesses the impairment of goodwill and intangible assets whenever events or changes in circumstances indicate that the carrying value may not be recoverable. Factors that the Company considers important which could trigger an impairment review include significant underperformance relative to historical or expected future operating results significant changes in the manner or use of the acquired assets or the strategy for the overall business, significant negative industry or economic trends or a decline in a company's stock price for a sustained period. Goodwill and intangible assets are subject to impairment to the extent the Company's operations experience significant negative results. These negative results can be the result of the Company's individual operations or negative trends in the Company's industry or in the general economy, which impact the Company. To the extent the Company's goodwill and intangible assets are determined to be impaired then these balances are written down to their estimated fair value on the date of the determination. At September 30, 2009, there were no such factors indicating that the Company's goodwill and intangible assets were impaired.

Share-based Compensation

The Company follows the provisions of ASC 718, "Compensation-Stock Compensation," to account for share-based compensation. Option awards granted after January 1, 2006 and those previously granted, but for which vesting provisions had not been met, are valued at fair value based on the Black-Scholes option-pricing model and the fair value is recognized as an expense on a straight line basis over the requisite service period. Restricted common stock granted after January 1, 2006 is valued at fair value based on the closing market price on the date of grant. Total share-based compensation expense included in selling, general and administrative expenses in the accompanying condensed consolidated statements of operations was \$92 thousand and \$140 thousand for the three months ended September 30, 2009 and 2008, respectively, including the expense recognized for the restricted common stock issued on October 21, 2008 and May 3, 2007. Total share-based compensation expense was \$487 thousand and \$420 thousand for the nine months ended September 30, 2009 and 2008, respectively. The Company did not grant any share-based awards for the three and nine months ended September 30, 2009.

Valuation of Warrants

The Company accounts for the issuance of common stock purchase warrants in accordance with the provisions of ASC 815-40. The Class A Warrants and Class B Warrants issued in connection with the sale of the Company's Series A-1 Senior Preferred Stock, par value \$0.01 per share (the "Series A-1 Preferred Stock"), contain a provision that could require cash settlement and that event is outside the control of the Company, and therefore are classified as a liability as of September 30, 2009. The Company assesses classification of put warrants at each reporting date to determine whether a change in classification is required. The Company values put warrants using the Black-Scholes valuation model. Put warrants are valued upon issuance, and re-valued at each financial statement reporting date. Any change in value is charged to other income or expense during the period.

Major Customers

Nearly all of the Company's revenue is from federal agencies and 78% and 75% of total revenue was generated from three major customers during the three and nine months ended September 30, 2009 and 70% and 66% of total revenue was generated from three major customers during the three and nine months ended September 30, 2008, respectively. The Company's accounts receivable related to these three major customers was 76% of total accounts receivable at September 30, 2009. The Company's accounts receivable related to the two major customers was 51% of total accounts receivable at December 31, 2008. The Company defines major customer by agencies within the federal government.

A majority of the Company's customer concentration is in the Mid-Atlantic states of the United States.

Segment Reporting

ASC 280, “Segment Reporting” establishes standards for the way that public business enterprises report information about operating segments in annual financial statements and requires that these enterprises report selected information about operating segments in interim financial reports. ASC 280 also establishes standards for related disclosures about products and services, geographic areas and major customers. Management has concluded that the Company operates in one segment based upon the information used by management in evaluating the performance of its business and allocating resources and capital.

Recently Issued Accounting Standards – Not Yet Adopted

In October 2009, the Financial Accounting Standards Board (“FASB”) issued Accounting Standards Update (ASU) 2009-13, Multiple-Deliverable Revenue Arrangements – a consensus of the FASB Emerging Issues Task Force to amend certain guidance in FASB Accounting Standards CodificationTM (ASC) 605, Revenue Recognition, 25, “Multiple-Element Arrangements”. The amended guidance in ASC 605-25 (1) modifies the separation criteria by eliminating the criterion that requires objective and reliable evidence of fair value for the undelivered item(s), and (2) eliminates the use of the residual method of allocation and instead requires that arrangement consideration be allocated, at the inception of the arrangement, to all deliverables based on their relative selling price. The FASB also issued ASU 2009-14, “Certain Revenue Arrangements That Include Software Elements – a consensus of the FASB Emerging Issues Task Force” to amend the scope of arrangements under ASC 985, “Software”, 605, “Revenue Recognition” to exclude tangible products containing software components and non-software components that function together to deliver a product’s essential functionality. The amended guidance in ASC 605-25 and ASC 985-605 is effective prospectively for revenue arrangements entered into or materially modified in fiscal years beginning on or after June 15, 2010, with early application and retrospective application permitted. The Company expects to prospectively apply the amended guidance in ASC 985-605, concurrently with the amended guidance in ASC 605-25, beginning on January 1, 2011. The Company is in the process of evaluating the impact the amendments to ASC 605-25 and ASC 985-605 will have on its consolidated finance statements.

In September 2009, the FASB issued ASU No. 2009-12, “Fair Value Measurements and Disclosure” (“ASU 2009-12”). This standard provides additional guidance on using the net asset value per share, provided by an investee, when estimating the fair value of an alternate investment that does not have a readily determinable fair value and enhances the disclosures concerning these investments. Examples of alternate investments, within the scope of this standard, include investments in hedge funds and private equity, real estate, and venture capital partnerships. This Standard is effective for interim and annual periods ending after December 15, 2009. This statement is likely not to have a material effect on the condensed consolidated financial statements as the Company does not currently have any investments measured at net asset value.

In August 2009, the FASB issued ASU No. 2009-05, “Measuring Liabilities at Fair Value” (“ASU 2009-05”). ASU 2009-05 amends ASC Topic 820, “Fair Value Measurements”. Specifically, ASU 2009-05 provides clarification that in circumstances in which a quoted price in an active market for the identical liability is not available, a reporting entity is required to measure fair value using one or more of the following methods: 1) a valuation technique that uses a) the quoted price of the identical liability when traded as an asset or b) quoted prices for similar liabilities or similar liabilities when traded as assets and/or 2) a valuation technique that is consistent with the principles of Topic 820 of the ASC (e.g. an income approach or market approach). ASU 2009-05 also clarifies that when estimating the fair value of a liability, a reporting entity is not required to adjust to include inputs relating to the existence of transfer restrictions on that liability. The adoption of this standard is effective on October 1, 2009 for the Company and is not expected to have an impact on the Company’s consolidated financial position or results of operations; however, this standard may impact the Company in future periods.

In June 2009, the FASB issued guidance to replace the calculation for determining which entities, if any, have a controlling financial interest in a variable interest entity (“VIE”) from a quantitative based risks and rewards calculation, to a qualitative approach that focuses on identifying which entities have the power to direct the activities of a variable interest entity that most significantly impact the entity’s economic performance and, the obligation to absorb losses of the entity or the right to receive benefits from the entity. This standard also requires ongoing assessments as to whether an enterprise is the primary beneficiary of a VIE (previously, reconsideration was only required upon the occurrence of specific events), modifies the presentation of consolidated VIE assets and liabilities, and requires additional disclosures about a company’s involvement in VIEs. This guidance will be effective for the Company beginning January 1, 2010. Management is currently evaluating the effect that adoption of this standard will have on the Company’s consolidated financial position and results of operations when it becomes effective in 2010.

Recently Adopted Accounting Standards

On July 1, 2009, the Company adopted ASU 2009-01 “FASB Accounting Standards Codification.” This guidance confirms that the FASB Accounting Standards Codification (the “Codification”) becomes the single official source of authoritative U.S. GAAP (other than guidance issued by the SEC), superseding existing FASB, American AICPA, EITF, and related literature. After that date, only one level of authoritative U.S. GAAP will exist. All other literature will be considered non-authoritative. The Codification does not change U.S. GAAP; instead, it introduces a new structure that is organized in an easily accessible, user-friendly online research system. The adoption of this guidance did not have a material impact on the Company’s condensed consolidated financial statements.

On June 30, 2009, the adopted Company provisions of ASC 825, “Financial Instruments”, which requires disclosures about fair value of financial instruments for interim reporting periods of publicly traded companies as well as in annual financial statements. The adoption of ASC 825 did not have a material impact on the Company’s statement of operations, financial position, or cash flows.

On June 30, 2009, the Company adopted ASC 855, “Subsequent Events,” which establishes general standards of accounting and disclosure for events that occur after the balance sheet date but before the financial statements are issued. The adoption of ASC 855 did not have a material impact on the Company’s statements of operations, financial position, or cash flows.

On January 1, 2009, the Company adopted ASC 815, “Derivatives and Hedging.” The statement modifies and expands the disclosure requirements for derivative instruments and hedging activities. ASC 815 requires that objectives for using derivative instruments be disclosed in terms of underlying risk and accounting designation and requires quantitative disclosures about fair value amounts and gains and losses on derivative instruments. It also requires disclosures about credit-related contingent features in derivative agreements. The adoption of ASC 815 did not have a material impact on the Company’s statements of operations, financial position or cash flows.

On January 1, 2009, the Company adopted ASC 810, “Consolidation.” The statement establishes the accounting and reporting standards for the noncontrolling interest in a subsidiary and for the deconsolidation of a subsidiary. The adoption of ASC 810 did not have a material impact on the Company’s statements of operations, financial position or cash flows as the Company does not have any noncontrolling interests in other active companies.

On January 1, 2009, the Company adopted ASC 805, “Business Combinations.” The statement establishes principles and requirements for how the acquirer recognizes and measures the identifiable assets acquired, the goodwill acquired, the liabilities assumed and any noncontrolling interest in the acquiree and determines what information to disclose to enable users of the financial statements to evaluate the nature and financial effects of the business combination. This standard did not have immediate impact upon adoption by the Company, but will result in items such as transaction and acquisition related-restructuring costs with respect to business combinations closing after December 31, 2008 being charged to expense when incurred. The Company will apply this ASC when evaluating potential future transactions to which it would apply.

2. FAIR VALUE MEASUREMENTS

In accordance with ASC 820, "Fair Value Measurements and Disclosures," a fair value measurement is determined based on the assumptions that a market participant would use in pricing an asset or liability. ASC 820 also established a three-tiered hierarchy that draws a distinction between market participant assumptions based on (i) observable inputs such as quoted prices in active markets (Level 1), (ii) inputs other than quoted prices in active markets that are observable either directly or indirectly (Level 2) and (iii) unobservable inputs that require the Company to use present value and other valuation techniques in the determination of fair value (Level 3).

The following table represents our financial assets and liabilities measured at fair value on a recurring basis and the basis for that measurement:

	Total Fair Value Measurement	Fair Value Measurement at September 30, 2009 Using:		
		Quoted Price in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Put warrants	\$ 1,465,082	\$ —	\$ 1,465,082	\$ —

The Company values the put warrants using the Black-Scholes model with the following assumptions:

Exercise price	\$0.078 & \$0.0858
Underlying common stock price	\$0.05
Volatility	123.2%
Contractual term	6.41 years
Risk free interest rate	2.93%
Common stock dividend rate	0%
Dilution factor	22.6%

In accordance with ASC 815, the Company has classified the fair value of the warrants as a liability and changes in the fair value of the warrants are recognized in the earnings of the Company as long as the warrants remain classified as a liability.

