
UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, DC 20549

FORM 10-Q
/X/ QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE
SECURITIES EXCHANGE ACT OF 1934

FOR THE QUARTERLY PERIOD ENDED DECEMBER 31, 2006.

COMMISSION FILE NUMBER 333-89756



Alion Science and Technology Corporation
(Exact Name of Registrant as Specified in Its Charter)

DELAWARE (State or Other Jurisdiction of Incorporation of Organization)	54-2061691 (I.R.S. Employer Identification No.)
10 West 35th Street Chicago, IL 60616 (312) 567-4000	1750 Tysons Boulevard, Suite 1300 McLean, VA 22102 (703) 918-4480
(Address, including Zip Code and Telephone Number with Area Code, of Principal Executive Offices)	

(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 is a large accelerated filer, and accelerated filer, or a non-accelerated filer (as defined in Rule 12b-2 of the Exchange Act).

Large Accelerated Filer Accelerated Filer Non-Accelerated Filer

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

Yes / / No /✓/

The number of shares outstanding of Alion Science and Technology Corporation Common Stock as of February 14, 2007, was: Common Stock 5,207,883

ALION SCIENCE AND TECHNOLOGY CORPORATION

FORM 10-Q

FOR THE THREE MONTHS DECEMBER 31, 2006

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ALION SCIENCE AND TECHNOLOGY CORPORATION
Condensed Consolidated Balance Sheets
As of December 31, 2006 and September 30, 2006 (unaudited)
(In thousands, except share and per share information)

	<u>December 31, 2006</u>	<u>September 30, 2006</u>
Current assets:		
Cash and cash equivalents	\$ 340	\$ 2,755
Accounts receivable, less allowance of \$4,277 and \$3,961 at December 31, 2006 and September 30, 2006, respectively	183,092	150,412
Stock subscriptions receivable	-	8,990
Prepaid expenses and other current assets	6,449	6,028
Total current assets	<u>189,881</u>	<u>168,185</u>
Property, plant and equipment, net	14,238	14,644
Intangible assets, net	71,151	75,403
Goodwill	391,166	387,927
Other assets	6,050	4,810
Total assets	<u><u>672,486</u></u>	<u><u>650,969</u></u>
Current liabilities:		
Book cash overdraft	3,261	-
Current portion, Term B Senior Credit Facility note payable	3,430	2,816
Current portion, acquisition obligations	9,172	11,457
Trade accounts payable and accrued liabilities	77,287	62,803
Accrued payroll and related liabilities	27,897	35,135
Billings in excess of costs and estimated earnings on uncompleted contracts	2,212	2,163
Total current liabilities	<u>123,259</u>	<u>114,374</u>
Acquisition obligations, excluding current portion	2,562	3,568
Notes payable to bank	32,550	12,300
Term B Senior Credit Facility note payable, excluding current portion	251,853	252,100
Bridge loan payable	163,830	164,680
Subordinated note payable	48,022	46,963
Accrued compensation, excluding current portion	26,446	21,026
Accrued postretirement benefit obligations	4,086	3,722
Non-current portion of lease obligations	4,114	4,292
Redeemable common stock warrants	37,258	35,234
Total liabilities	<u>693,980</u>	<u>658,259</u>
Shareholder's deficit:		
Common stock, \$0.01 par value, 8,000,000 shares authorized, 5,207,883 and 5,210,126 shares issued and outstanding at December 31, 2006 and September 30, 2006	52	52
Additional paid-in capital	91,737	91,829
Accumulated deficit	(113,283)	(99,171)
Total shareholder's deficit	<u>(21,494)</u>	<u>(7,290)</u>
Total liabilities and shareholder's deficit	<u><u>\$ 672,486</u></u>	<u><u>\$ 650,969</u></u>

See accompanying notes to condensed consolidated financial statements.

ALION SCIENCE AND TECHNOLOGY CORPORATION
Condensed Consolidated Statements of Operations (unaudited)
(In thousands, except share and per share information)

	Three Months Ended December 31,	
	2006	2005
Contract revenue	\$ 181,139	\$ 101,289
Direct contract expense	140,101	76,305
Gross profit	41,038	24,984
Operating expenses:		
Indirect contract expense	9,475	5,355
Research and development	654	245
General and administrative	16,613	12,359
Rental and occupancy expense	8,265	4,957
Depreciation and amortization	5,655	4,790
Bad debt expense	333	106
Total operating expenses	40,995	27,812
Operating income (loss)	43	(2,828)
Other income (expense):		
Interest income	116	372
Interest expense	(14,358)	(5,445)
Other	74	140
Loss before income taxes	(14,125)	(7,761)
Income tax benefit (expense)	13	(19)
Net loss	\$(14,112)	\$ (7,780)
Basic and diluted loss per share	\$ (2.71)	