The Company's financial instruments also include cash and cash equivalents, accounts receivable, accounts payable, note payable - line of credit, and mandatorily redeemable preferred stock. The fair values of cash and cash equivalents, accounts receivable, accounts payable and note payable - line of credit approximated the carrying values based on market interest rates and the time to maturity. The mandatorily redeemable preferred stock was initially valued using the discounted cash flow method based on the weighted average cost of capital of 29%, and subsequently accreted to the redemption amount using the effective interest method. At September 30, 2009, the estimated fair values and carrying amounts of the mandatorily redeemable preferred stock was \$4.8 million.

3. ACCOUNTS RECEIVABLE

Accounts receivable consists of billed and unbilled amounts under contracts in progress with governmental units, principally, the Office of the Comptroller of the Currency, the Department of State, and the Internal Revenue Service. The components of accounts receivable are as follows:

	September 30, 2009	December 31, 2008
Billed receivables	\$ 2,227,260	\$ 3,826,514
Unbilled receivables	2,985,672	3,094,254
Total accounts receivable – contracts, net	\$ 5,212,932	\$ 6,920,768

All receivables are expected to be collected within the next twelve months and are pledged to SVB as collateral for the Loan and Security Agreement with SVB. The Company's unbilled receivables are comprised of contract costs that cover the current service period and are normally billed in the following month and do not include the offset of any advances received. In general, for cost-plus and time and material contracts, invoicing of the unbilled receivables occurs when contractual obligations or milestones are met. Invoicing for firm fixed price contracts occurs on delivery and acceptance. The Company's unbilled receivables at September 30, 2009 do not contain retainage. All advance payments received, if any, are recorded as deferred revenue.

The Company establishes an allowance for doubtful accounts based upon factors surrounding the historical trends and other information of the government agencies it conducts business with. Such losses have been within management's expectations. The Company reserved \$20,733 as an allowance for doubtful accounts related to certain customers at September 30, 2009 and December 31, 2008.

4. PREPAID EXPENSES

Prepaid expenses consist of the following:

	September 30, 2009	December 31, 2008
Prepaid insurance, rent and software maintenance agreements	\$ 122,365	\$ 136,357
Contract-related prepaid expenses	214,990	618,439
Other prepaid expenses	408,330	279,041
Total prepaid expenses	\$ 745,685	\$ 1,033,837

5. PROPERTY AND EQUIPMENT

Property and equipments are as follows:

	September 30, 2009	December 31, 2008
Furniture and fixtures	\$ 92,411	\$ 109,445
Equipment	740,614	778,121
Software	563,082	528,768
Leasehold improvement	31,978	43,194
Total property and equipment	1,428,085	1,459,528
Accumulated depreciation	(1,295,260)	(1,275,916)
Property and equipment, net	\$ 132,825	\$ 183,612

Depreciation and amortization expense included in selling, general and administrative expenses in the accompanying condensed consolidated statements of operations for the three and nine months ended September 30, 2009 was \$22,901 and \$68,627, respectively, and depreciation and amortization expense for the three and nine months ended September 30, 2008 was \$56,026 and \$208,369, respectively.

6. DEFERRED FINANCING COSTS

Deferred financing costs are as follows:

	September 30, 2009	December 31, 2008
Financing costs	\$ 1,175,078	\$ —
Accumulated amortization	(226,660)	—
Net carrying amount	<u>\$ 948,418</u>	<u>\$ —</u>

Financing costs incurred are amortized over the life of the associated financing arrangements using the effective interest rate method. Amortization expense included in interest expense in the accompanying condensed consolidated statements of operations for the three and nine months ended September 30, 2009 was \$98,230 and \$226,660, respectively. There was no amortization expense for the three and nine months ended September 30, 2008. Anticipated future amortization is as follows:

For the remaining three months ending December 31, 2009	\$ 100,124
For the years ending December 31, 2010	404,970
2011	399,870
2012	43,454

7. INTANGIBLE ASSETS

Intangible assets are as follows:

	September 30, 2009	December 31, 2008
Contract backlog	\$ 1,810,000	\$ 1,810,000
Accumulated amortization	(825,864)	(565,409)
Net carrying amount	<u>\$ 984,136</u>	<u>\$ 1,244,591</u>

The Company recorded \$1.8 million of contract backlog associated with the Trinity and CTS acquisitions. These intangible assets are being amortized over a period of five years and have no residual value at the end of their useful lives. Amortization expense included in selling, general and administrative expenses in the accompanying condensed consolidated statements of operations for the three and nine months ended September 30, 2009 was \$86,819 and \$260,455, respectively, and amortization expense for the three and nine months ended September 30, 2008 was \$86,818 and \$260,455, respectively. The Company estimates that it will incur the following amortization expense for the future periods indicated below.

For the remaining three months ending December 31, 2009	\$ 86,818
For the years ending December 31, 2010	347,273
2011	347,273
2012	202,772

8. ACCOUNTS PAYABLE AND ACCRUED EXPENSES

Accounts payable and accrued expenses are as follows:

	September 30, 2009	December 31, 2008
Accounts payable	\$ 1,660,550	\$ 2,969,262
Accrued expenses	494,641	529,428
Total accounts payable and accrued expenses	<u>\$ 2,155,191</u>	<u>\$ 3,498,690</u>

9. DEBT

At September 30, 2009 and December 31, 2008, outstanding debts consisted of the following:

	September 30, 2009	December 31, 2008
Current debts:		
Note payable – line of credit	\$ 3,096,851	\$ 5,949,983
Note payable – promissory note	—	2,000,000
Mandatorily redeemable preferred stock, current portion	350,000	—
Total current debt	<u>\$ 3,446,851</u>	<u>\$ 7,949,983</u>
Long-term debts:		
Mandatorily redeemable preferred stock	\$ 6,206,000	\$ —
Accretion of preferred stock	283,370	—
Less: unamortized discount	(1,655,447)	—
Carrying amount	4,833,923	—
Less: current portion	(350,000)	—
Mandatorily redeemable preferred stock, net of current portion	<u>\$ 4,483,923</u>	<u>\$ —</u>
Put warrants	<u>\$ 1,465,082</u>	<u>\$ —</u>
Total long-term debt, net of current portion	<u>\$ 5,949,005</u>	<u>\$ —</u>

Note Payable – Line of Credit

On March 13, 2007, the Company entered into two Loan and Security Agreements with SVB, one of which provided for a revolving credit facility of up to \$10 million and the other of which provided for a working capital line of credit of up to \$12 million. SVB and the Company have agreed that the revolving credit facility has no further force or effect. The Company continues to use the working capital line of credit to borrow funds for working capital and general corporate purposes. References to the Loan and Security Agreement in this description refer to the working capital line of credit agreement. The Loan and Security Agreement is secured by a first priority perfected security interest in any and all properties, rights and assets of the Company, wherever located, whether now owned or thereafter acquired or arising and all proceeds and products thereof as described in the Loan and Security Agreement.

Under the Loan and Security Agreement, the line of credit is due on demand and interest is payable monthly based on a floating per annum rate equal to the aggregate of the Prime Rate plus the applicable spread which ranges from 1.00% to 2.00%, as well as other fees and expenses as set forth more fully in the agreements. The Loan and Security Agreement requires the Company to maintain certain EBITDA covenants as specified in the Loan and Security Agreement. Because the Company was not in compliance with the EBITDA covenant at June 30, 2008, the Company and SVB amended the Loan and Security Agreement to waive the covenant compliance for the periods ended June 30 and July 31, 2008. On March 18, 2009, the Company and SVB entered into a Second Loan Modification Agreement. This Second Loan Modification Agreement amended the Loan and Security Agreement to extend the maturity date to May 12, 2009 and modify the funds available under the working capital line of credit facility to not exceed \$4.5 million and the total funds available under the Loan and Security Agreement to a maximum amount of \$5.625 million. The interest rates and EBITDA covenant are consistent with the previous agreement for the remainder of the extension period. On May 4, 2009, the Company and SVB entered into a Third Loan Modification Agreement. This Third Loan Modification Agreement amended the Loan and Security Agreement to extend the maturity date to June 12, 2009.

On July 2, 2009, the Company and SVB entered into a Fourth Loan Modification Agreement. This Fourth Loan Modification Agreement, among other things, (i) modifies the collateral handling fee payable by the Company, (ii) revises certain of the Company's representations and warranties, (iii) increases the charge to the Company for certain inspections and audits from \$750 per person per day to \$850 per person per day, (iv) revises the Company's financial covenants, (v) revises the negative covenant regarding the Company's ability to pay dividends or make any distribution or payment or redeem, retire or repurchase any capital stock without the prior consent of SVB to allow for such payments (subject to certain restrictions) to certain holders of the Company's Series A-1 Senior Preferred Stock, (vi) amends the definitions of "Prime Rate", "Applicable Rate" and "EBITDA" and (vii) extends the maturity date to June 11, 2010. The Company was in compliance with the EBITDA covenant set forth in Section 6.7(b) of the Loan and Security Agreement as of the three month period ended September 30, 2009. As of September 30, 2009, the Company had \$3.1 million outstanding, and \$1.4 million additional availability, under its working capital line of credit with SVB.

The Loan and Security Agreement contains events of default that include among other things, non-payment of principal, interest or fees, violation of covenants, inaccuracy of representations and warranties, cross default to certain other indebtedness, bankruptcy and insolvency events, change of control and material judgments. Upon occurrence of an event of default, SVB is entitled to, among other things, accelerate all obligations of the Company and sell the Company's assets to satisfy the Company's obligations under the Loan and Security Agreement. As of September 30, 2009, no events of default had occurred.

Note Payable – Promissory Note

On April 9, 2007, the Company issued a \$4.0 million promissory note to the former shareholders of Trinity to finance the acquisition of Trinity.

Under the terms of the promissory note, the Company was required to repay the principal plus interest at the annual rate of 7.75% of the unpaid balance pursuant to the following terms:

- (a) \$500 thousand was required to be paid within three business days of April 9, 2007;
- (b) \$1.5 million (the "Second Amount") was required to be paid on June 30, 2007; and
- (c) the remainder amount (the "Remainder Amount") of \$2.0 million was required be paid on October 31, 2008.

Effective as of October 31, 2008, the Company negotiated an amendment to the promissory note that extended the payment date of the Remainder Amount from October 31, 2008 to December 15, 2008 in exchange for a cash fee of \$40,000 plus accrued and unpaid interest based on the original terms. If the Company failed to pay the Remainder Amount by December 15, 2008, the Company was required to pay an amount equal to \$60,000 plus all accrued and unpaid interest through December 15, 2008. If the Company failed to pay the amounts owed under the promissory note by December 15, 2008, interest was to accrue, at a rate equal to 12% per annum, on such amounts. The Company did not pay the Remainder Amount prior to December 15, 2008. The failure by the Company to pay the Remainder Amount on or before December 15, 2008 did not constitute a default under the promissory note. The Company and Christian Kleszewski (the Company's Vice President (Trinity, IMS)) separately agreed that the \$1.0 million portion of the promissory note payable to Mr. Kleszewski was to be due in January 2009. The Company used a portion of the proceeds from the private placement described below to pay the note in full on February 27, 2009.

Mandatorily Redeemable Preferred Stock and Warrants

On February 27, 2009, the Company completed a private placement to a group of investors led by Hale Capital Partners, LP (“the Purchasers”) for gross proceed of \$6.2 million. The Company issued 6,206 shares of Series A-1 Preferred Stock, which bear an annual dividend of 12.5%. Each share of Series A-1 Preferred Stock has an initial stated value of \$1,000 per share (the “Stated Value”). The private placement included 7-year Class A Warrants to purchase an aggregate of 79,602,604 shares of Common Stock at an exercise price of \$0.0780 per share and 7-year Class B Warrants to purchase an aggregate of 69,062,248 shares of Common Stock at an exercise price of \$0.0858 per share (collectively, the “Warrants”). We refer to the Class A Warrants, the Class B Warrants and the Series A-1 Preferred Stock collectively as the “Securities”. Except for the exercise price and number of shares of Common Stock subject to the Warrants, the terms of the Class A Warrants and the Class B Warrants are substantially similar. In addition, the Class A Warrants are subject to extension for an additional seven years if the Company has not met certain milestones. The Warrants may be exercised for cash or on a cashless exercise basis. The Warrants are subject to full ratchet anti-dilution provisions and other customary anti-dilution provisions as described therein. The Warrants further provide that in the event of certain fundamental transactions or the occurrence of an event of default under the Certificate of Designations that the holder of the Warrants may cause the Company to repurchase such Warrants for the purchase price specified therein. Among the use of proceeds, \$2.1 million was used to pay off the promissory note issued in connection with our acquisition of Trinity, we paid fees and transaction costs of approximately \$1.1 million and we used the remaining \$3.0 million to pay down debt and for general working capital purposes.

Voting

The holders of Series A-1 Preferred Shares are entitled to vote together with the common stock on all matters and in the same manner. Each share of the Series A Preferred Stock shall entitle the holders to the number of votes equal to the number of shares of the common stock issuable upon exercise of all Class A Warrants held by such holder as of the record date for the vote.

Dividends

The holders of the Series A-1 Preferred Stock are entitled to receive cumulative dividends at the rate of 12.5% per annum, accruing on a daily basis and compounding monthly, with 40% of such dividends payable in cash and 60% of such dividends payable by adding such amount to the Stated Value per share of the Series A-1 Preferred Stock. The dividend shall be paid on a monthly basis to the holders of Series A-1 Preferred Stock entitled to receive such dividends.

Liquidation

Upon the occurrence of a liquidation event (including certain fundamental transactions), the holders of the Series A-1 Preferred Stock are entitled to receive prior and in preference to the payment of any amounts to the holders of any other equity securities of the Company (the “Junior Securities”) (i) 125% of the Stated Value of the outstanding shares of Series A-1 Preferred Stock, (ii) all accrued but unpaid cash dividends with respect to such shares of Series A-1 Preferred Stock and the (iii) specified repurchase prices with respect to all Warrants (as defined below) held by such holders.

Redemption

The Certificate of Designations of the Series A-1 Preferred Stock provides that any shares of Series A-1 Preferred Stock outstanding as of February 9, 2012 are to be redeemed by the Company for their Stated Value plus all accrued but unpaid cash dividends on such shares (the “Redemption Price”). In addition, on the last day of each calendar month beginning February 2009 through and including February 2010, the Company is required to redeem the number of shares of Series A-1 Preferred Stock obtained by dividing 100% of all Excess Cash Flow (as defined in the Certificate of Designations) with respect to such month by the Redemption Price applicable to the shares to be redeemed. Further, on the last day of each month beginning March 2010 through and including January 2012, the Company shall redeem the number of shares of Series A-1 Preferred Stock obtained by dividing the sum of \$50,000 plus 50% of the Excess Cash Flow with respect to such month by the Redemption Price applicable to the shares to be redeemed. At anytime prior to February 9, 2012, the Company may redeem shares of Series A-1 Preferred Stock for 125% of the Stated Value of such shares plus all accrued but unpaid cash dividends for such shares. If at anytime a Purchaser realizes cash proceeds with respect to the Securities or common stock received upon exercise of the Warrants equal to or greater than the aggregate amount paid by the Purchaser for the Securities plus 200% of such amount then the Company has the option to repurchase all outstanding shares of Series A-1 Preferred Stock held by that Purchaser for no additional consideration.

Covenants

The Preferred Stock Purchase Agreement and the Certificate of Designations also contain certain affirmative and negative covenants. The negative covenants require the prior approval of Hale Capital, for so long as (i) an aggregate of not less than 15% of the shares of Series A-1 Preferred Stock purchased on February 27, 2009 are outstanding, (ii) Warrants to purchase an aggregate of not less than 20% of the shares issuable pursuant to the Warrants on February 27, 2009 are outstanding or (iii) the Purchasers, in the aggregate, own not less than 15% of the common stock issuable upon exercise of all Warrants on February 27, 2009 (we refer to (i), (ii) and (iii) as the "Ownership Threshold") in order for the Company to take certain actions, including, among others, (i) amending the Company's Articles of Incorporation or other charter documents, (ii) liquidating, dissolving or winding-up the Company, (iii) merging with, consolidating with or acquiring or being acquired by, or selling all or substantially all of its assets to, any person, (iv) selling, licensing or transferring any capital stock or assets with a value, individually or in the aggregate, of \$100,000 or more, (v) undergoing certain fundamental transactions, (vi) certain issuances of capital stock, (vii) certain redemptions or dividend payments, (viii) the creation, incurrence or assumption of certain types of indebtedness or liens, (ix) increasing or decreasing the size of the Company's Board of Directors and (x) appointing, hiring, suspending or terminating the employment or materially modifying the compensation of any executive officer.

The Company accounts for its preferred stock based upon the guidance enumerated in ASC 480, "Distinguishing Liabilities from Equity." The Series A-1 Preferred Stock is mandatorily redeemable on February 9, 2012 and therefore is classified as a liability instrument on the date of issuance. The mandatorily redeemable preferred stock was initially valued using the discounted cash flow method based on the weighted average cost of capital of 29%, and subsequently accreted to the redemption amount using the effective interest method. Interest expense related to the mandatorily redeemable preferred stock included in other expense in the accompanying condensed consolidated statements of operations for the three and nine months ended September 30, 2009 was \$418 thousand and \$950 thousand, respectively. There was no interest expense related to the mandatorily redeemable preferred stock for the three and nine months ended September 30, 2008. The Warrants issued in connection with the Series A-1 Preferred Stock provide that the holders of the Warrants may cause the Company to repurchase such Warrants for the purchase price in the event of certain fundamental transactions or the occurrence of an event of default. The Company evaluated the Warrants pursuant to ASC 815-40 and determined that the Warrants should be classified as liabilities because they contain a provision that could require cash settlement and that event is outside the control of the Company. The warrants should be measured at fair value, with changes in fair value reported in earnings as long as the warrants remain classified as a liability. The initial proceeds allocated to preferred shares and warrants were \$4,299,274 and \$1,906,726, respectively

The Company is amortizing the warrant discount using the effective interest rate method over the three year term of the Series A-1 Preferred Stock. Although the stated interest rate of the Series A-1 Preferred Stock is 12.5%, as a result of the discount recorded for the warrants, the effective interest rate is 26.79%. The Company also incurred \$1,175,078 of costs in relation to this transaction, which were recorded as deferred financing costs to be amortized over the term of the Series A-1 Preferred Stock.

The Company calculated the fair value of the warrants at the date of issuance using the Black-Scholes option pricing model. The change in fair value of the Warrants issued in connection with the Series A-1 Preferred stock from the date of issuance to September 30, 2009, was a decrease of approximately \$0.4 million from \$1.9 million as of February 27, 2009 to \$1.5 million as of September 30, 2009. This change of fair value of the Warrants was reflected as a component of other expense within the statement of operations. For the three and nine months ended September 30, 2009, the change of fair value of the Warrants was \$1.5 million and (\$0.5) million, respectively.

10. INCOME TAXES

The Company accounts for income taxes in accordance with ASC 740, "Income Taxes." Under ASC 740, the Company recognizes deferred income taxes for all temporary differences between the financial statement basis and the tax basis of assets and liabilities at currently enacted income tax rates.

Deferred income taxes are recognized for the tax consequences in future years of differences between the tax bases of assets and liabilities and their financial reporting amounts at each year end based on enacted tax laws and statutory tax rates applicable to the periods in which the differences are expected to affect taxable earnings. Valuation allowances are established when necessary to reduce deferred tax assets to the amount more likely than not to be realized.

ASC 740 clarifies the accounting for uncertainty in income taxes recognized in an enterprise's financial statements and prescribes a recognition threshold and measurement process for financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. ASC 740 also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure and transition.

The Company concluded that there are no significant uncertain tax positions requiring recognition in the financial statements based on an evaluation performed for the tax years ended December 31, 2006, 2007, 2008 and 2009, the tax years which remain subject to examination by major tax jurisdictions as of September 30, 2009.

The Company may from time to time be assessed interest or penalties by major tax jurisdictions, although any such assessments historically have been immaterial to the financial results. As of September 30, 2009, the Company had recorded immaterial interest and penalties associated with the filing of the 2008 tax returns and no unrecognized tax benefits that would have an effect on the effective tax rate. The Company elected to continue to report interest and penalties as income taxes.

The Company recorded a current income tax benefit as of September 30, 2009 of \$89 thousand. The Company expects to utilize this benefit to off-set taxable income from the remaining three months ending December 31, 2009.

11. NET INCOME (LOSS) PER COMMON SHARE

Net income (loss) per common share is computed by dividing net income (loss) by the weighted average number of common shares outstanding during the reported period. Shares issued during the period and shares reacquired during the period are weighted for the portion of the period in which the shares were outstanding. Diluted net income (loss) per common share has been computed in a manner consistent with that of basic net income (loss) per common share while giving effect to all potentially dilutive common shares that were outstanding during each period. The following table reflects the computation of the Company's basic and diluted net income (loss) per common share for the three and nine months ended September 30, 2009 and 2008.

	Three Months Ended		Nine months Ended	
	September 30, 2009	September 30, 2008	September 30, 2009	September 30, 2008
Basic net income (loss) per common share:				
Net income (loss)	\$ 957,679	\$ (224,147)	\$ (1,140,669)	\$ (627,313)
Dividends on preferred stock	—	45,000	78,870	135,000
Net income (loss) attributable to common stockholders - basic	957,679	(269,147)	(1,219,539)	(762,313)
Change in fair value of put warrants, net of income tax	(1,282,963)	—	—	—
Net loss attributable to common stockholders - diluted	\$ (325,284)	\$ (269,147)	\$ (1,219,539)	\$ (762,313)
Weighted average common shares outstanding - basic	41,243,027	19,148,153	36,299,722	19,148,153
Treasury effect of put warrants	38,019,803	—	—	—
Total weighted average common shares outstanding - diluted	79,262,830	19,148,153	36,299,722	19,148,153
Basic net income (loss) per common share	\$ 0.02	\$ (0.01)	\$ (0.03)	\$ (0.04)
Diluted net loss per common share	\$ (0.01)	\$ (0.01)	\$ (0.03)	\$ (0.04)

Common stock equivalents of 116,655,347 and 121,393,423 were not included in the computation of diluted net income (loss) per common share for the three and nine months ended September 30, 2009, respectively, and common stock equivalents of 7,203,407 and 5,658,517 were not included in the computation of diluted net income (loss) per common share for the three and nine months ended September 30, 2008, as the inclusion of these common stock equivalents would be anti-dilutive.

12. STOCK INCENTIVE PLAN

On August 3, 2006, the Board of Directors and stockholders approved the 2006 Stock Incentive Plan (the "Plan"). A total of 2,500,000 shares of common stock were initially reserved for issuance under the Plan. At September 30, 2009, 3,758,799 shares of common stock were reserved for issuance under the Plan. The shares of common stock reserved for issuance under the Plan are in addition to approximately 1,044,667 shares of common stock which have been reserved for issuance related to standalone stock options that were granted by the Company to employees and directors on December 15, 2005 and May 15, 2006. As of September 30, 2009, 2,925,000 shares of restricted common stock and options to purchase 507,000 shares of common stock have been issued under the Plan and options to purchase 2,622,000 shares of common stock have been granted outside of the Plan. Individual awards under the Plan may take the form of incentive stock options and nonqualified stock options. To date, only nonqualified stock options have been granted under the Plan. These awards generally vest over three years of continuous service.

The Compensation Committee administers the Plan, selects the individuals who will receive awards and establishes the terms and conditions of those awards. Shares of common stock subject to awards that have expired, terminated, or been canceled or forfeited are available for issuance or use in connection with future awards.

Stock Options

The following table summarizes the Company's stock option activity.

	Number of Options	Weighted Average Exercise Price	Aggregate Intrinsic Value	Weighted Average Remaining Contractual Life (in years)
Outstanding at December 31, 2008	1,578,000	\$ 0.29	\$ —	7.6
Granted	—	—		
Exercised	—	—		
Canceled	(28,000)	0.26		
Outstanding at September 30, 2009	<u>1,550,000</u>	<u>\$ 0.29</u>	<u>\$ —</u>	<u>6.9</u>
Exercisable at December 31, 2008	1,081,667	\$ 0.30		7.3
Exercisable at September 30, 2009	<u>1,309,333</u>	<u>\$ 0.30</u>	<u>\$ —</u>	<u>6.6</u>

Aggregate intrinsic value is calculated by multiplying the excess of the closing market price of \$0.05 at September 30, 2009 over the exercise price by the number of "in-the money" options outstanding.

Share-based compensation expense included in selling, general and administrative expenses in the accompanying condensed consolidated statements of operations for the three and nine months ended September 30, 2009 was \$23 thousand and \$160 thousand and share-based compensation for the three and nine months ended September 30, 2008 was \$80 thousand and \$240 thousand, respectively.

The Company did not grant any stock options for the three and nine months ended September 30, 2009. The fair value of the options granted during fiscal 2008 was \$20 thousand and is included as part of additional paid-in capital as vested. As of September 30, 2009, the Company had \$63 thousand of total unrecognized option compensation costs, which will be recognized over a weighted average period of 1 year.

Restricted Common Stock

On May 3, 2007, the Board of Directors of the Company granted restricted shares of common stock, par value \$0.01 per share, to certain individuals. The restricted shares will vest on January 2, 2012 and have no interim vesting periods. On October 21, 2008, the Board of Directors of the Company granted restricted shares of common stock, par value \$0.01 per share, to certain individuals. The restricted shares will vest on January 2, 2013 and have no interim vesting periods. During the quarter ended June 30, 2009, 300,000 shares of restricted stock vested due to the resignation of two members of the Company's Board of Directors and the vesting was accelerated and the remaining compensation expense was recognized as of that date.

The restricted shares were issued from the Plan with the intent of providing a longer-term employment retention mechanism to key management and board members.

The following table summarizes the Company's restricted common stock activity.

	Number of Restricted Common Stock	Aggregate Fair Value	Weighted Average Vesting Periods (in years)	Weighted Average Remaining Vesting Periods (in years)
Outstanding at December 31, 2008	2,925,000	\$ 1,425,000	4.4	3.3
Granted	—			
Vested	(300,000)	180,000		
Outstanding at September 30, 2009	<u>2,625,000</u>	<u>\$ 1,245,000</u>	<u>4.4</u>	<u>2.6</u>

Share-based compensation expense for the restricted stock was included in selling, general and administrative expenses in the accompanying condensed consolidated statements of operations. The compensation expense recognized for the three and nine months ended September 30, 2009 was \$68 thousand and \$327 thousand, respectively, and the compensation expense recognized for the three and nine months ended September 30, 2008 was \$60 thousand and \$180 thousand, respectively.

The total fair value of the restricted stock granted in fiscal 2008 and 2007 was \$0.3 million and \$1.1 million, respectively, calculated by multiplying the number of shares of restricted common stock granted and the closing market price of \$0.20 on October 21, 2008 and \$0.80 on May 3, 2007, respectively, and will be included as part of additional paid-in capital over the vesting period. As of September 30, 2009, the unrecognized compensation costs related to the remaining nonvested restricted stock was \$0.7 million, which will be recognized over a weighted average period of 2.6 years.

13. STOCKHOLDERS' EQUITY

Series A Preferred Stock

On July 25, 2007, the Company completed a private placement led by members of the Company's senior management and Board of Directors for gross proceeds of \$1.8 million. The Company issued 1,800 shares of convertible preferred stock ("Series A Preferred Stock") with par value of \$0.01 per share, which bore an annual dividend of 10% and were convertible into 1.5 million shares of the Company's common stock at an average of \$1.20 per common share. The private placement included 5-year warrants to purchase approximately 149,400 shares of common stock at \$1.20 per share. Proceeds from this offering were used for general working capital and acquisition financing. The investors included certain of the officers and directors of the Company.

In connection with the private placement on February 27, 2009, the Company exchanged 1,700 shares of the Company's outstanding Series A Preferred Stock for an aggregate of approximately 21.8 million shares of common stock and repurchased 100 shares of Series A Preferred Stock for a cash payment to certain shareholders of an aggregate of approximately \$107,000, excluding approximately \$4,000 of dividends.

Warrants

In connection with the Series A Preferred Stock issuance on July 25, 2007, the Company issued the purchasers of the Series A Preferred Stock 5-year warrants to purchase an aggregate of approximately 149,400 shares of common stock at \$1.20 per share. The Company also issued warrants to the placement agent to purchase 83,333 common shares of the Company at \$1.20 per share. The warrants were classified as equity in accordance with ASC 815-40 primarily because such warrants do not provide for net cash settlement. Warrants issued were valued at \$139 thousand, using the Black Scholes model, and recorded as part of additional paid-in capital using the Black Scholes model.

14. CONTRACT STATUS

Provisional Indirect Cost Rates

Billings under cost-plus government contracts are calculated using provisional rates which permit recovery of indirect costs. These rates are subject to audit on an annual basis by governmental audit agencies. The cost audits will result in the negotiation and determination of the final indirect cost rates which the Company may use for the period(s) audited. The final rates, if different from the provisional, may create an additional receivable or liability.

As of September 30, 2009, the Company has had no final settlements on indirect rates. The Company periodically reviews its cost estimates and experience rates and adjustments, if needed, are made and reflected in the period in which the estimates are revised. In the opinion of management, redetermination of any cost-based contracts for the open years will not have any material effect on the Company's financial position or results of operations.

The Company has authorized but uncompleted contracts on which work is in progress at September 30, 2009, approximately, as follows:

Total contract prices of initial contract awards, including exercised options and approved change orders (modifications)	\$ 133,770,972
Completed to date	<u>114,463,499</u>
Authorized backlog	<u>\$ 19,307,472</u>

The foregoing contracts contain unfunded and unexercised options not reflected in the above amounts of approximately \$72,700,000.

As of September 30, 2009, none of the Company's existing contracts is subject to renegotiation during the remainder of 2009.

15. LITIGATION AND CLAIMS

On April 8, 2009, Samuel Caldwell and Zulema Caldwell, former owners of Caldwell Technology Solutions, LLC ("CTS"), initiated an action against the Company in Montgomery County Circuit Court, Maryland, alleging claims arising out of the Company's purchase of CTS in July 2007. Specifically, the complaint alleges that the Company breached the Purchase Agreement dated June 6, 2007 among the Company, CTS and Mr. and Mrs. Caldwell (the "Purchase Agreement") by failing to pay "earn-out" compensation pursuant to the terms of the Purchase Agreement. The complaint alleges that if certain revenue and profits metrics had been met by CTS in the first 12 months following its acquisition by the Company, Mr. and Mrs. Caldwell would have been entitled to receive the maximum earn-out compensation of \$2,540,000 (which the Purchase Agreement provides was payable in cash and shares of the Company's common stock) under the Purchase Agreement as opposed to the \$165,000 in cash and \$254,000 in shares of the Company's common stock paid to Mr. and Mrs. Caldwell by the Company. The complaint further alleges that such metrics were met or would have been met had it not been for interference by the Company and non-GAAP-based accounting on the part of the Company.

In addition to the breach of contract claim, the complaint also includes (i) a claim of fraud, based on the allegation that the Company made misrepresentations when it entered into the Purchase Agreement regarding the accounting that would determine payment of the earn-out; (ii) a request for a legal “accounting” of the Company’s books; (iii) a request for pre-judgment attachment of the Company’s assets in the State of Maryland and (iv) a request that the court issue a declaratory judgment invalidating a non-competition agreement entered into by Mr. Caldwell as part of the CTS transaction. In addition to the alleged contract damages of \$2,540,000 (less amounts previously paid to Mr. and Mrs. Caldwell as earn-out compensation), under their fraud claim, Mr. and Mrs. Caldwell seek \$6,000,000 in punitive damages.

The Company has filed its answer and a counter-claim for breach of contract and fraud for undisclosed IRS liabilities, accounts receivable, disclosure of proprietary information, conversion of IRS checks and corporate credit cards, and unjust enrichment relating to certain payments made by the Company on behalf of the plaintiffs, in amounts to be determined at trial. Plaintiffs answer to the Company’s counterclaim was filed in early October. A schedule has been set by the court with a deadline for completing discovery of February 11, 2010. The Company intends to vigorously defend the allegations in the complaint and pursue its counter-claims; however, it is difficult to predict the final outcome of the respective claims of the parties.

16. SUBSEQUENT EVENTS

The Company has evaluated subsequent events that have occurred through November 11, 2009, the date of financial statement issuance and there are no reportable subsequent events.

PARADIGM HOLDINGS, INC.
MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION
AND RESULTS OF OPERATIONS

This quarterly report contains forward-looking statements. These statements relate to future events or our future financial performance. In some cases, you can identify forward-looking statements by terminology such as “may,” “will,” “should,” “could,” “forecasts,” “expects,” “plans,” “anticipates,” “believes,” “estimates,” “predicts,” “potential,” “see,” “target,” “projects,” “position,” or “continue” or the negative of such terms and other comparable terminology. These statements reflect our current expectations, estimates, and projections. These statements are not guarantees of future performance and involve risks, uncertainties, and assumptions that are difficult to predict. Actual events or results may differ materially from what is expressed or forecasted in these forward-looking statements. We disclaim any intention or obligation to update any forward-looking statement.

ITEM 2: MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

OVERVIEW

Paradigm Holdings, Inc. (the “Company” or “Paradigm”) provides information technology (“IT”), information assurance, and business continuity solutions, primarily to U.S. Federal Government customers. Headquartered in Rockville, Maryland, the Company was founded based upon strong commitment to high standards of performance, integrity, customer satisfaction, and employee development.

With an established core of experienced executives, the Company has grown from six employees in 1996 to 174 personnel (full time, part time, and consultants) at September 30, 2009. The 2009 annual run-rate of revenue is approximately \$33 million, based on revenue for the nine months ended September 30, 2009. The results for the interim periods are not necessarily indicative of the results to be expected for the fiscal year.

As of September 30, 2009, Paradigm had three wholly-owned subsidiaries, Paradigm Solutions Corp. (“PSC”), which was incorporated in 1996 to deliver IT services to federal agencies, Trinity IMS, Inc. (“Trinity”), which was acquired on April 9, 2007 to deliver IT solutions into the national security marketplace and Caldwell Technology Solutions, LLC (“CTS”) which was acquired on July 2, 2007 to provide advanced IT solutions in support of National Security programs within the intelligence community.

We derive substantially all of our revenue from fees for IT solutions and services. We generate these fees from contracts with various payment arrangements, including time and materials contracts, fixed-price contracts and cost-plus contracts. We typically issue invoices monthly to manage outstanding accounts receivable balances. We recognize revenue on time and materials contracts as the services are provided. For the quarter ended September 30, 2009, our business was comprised of 56% fixed price and 44% time and material contracts.

For the quarter ended September 30, 2009, contracts with the federal government and contracts with prime contractors of the federal government accounted for 100% of our revenue. During that same period, our three largest clients, all agencies within the federal government, generated approximately 78% of our revenue. In most of these engagements, we retain full responsibility for the end-client relationship and direct and manage the activities of our contract staff.

Our most significant expense is direct costs, which consist primarily of direct labor, subcontractors, materials, equipment, travel and an allocation of indirect costs including fringe benefits. The number of subcontract and consulting employees assigned to a project will vary according to the size, complexity, duration and demands of the project.

Selling, general and administrative expenses consist primarily of costs associated with executive management, finance and administrative groups, human resources, marketing and business development resources, employee training, occupancy costs, research and development expenses, depreciation and amortization, travel, and all other corporate costs.

Other income and expense consists primarily of interest income earned on cash and cash equivalents, interest payable on our revolving credit facility, interest expense related to the mandatorily redeemable preferred stock and the change in fair value of put warrants.

CRITICAL ACCOUNTING POLICIES

Management's Discussion and Analysis of Financial Condition and Results of Operations discusses the condensed consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States of America ("GAAP"). The preparation of these condensed consolidated financial statements requires management to make estimates and judgments that affect the reported amount of assets and liabilities and the disclosure of contingent assets and liabilities at the date of the condensed consolidated financial statements and the reported amounts of revenues and expenses during the reporting period. On an ongoing basis, management evaluates its estimates including those related to contingent liabilities, revenue recognition, and other intangible assets. Management bases its estimates on historical experience and on various other factors that are believed to be reasonable at the time the estimates are made. Actual results may differ from these estimates under different assumptions or conditions.

The following critical accounting policies require management's judgment and estimation, where such estimates have a material effect on the condensed consolidated financial statements:

- accounting for revenue recognition
- accounting for cost of revenue
- accounting for goodwill and intangible assets
- accounting for impairment of long-lived assets
- accounting for share-based compensation
- accounting for valuation of warrants
- accounting for income taxes
- accounting for segment reporting

For a description of these critical accounting policies except for the accounting for valuation of warrants, refer to "Management's Discussion and Analysis of Financial Condition and Results of Operations" in Paradigm's Annual Report on Form 10-K for the fiscal year ended December 31, 2008.

Valuation of Warrants

The Company accounts for the issuance of common stock purchase warrants in accordance with the provisions of ASC 815-40. The Class A Warrants and Class B Warrants issued in connection with the sale of the Company's Series A-1 Senior Preferred Stock, par value \$0.01 per share (the "Series A-1 Preferred Stock"), contain a provision that could require cash settlement and that event is outside the control of the Company, and therefore are classified as a liability as of September 30, 2009. The Company assesses classification of put warrants at each reporting date to determine whether a change in classification is required. The Company values put warrants using the Black-Scholes valuation model. Put warrants are valued upon issuance, and re-valued at each financial statement reporting date. Any change in value is charged to other income or expense during the period.

RECENT ACCOUNTING STANDARDS

New accounting standards that have a current or future potential impact on Paradigm's condensed consolidated financial statements are as follows:

In June 2009, the FASB issued guidance to replace the calculation for determining which entities, if any, have a controlling financial interest in a variable interest entity ("VIE") from a quantitative based risks and rewards calculation, to a qualitative approach that focuses on identifying which entities have the power to direct the activities of a variable interest entity that most significantly impact the entity's economic performance and, the obligation to absorb losses of the entity or the right to receive benefits from the entity. This standard also requires ongoing assessments as to whether an enterprise is the primary beneficiary of a VIE (previously, reconsideration was only required upon the occurrence of specific events), modifies the presentation of consolidated VIE assets and liabilities, and requires additional disclosures about a company's involvement in VIEs. This guidance will be effective for the Company beginning January 1, 2010. Management is currently evaluating the effect, if any, that adoption of this standard will have on the Company's consolidated financial position and results of operations when it becomes effective in 2010.

Recently Adopted Accounting Standards

On July 1, 2009, the Company adopted SFAS No. 168, "The FASB Accounting Standards CodificationTM and the Hierarchy of Generally Accepted Accounting Principles—a replacement of FASB Statement No. 162." This statement confirms that the FASB Accounting Standards Codification (the "Codification") becomes the single official source of authoritative U.S. GAAP (other than guidance issued by the SEC), superseding existing FASB, American AICPA, EITF, and related literature. After that date, only one level of authoritative U.S. GAAP will exist. All other literature will be considered non-authoritative. The Codification does not change U.S. GAAP; instead, it introduces a new structure that is organized in an easily accessible, user-friendly online research system. The adoption of SFAS 168 did not have a material impact on the Company's condensed consolidated financial statements.

On June 30, 2009, the adopted Company provisions of ASC 825, "Financial Instruments", which requires disclosures about fair value of financial instruments for interim reporting periods of publicly traded companies as well as in annual financial statements. The adoption of ASC 825 did not have a material impact on the Company's statement of operations, financial position, or cash flows.

On June 30, 2009, the Company adopted ASC 855, "Subsequent Events," which establishes general standards of accounting and disclosure for events that occur after the balance sheet date but before the financial statements are issued. The adoption of ASC 855 did not have a material impact on the Company's statements of operations, financial position, or cash flows.

On January 1, 2009, the Company adopted ASC 815, "Derivatives and Hedging." This ASC modifies and expands the disclosure requirements for derivative instruments and hedging activities. ASC 815 requires that objectives for using derivative instruments be disclosed in terms of underlying risk and accounting designation and requires quantitative disclosures about fair value amounts and gains and losses on derivative instruments. It also requires disclosures about credit-related contingent features in derivative agreements. The adoption of ASC 815 did not have a material impact on the Company's statements of operations, financial position or cash flows.

On January 1, 2009, the Company adopted ASC 810, "Consolidation." This ASC establishes the accounting and reporting standards for the noncontrolling interest in a subsidiary and for the deconsolidation of a subsidiary. The adoption of ASC 810 did not have a material impact on the Company's statements of operations, financial position or cash flows.

On January 1, 2009, the Company adopted ASC 805, "Business Combinations." This ASC establishes principles and requirements for how the acquirer recognizes and measures the identifiable assets acquired, the goodwill acquired, the liabilities assumed and any noncontrolling interest in the acquiree and determines what information to disclose to enable users of the financial statements to evaluate the nature and financial effects of the business combination. The adoption of ASC 805 did not have a material impact on the Company's statements of operations, financial position or cash flows. The Company will apply ASC 805 to its future acquisitions, if any.

RESULTS OF OPERATIONS

The following discussion and analysis should be read in conjunction with Paradigm's condensed consolidated financial statements and related notes included elsewhere in this Quarterly Report on Form 10-Q and with Paradigm's consolidated financial statements and the information under the heading "Management's Discussion and Analysis of Financial Condition and Results of Operations," which are included in Paradigm's Annual Report on Form 10-K for the fiscal year ended December 31, 2008.

The following table sets forth certain items from our condensed consolidated statements of operations for the periods indicated.

(Dollars in thousands)	Three Months Ended September 30,				Nine months Ended September 30,			
	2009	2008	2009	2008	2009	2008	2009	2008
Revenue	\$ 8,037	\$ 9,564	100.0%	100.0%	\$ 24,416	\$ 30,982	100.0%	100.0%
Cost of revenue	6,159	7,548	76.6	78.9	19,156	24,812	78.5	80.1
Gross margin	1,878	2,016	23.4	21.1	5,260	6,170	21.5	19.9
Selling, general & administrative	1,712	2,115	21.3	22.1	5,566	6,319	22.8	20.4
Income (loss) from operations	166	(99)	2.1	(1.0)	(306)	(149)	(1.3)	(0.5)
Other income (expense)	927	(230)	11.5	(2.4)	(923)	(734)	(3.8)	(2.3)
Provision (benefit) for income taxes	135	(105)	1.7	(1.1)	(88)	(256)	(0.4)	(0.8)
Net income (loss)	\$ 958	\$ (224)	11.9%	(2.3%)	\$ (1,141)	\$ (627)	(4.7%)	(2.0%)

The table below sets forth, for the periods indicated the service mix in revenue with related percentages of total revenue.

(Dollars in thousands)	Three Months Ended September 30,				Nine months Ended September 30,			
	2009	2008	2009	2008	2009	2008	2009	2008
Federal service contracts	\$ 5,714	\$ 7,079	71.1%	74.0%	\$ 17,180	\$ 21,389	70.4%	69.0%
Federal repair & maintenance contracts	2,323	2,485	28.9	26.0	7,236	9,593	29.6	31.0
Total revenue	\$ 8,037	\$ 9,564	100.0%	100.0%	\$ 24,416	\$ 30,982	100.0%	100.0%

The Company's revenues and operating results may be subject to significant variation from quarter to quarter depending on a number of factors, including the progress of contracts, revenues earned on contracts, the number of billable days in a quarter, the timing of the pass-through of other direct costs, the commencement and completion of contracts during any particular quarter, the schedule of government agencies for awarding contracts, the term of each contract that has been awarded and general economic conditions. Because a significant portion of total expenses, such as personnel and facilities costs, are fixed in the short term, successful contract performance and variation in the volume of activity as well as in the number of contracts commenced or completed during any quarter may cause significant variations in operating results from quarter to quarter.

The Federal Government's fiscal year ends September 30. If a budget for the next fiscal year has not been approved by that date, the Company's clients may have to suspend engagements that are in progress until a budget has been approved. Such suspensions may cause the Company to realize lower revenues in the fourth quarter of the year. Further, a change in presidential administrations and in senior government officials may negatively affect the rate at which the Federal Government purchases technology.

As a result of the factors above, period-to-period comparisons of Paradigm's revenues and operating results may not be meaningful. Readers should not rely on these comparisons as indicators of future performance as no assurances can be given that quarterly results will not fluctuate, causing a possible material adverse effect on Paradigm's operating results and financial condition.

COMPARISON OF THE THREE MONTHS ENDED SEPTEMBER 30, 2009 AND 2008

Revenue. For the three months ended September 30, 2009, revenue decreased 16.0% to \$8.0 million from \$9.6 million for the same period in 2008. The decrease in revenue is attributable to the completion of two of our federal service contracts during the second half of 2008 and a decrease in our federal repair and maintenance contracts business. The decrease in repair and maintenance business is attributable to a reduction in revenue on one federal contract due to a reduction in scope. We expect our current lower revenue run-rate to be reflective of near-term anticipated results.

Cost of Revenue. Cost of revenue includes direct labor, materials, subcontractors and an allocation for indirect costs. Generally, changes in cost of revenue correlate to fluctuations in revenue as resources are consumed in the production of that revenue. For the three months ended September 30, 2009, cost of revenue decreased by 18.4% to \$6.2 million from \$7.5 million for the same period in 2008. The decrease in cost of revenue was primarily attributable to the corresponding decrease in revenue on the repair and maintenance contracts. As a percentage of revenue, cost of revenue was 76.6% for the three months ended September 30, 2009 as compared to 78.9% for the same period in 2008. The decrease in cost as a percentage of revenue was primarily due to better contract management and better profitability on our existing contract mix.

Gross Margin. For the three months ended September 30, 2009, gross margin decreased 6.8% to \$1.9 million from \$2.0 million for the same period in 2008. Gross margin as a percentage of revenue increased to 23.4% for the three months ended September 30, 2009 from 21.1% for the same period in 2008. Gross margin as a percentage of revenue increased due to higher gross margin on our time and material contracts and better contract management on our fixed price contracts. Gross margin, as it relates to the service contracts, decreased 22.5% to \$1.4 million from \$1.7 million for the same period in 2008. The decrease in services gross margin is due to the completion of two of our federal service contracts during the second half of 2008. Gross margin, as it relates to the maintenance contracts, increased 98.5% to \$0.5 million from \$0.3 million for the same period in 2008. The increase in maintenance gross margin is attributable to better contract management.

Selling, General & Administrative Expenses. For the three months ended September 30, 2009, selling, general and administrative ("SG&A") expenses decreased 19.1% to \$1.7 million from \$2.1 million for the same period in 2008. As a percentage of revenue, SG&A expenses decreased to 21.3% for the three months ended September 30, 2009 from 22.1% for the same period in 2008. The decrease in SG&A expenses is due to the Company's cost reduction efforts. Management will continue monitoring SG&A expenses to balance the impact resulting from decreased revenues.

Other Income. For the three months ended September 30, 2009, other income increased to an income of \$927 thousand from an expense of \$231 thousand for the same period in 2008. The increase in other income was primarily attributable to the gain from the change in fair value of the warrants which is partially offset by higher interest expense recorded on the mandatorily redeemable preferred stock issued on February 27, 2009 via a private placement discussed below.

Income Taxes. For the three months ended September 30, 2009, income tax provision increased to a provision of \$135 thousand from a benefit of \$105 thousand for the same period in 2008. The Company's tax provision for the three months ended September 30, 2009 and 2008 represents an estimated annual effective tax rate, excluding discrete items, of 12.3% and 32.2%, respectively. The decrease in estimated annual effective tax rate is due to the interest expense on the mandatorily redeemable preferred stock and change in fair value of warrants which are not deductible under applicable tax laws.

Net Loss. For the three months ended September 30, 2009, net income increased to \$958 thousand from a net loss of \$224 thousand for the same period in 2008. The net income was due to the gain from the change in fair value of put warrants and lower SG&A expenses which is partially offset by lower revenue and higher interest expense as discussed above.

COMPARISON OF THE NINE MONTHS ENDED SEPTEMBER 30, 2009 AND 2008

Revenue. For the nine months ended September 30, 2009, revenue decreased 21.2% to \$24.4 million from \$31.0 million for the same period in 2008. The decrease in revenue is attributable to the completion of two of our federal service contracts during the second half of 2008 and a decrease in our federal repair and maintenance contracts business. The decrease in repair and maintenance business is attributable to a reduction in revenue on one federal contract due to a reduction in scope. We expect our current lower revenue run-rate to be reflective of near-term anticipated results.

Cost of Revenue. Cost of revenue includes direct labor, materials, subcontractors and an allocation for indirect costs. Generally, changes in cost of revenue correlate to fluctuations in revenue as resources are consumed in the production of that revenue. For the nine months ended September 30, 2009, cost of revenue decreased 22.8% to \$19.2 million from \$24.8 million for the same period in 2008. The decrease in cost of revenue was primarily attributable to the corresponding decrease in revenue. As a percentage of revenue, cost of revenue was 78.5% for the nine months ended September 30, 2009 as compared to 80.1% for the same period in 2008. The decrease in cost as a percentage of revenue was primarily due to better contract management and better profitability on our existing contract mix.

Gross Margin. For the nine months ended September 30, 2009, gross margin decreased 14.7% to \$5.3 million from \$6.2 million for the same period in 2008. Gross margin as a percentage of revenue increased to 21.5% for the nine months ended September 30, 2009 from 19.9% for the same period in 2008. Gross margin as a percentage of revenue increased due to higher gross margin on our time and material contracts and better contract management on our fixed price contracts. Gross margin as it relates to the service contracts decreased 21.2% to \$3.9 million from \$5.0 million for the same period in 2008. The decrease in services gross margin is due to the completion of two of our federal service contracts during the second half of 2008. Gross margin, as it relates to the maintenance contracts, increased 12.7% to \$1.3 million from \$1.2 million for the same period in 2008. The increase in maintenance gross margin is attributable to better contract management.

Selling, General & Administrative Expenses. For the nine months ended September 30, 2009, SG&A expenses decreased 11.9% to \$5.6 million from \$6.3 million for the same period in 2008. As a percentage of revenue, SG&A expenses increased to 22.8% for the nine months ended September 30, 2009 from 20.4 % for the same period in 2008. The increase in percentage is directly attributable to the decrease in revenues. Management will continue monitoring SG&A expenses to balance the impact resulting from decreased revenues.

Other Expense. For the nine months ended September 30, 2009, other expense increased to \$923 thousand from \$734 thousand for the same period in 2008. As a percentage of revenue, other expense increased to 3.8% for the nine months ended September 30, 2009 from 2.4% for the same period in 2008. The increase in other expense was primarily attributable to interest expense recorded on the mandatorily redeemable preferred stock issued on February 27, 2009 via a private placement which is partially offset by the gain from the change in fair value of the warrants issued.

Income Taxes. For the nine months ended September 30, 2009, income tax benefit decreased to \$88 thousand from \$256 thousand for the same period in 2008. The Company's tax provision for the nine months ended September 30, 2009 and 2008 represents an estimated annual effective tax rate, excluding discrete items, of 12.3% and 32.2%, respectively. The decrease in estimated annual effective tax rate is due to the interest expense on the mandatorily redeemable preferred stock and change in fair value of warrants which are not deductible under applicable tax laws.

Net Loss. For the nine months ended September 30, 2009, net loss increased to \$1.1 million from \$0.6 million for the same period in 2008. The net loss was due to lower revenue and higher interest expenses, partially offset by the gain from the change in fair value of put warrants as discussed above.

Liquidity and Capital Resources

Our primary liquidity needs are financing our cost of operations, capital expenditures, servicing our debt and paying dividends and redemption payments on our preferred stock. Our sources of liquidity are existing cash, cash generated from operations, and cash available from borrowings under our working capital line of credit and the cash realized from the private placement in February 2009. We have historically financed our operations through our existing cash, cash generated from operations and cash available from borrowings under our working capital line of credit. Based upon the current level of operations, we believe that cash flow from operations, together with borrowings available from our working capital line of credit with SVB and the combination of in-process cost reductions will be adequate to meet future liquidity needs for the next twelve months.

For the nine months ended September 30, 2009, the Company generated \$82 thousand in cash and cash equivalents compared to the used of \$6 thousand of cash for the same period in 2008.

Cash flow from operating activities provided by continuing operations was \$57 thousand for the nine months ended September 30, 2009 compared to \$1.0 million of cash provided for the same period in 2008. Cash flow from operating decreased primarily due to a decrease in accounts payable. As of September 30, 2009, the Company had \$135 thousand of cash on hand and a working capital deficit of \$0.8 million.

Net loss was \$1.1 million for the nine months ended September 30, 2009 compared to \$0.6 million for the same period in 2008. The higher net loss was primarily due to lower revenue and higher interest expenses, partially offset by the gain from the change in fair value of put warrants.

Accounts receivable decreased by \$1.7 million for the nine months ended September 30, 2009 compared to \$0.7 million for the same period in 2008. The decrease in the accounts receivable balance for 2009 is attributable to lower revenue and more focused billings and collection efforts.

Accounts payable decreased by \$1.3 million for the nine months ended September 30, 2009 compared to a decrease of \$0.2 million for the same period in 2008. The decrease during the nine months ended September 30, 2009 is primarily reflective of decreased cost of revenue and the payment of certain payables with a portion of the proceeds from the private placement on February 27, 2009.

Net cash used in investing activities was \$31 thousand for the nine months ended September 30, 2009 compared to \$108 thousand for the same period in 2008. Cash used in investing activities in 2009 was for purchases of property and equipment. Cash used in investing activities in 2008 was primarily due to the cash payment of earn-out compensation earned by the members of CTS as of December 31, 2008.

Net cash provided by financing activities was \$56 thousand for the nine months ended September 30, 2009 compared to \$0.9 million used for the same period in 2008. The increase in net cash provided by financing activities is due to proceeds from the private placement completed on February 27, 2009 which were partially offset by payments made to pay down the Company's line of credit with SVB and to pay off the promissory note issued in connection with the Company's acquisition of Trinity. Cash provided by financing activities in 2008 was due to proceeds from the line of credit to fund operations.

Private Placement

On February 27, 2009, the Company completed the sale, in a private placement transaction, of 6,206 shares of Series A-1 Senior Preferred Stock (the "Series A-1 Preferred Stock"), Class A Warrants to purchase up to an aggregate of approximately 79.6 million shares of common stock with an exercise price equal to \$0.0780 per share (the "Class A Warrants") and Class B Warrants to purchase up to an aggregate of approximately 69.1 million shares of common stock at an exercise price of \$0.0858 per share (the "Class B Warrants" and together with the Class A Warrants and the Series A-1 Preferred Stock, the "Securities") to a group of investors, led by Hale Capital (the "Purchasers"). The Series A-1 Preferred Stock bears an annual dividend of 12.5%. Each share of Series A-1 Preferred Stock has an initial stated value of \$1,000 per share (the "Stated Value"). Paradigm received gross proceeds of approximately \$6.2 million from the private placement. Among the use of proceeds, \$2.1 million was used to pay off the promissory note issued in connection with the Company's acquisition of Trinity, the Company paid fees and transaction costs of approximately \$1.1 million and the remaining \$3.0 million was used to pay down debt and for general working capital purposes.

The annual dividend on the Series A-1 Preferred Stock accrues on a daily basis and compounds monthly, with 40% of such dividend payable in cash and 60% of such dividend payable by adding such amount to the Stated Value per share of the Series A-1 Preferred Stock. The Company is generally required to make cash dividend payments ranging from \$26,000 to \$29,000 a month.

Any shares of Series A-1 Preferred Stock outstanding as of February 9, 2012 are to be redeemed by the Company for their Stated Value plus all accrued but unpaid cash dividends on such shares (the "Redemption Price"). In addition, on the last day of each calendar month beginning February 2009 through and including February 2010, the Company is required to redeem the number of shares of Series A-1 Preferred Stock obtained by dividing 100% of all Excess Cash Flow (as defined in the Certificate of Designations of Series A-1 Senior Preferred Stock (the "Certificate of Designations")) with respect to such month by the Redemption Price applicable to the shares to be redeemed. Further, on the last day of each month beginning March 2010 through and including January 2012, the Company shall redeem the number of shares of Series A-1 Preferred Stock obtained by dividing the sum of \$50,000 plus 50% of the Excess Cash Flow with respect to such month by the Redemption Price applicable to the shares to be redeemed. At anytime prior to February 9, 2012, the Company may redeem shares of Series A-1 Preferred Stock for 125% of the Stated Value of such shares plus all accrued but unpaid cash dividends for such shares. If at anytime a Purchaser realizes cash proceeds with respect to the Securities or common stock received upon exercise of the Class A Warrants and Class B Warrants (together, the "Warrants") equal to or greater than the aggregate amount paid by the Purchaser for the Securities plus 200% of such amount then the Company has the option to repurchase all outstanding shares of Series A-1 Preferred Stock held by that Purchaser for no additional consideration.

For so long as (i) an aggregate of not less than 15% of the shares of Series A-1 Preferred Stock purchased on February 27, 2009 are outstanding, (ii) Warrants to purchase an aggregate of not less than 20% of the shares issuable pursuant to the Warrants on February 27, 2009 are outstanding or (iii) the Purchasers, in the aggregate, own not less than 15% of the common stock issuable upon exercise of all Warrants on February 27, 2009 (we refer to (i), (ii) and (iii) as the "Ownership Threshold"), the Preferred Stock Purchase Agreement between the Company and the Purchasers (the "Preferred Stock Purchase Agreement") limits the Company's ability to offer or sell certain evidences of indebtedness or equity or equity equivalent securities (other than certain excluded securities and permitted issuances) without the prior consent of Hale Capital. Other than with respect to the issuance of certain excluded securities by the Company, the Preferred Stock Purchase Agreement further grants the Purchasers a right of first refusal to purchase certain evidences of indebtedness, equity and equity equivalent securities sold by the Company. The Company is further required to use a portion of the proceeds it receives from a subsequent placement of its securities to repurchase shares of Series A-1 Preferred Stock, Warrants and/or shares of common stock from the Purchasers.

The Preferred Stock Purchase Agreement and the Certificate of Designations also contain certain affirmative and negative covenants. The negative covenants require the prior approval of Hale Capital, for so long as the Ownership Threshold is met, in order for the Company to take certain actions, including, among others, (i) amending the Company's Articles of Incorporation or other charter documents, (ii) liquidating, dissolving or winding-up the Company, (iii) merging with, consolidating with or acquiring or being acquired by, or selling all or substantially all of its assets to, any person, (iv) selling, licensing or transferring any capital stock or assets with a value, individually or in the aggregate, of \$100,000 or more, (v) undergoing certain fundamental transactions, (vi) certain issuances of capital stock, (vii) certain redemptions or dividend payments, (viii) the creation, incurrence or assumption of certain types of indebtedness or liens, (ix) increasing or decreasing the size of the Company's Board of Directors and (x) appointing, hiring, suspending or terminating the employment or materially modifying the compensation of any executive officer.

The Certificate of Designations further provides that upon the occurrence of certain defined events of default each holder of Series A-1 Preferred Stock may elect to require the Company to repurchase any outstanding shares of Series A-1 Preferred Stock held by such holder for 125% of the Stated Value of such shares plus all accrued but unpaid cash dividends for such shares payable, at the holder's election, in cash or Common Stock. In addition, upon the occurrence of such event of default, the number of directors constituting the Company's Board of Directors will automatically increase by a number equal to the number of directors then constituting the Board of Directors plus one and the holders of the Series A-1 Preferred Stock are entitled to elect such additional directors.

The Warrants provide that in the event of certain fundamental transactions or the occurrence of an event of default, the holder of the Warrants may cause the Company to repurchase such Warrants for the purchase price specified therein (the "Repurchase Price").

In addition, upon the occurrence of a liquidation event (including certain fundamental transactions), the holders of the Series A-1 Preferred Stock are entitled to receive prior and in preference to the payment of any amounts to the holders of any other equity securities of the Company (the "Junior Securities") (i) 125% of the Stated Value of the outstanding shares of Series A-1 Preferred Stock, (ii) all accrued but unpaid cash dividends with respect to such shares of Series A-1 Preferred Stock and the (iii) Repurchase Price with respect to all Warrants held by such holders.

In connection with the private placement, the Company paid Noble International Investments, Inc. ("Noble") \$100,000 and issued Noble a warrant to purchase up to 1,602,565 shares of the Company's common stock for an exercise price of \$0.0780 per share.

The Company accounts for its preferred stock based upon the guidance enumerated in ASC 480, "Distinguishing Liabilities from Equity." The Series A-1 Preferred Stock is mandatorily redeemable on February 9, 2012 and therefore is classified as a liability instrument on the date of issuance. The Warrants issued in connection with the Series A-1 Preferred Stock provide that the holders of the Warrants may cause the Company to repurchase such Warrants for the Repurchase Price in the event of certain fundamental transactions or the occurrence of an event of default. The Company evaluated the Warrants pursuant to ASC 815-40 and determined that the Warrants should be classified as liabilities because they contain a provision that could require cash settlement and that event is outside the control of the Company. The Warrants should be measured at fair value, with changes in fair value reported in earnings as long as the Warrants remain classified as liabilities. The initial proceeds allocated to shares of Series A-1 Preferred Stock and the Warrants were \$4,299,274 and \$1,906,726, respectively

The Company is amortizing the warrant discount using the effective interest rate method over the three year term of the Series A-1 Preferred Stock. Although the stated interest rate of the Series A-1 Preferred Stock is 12.5%, as a result of the discount recorded for the Warrants, the effective interest rate is 26.79%. The Company also incurred approximately \$1,175,000 of costs in relation to this transaction, which were recorded as deferred financing costs to be amortized over the term of the Series A-1 Preferred Stock.

The Company calculated the fair value of the Warrants at the date of issuance using the Black-Scholes option pricing model. The change in fair value of the Warrants issued in connection with the Series A-1 Preferred Stock from the date of issuance to September 30, 2009, was a decrease of approximately \$0.4 million from \$1.9 million as of February 27, 2009 to \$1.5 million as of September 30, 2009. This change of fair value of the Warrants was reflected as a component of other expense within the statement of operations. For the three and nine months ended September 30, 2009, the change of fair value of the Warrants was \$1.5 million and (\$0.5) million, respectively

Loan and Security Agreement

On March 13, 2007, the Company entered into two Loan and Security Agreements with SVB, one of which provided for a revolving credit facility of up to \$10 million and the other of which provided for a working capital line of credit of up to \$12 million. SVB and the Company have agreed that the revolving credit facility has no further force or effect. The Company continues to use the working capital line of credit to borrow funds for working capital and general corporate purposes. References to the Loan and Security Agreement in this description refer to the working capital line of credit agreement. The Loan and Security Agreement is secured by a first priority perfected security interest in any and all properties, rights and assets of the Company, wherever located, whether now owned or thereafter acquired or arising and all proceeds and products thereof as described in the Loan and Security Agreement. Under the Loan and Security Agreement, the line of credit is due on demand and interest is payable monthly based on a floating per annum rate equal to the aggregate of the Prime Rate plus the applicable spread which ranges from 1.00% to 2.00%, as well as other fees and expenses as set forth more fully in the agreements. The Loan and Security Agreement, requires the Company to maintain certain EBITDA covenants as specified in the Loan and Security Agreement. Because the Company was not in compliance with the EBITDA covenant at June 30, 2008, the Company and SVB amended the Loan and Security Agreement to waive the covenant compliance for the periods ended June 30 and July 31, 2008. On March 18, 2009, the Company and SVB entered into a Second Loan Modification Agreement. This Second Loan Modification Agreement amended the Loan and Security Agreement to extend the maturity date to May 12, 2009 and modify the funds available under the working capital line of credit facility to not exceed \$4.5 million and the total funds available under the Loan and Security Agreement to a maximum amount of \$5.625 million. The interest rates and EBITDA covenant are consistent with the previous agreement for the remainder of the extension period. On May 4, 2009, the Company and SVB entered into a Third Loan Modification Agreement. This Third Loan Modification Agreement amended the Loan and Security Agreement to extend the maturity date to June 12, 2009.

On July 2, 2009, the Company and SVB entered into a Fourth Loan Modification Agreement. This Fourth Loan Modification Agreement, among other things, (i) modifies the collateral handling fee payable by the Company, (ii) revises certain of the Company's representations and warranties, (iii) increases the charge to the Company for certain inspections and audits from \$750 per person per day to \$850 per person per day, (iv) revises the Company's financial covenants, (v) revises the negative covenant regarding the Company's ability to pay dividends or make any distribution or payment or redeem, retire or repurchase any capital stock without the prior consent of SVB to allow for such payments (subject to certain restrictions) to certain holders of the Company's Series A-1 Senior Preferred Stock, (vi) amends the definitions of "Prime Rate", "Applicable Rate" and "EBITDA" and (vii) extends the maturity date to June 11, 2010.

The Loan and Security Agreement contains events of default that include among other things, non-payment of principal, interest or fees, violation of covenants, inaccuracy of representations and warranties, cross default to certain other indebtedness, bankruptcy and insolvency events, change of control and material judgments. Upon occurrence of an event of default, SVB is entitled to, among other things, accelerate all obligations of the Company and sell the Company's assets to satisfy the Company's obligations under the Loan and Security Agreement.

The Company was in compliance with the EBITDA covenant set forth in Section 6.7(b) of the Loan and Security Agreement as of the three month period ended September 30, 2009. As of September 30, 2009, the Company had \$3.1 million outstanding, and \$1.4 million additional availability, under its working capital line of credit with SVB.

As of September 30, 2009, 38% of the total assets were in the form of accounts receivable, thus, the Company depends on the collection of its receivables to generate cash flow, provide working capital, pay down debt and continue its business operations. As of September 30, 2009, the Company had unbilled receivables of \$3.0 million included in the total accounts receivable for which it is awaiting authorization to invoice. If the federal government, any of the Company's other clients or any prime contractor for whom the Company is a subcontractor does not authorize the Company to invoice or fails to pay or delays the payment of the Company's outstanding invoices for any reason, the Company's business and financial condition may be materially adversely affected. The government may fail to pay outstanding invoices for a number of reasons, including a reduction in appropriated funding, lack of appropriated funds or lack of an approved budget.

In the event cash flows are not sufficient to fund operations at the present level and the Company is unable to obtain additional financing, it would attempt to take appropriate actions to tailor its activities to its available financing, including reducing its business operations through additional cost cutting measures and revising its business strategy. However, there can be no assurances that the Company's attempts to take such actions will be successful.

ITEM 3: QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Not applicable.

ITEM 4: CONTROLS AND PROCEDURES

Not applicable.

ITEM 4T: CONTROLS AND PROCEDURES

Evaluation of Disclosure Controls and Procedures

The Company's management, with the participation of the Company's Chief Executive Officer and Chief Financial Officer, has evaluated the effectiveness of the Company's disclosure controls and procedures (as such term is defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended (the "Exchange Act"), as of the quarter ended September 30, 2009. Based on such evaluation, the Company's Chief Executive Officer and Chief Financial Officer have concluded that, as of September 30, 2009, the Company's disclosure controls and procedures are effective in ensuring that information required to be disclosed by the Company in reports that it files or submits under the Exchange Act is recorded, processed, summarized and reported within the time periods specified by the SEC's rules and forms, and accumulated and communicated to the Company's management, including the Company's Chief Executive Officer and Chief Financial Officer, as appropriate to allow timely decisions regarding required disclosure.

Changes in Internal Control over Financial Reporting

In connection with the evaluation required by paragraph (d) of Rule 13a-15 under the Exchange Act, there was no change identified in the Company's internal control over financial reporting that occurred during the three months ended September 30, 2009 that has materially affected, or is reasonably likely to materially affect, the Company's internal control over financial reporting.

PART II: OTHER INFORMATION

ITEM 1: LEGAL PROCEEDINGS

On April 8, 2009, Samuel Caldwell and Zulema Caldwell, former owners of Caldwell Technology Solutions, LLC (“CTS”), initiated an action against the Company in Montgomery County Circuit Court, Maryland, alleging claims arising out of the Company’s purchase of CTS in July 2007. Specifically, the complaint alleges that the Company breached the Purchase Agreement dated June 6, 2007 among the Company, CTS and Mr. and Mrs. Caldwell (the “Purchase Agreement”) by failing to pay “earn-out” compensation pursuant to the terms of the Purchase Agreement. The complaint alleges that if certain revenue and profits metrics had been met by CTS in the first 12 months following its acquisition by the Company, Mr. and Mrs. Caldwell would have been entitled to receive the maximum earn-out compensation of \$2,540,000 (which the Purchase Agreement provides was payable in cash and shares of the Company’s common stock) under the Purchase Agreement as opposed to the \$165,000 in cash and \$254,000 in shares of the Company’s common stock paid to Mr. and Mrs. Caldwell by the Company. The complaint further alleges that such metrics were met or would have been met had it not been for interference by the Company and non-GAAP-based accounting on the part of the Company.

In addition to the breach of contract claim, the complaint also includes (i) a claim of fraud, based on the allegation that the Company made misrepresentations when it entered into the Purchase Agreement regarding the accounting that would determine payment of the earn-out; (ii) a request for a legal “accounting” of the Company’s books; (iii) a request for pre-judgment attachment of the Company’s assets in the State of Maryland and (iv) a request that the court issue a declaratory judgment invalidating a non-competition agreement entered into by Mr. Caldwell as part of the CTS transaction. In addition to the alleged contract damages of \$2,540,000 (less amounts previously paid to Mr. and Mrs. Caldwell as earn-out compensation), under their fraud claim, Mr. and Mrs. Caldwell seek \$6,000,000 in punitive damages.

The Company has filed its answer and a counter-claim for breach of contract and fraud for undisclosed IRS liabilities, accounts receivable, disclosure of proprietary information, conversion of IRS checks and corporate credit cards, and unjust enrichment relating to certain payments made by the Company on behalf of the plaintiffs, in amounts to be determined at trial. Plaintiffs answer to the Company’s counterclaim was filed in early October. A schedule has been set by the court with a deadline for completing discovery of February 10, 2010. The Company intends to vigorously defend the allegations in the complaint and pursue its counter-claims; however, it is difficult to predict the final outcome of the respective claims of the parties.

ITEM 1A: RISK FACTORS

Smaller reporting companies are not required to provide the information required by this item.

ITEM 2: UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS

None.

ITEM 3: DEFAULTS UPON SENIOR SECURITIES

None.

ITEM 4: SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

None.

ITEM 5: OTHER INFORMATION

None.

ITEM 6: EXHIBITS

<u>EXHIBIT NO.</u>	<u>DESCRIPTION</u>
10.1	Fourth Loan Modification Agreement dated July 2, 2009 among Silicon Valley Bank, Paradigm Holdings, Inc., Paradigm Solutions Corporation, Caldwell Technology Solutions LLC and Trinity Information Management Services. Previously filed as an exhibit to the Form 8-K filed on July 8, 2009 and incorporated herein by reference.
31.1	Certification of CEO pursuant to Rule 13a-14(a)/ 15d-14(a), as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
31.2	Certification of CFO pursuant to Rule 13a-14(a)/ 15d-14(a), as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
32.1	Certification of CEO pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
32.2	Certification of CFO pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

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.

PARADIGM HOLDINGS, INC.
(Registrant)

Date: November 11, 2009

By: /s/ Peter B. LaMontagne

Peter B. LaMontagne
President and Chief Executive Officer

Date: November 11, 2009

By: /s/ Richard Sawchak

Richard Sawchak
Senior Vice President and
Chief Financial Officer

CERTIFICATIONS

I, Peter B. LaMontagne, certify that:

1. I have reviewed this Quarterly Report on Form 10-Q for the quarterly period ended September 30, 2009 of Paradigm Holdings, Inc.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer(s) and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)), and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
 - (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
 - (b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
 - (c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
 - (d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
 - (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
 - (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: November 11, 2009

/s/ Peter B. LaMontagne
Peter B. LaMontagne
President and Chief Executive Officer

CERTIFICATIONS

I, Richard Sawchak, certify that:

1. I have reviewed this Quarterly Report on Form 10-Q for the quarterly period ended September 30, 2009 of Paradigm Holdings, Inc.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer(s) and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)), and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
 - (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
 - (b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
 - (c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
 - (d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
 - (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
 - (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: November 11, 2009

/s/ Richard Sawchak

Richard Sawchak
Senior Vice President and Chief Financial Officer

CERTIFICATION PURSUANT TO
18 U.S.C. SECTION 1350
AS ADOPTED PURSUANT TO
SECTION 906 OF THE SARBANES OXLEY ACT OF 2002

In connection with the Quarterly Report on Form 10-Q of Paradigm Holdings, Inc. (the "Company") for the quarterly period ended September 30, 2009 as filed with the Securities and Exchange Commission on the date hereof (the "Report"), Peter B. LaMontagne, President and Chief Executive Officer of the Company, hereby certifies pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that to his knowledge:

1. The Report fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934; and
2. The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

Date: November 11, 2009

/s/ Peter B. LaMontagne

Peter B. LaMontagne
President and Chief Executive Officer

A signed original of this written statement required by Section 906, or other document authenticating, acknowledging, or otherwise adopting the signature that appears in typed form within the electronic version of this written statement required by Section 906, has been provided to Paradigm Holdings, Inc. and will be retained by Paradigm Holdings, Inc. and furnished to the Securities and Exchange Commission or its staff upon request.

CERTIFICATION PURSUANT TO
18 U.S.C. SECTION 1350,
AS ADOPTED PURSUANT TO
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002

In connection with the Quarterly Report on Form 10-Q of Paradigm Holdings, Inc. (the "Company") for the quarterly period ended September 30, 2009 as filed with the Securities and Exchange Commission on the date hereof (the "Report"), Richard Sawchak, the Senior Vice President and Chief Financial Officer of the Company, hereby certifies pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that to his knowledge:

1. The Report fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934; and
2. The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

Date: November 11, 2009

/s/ Richard Sawchak

Richard Sawchak

Senior Vice President and Chief Financial Officer

A signed original of this written statement required by Section 906, or other document authenticating, acknowledging, or otherwise adopting the signature that appears in typed form within the electronic version of this written statement required by Section 906, has been provided to Paradigm Holdings, Inc. and will be retained by Paradigm Holdings, Inc. and furnished to the Securities and Exchange Commission or its staff upon request.
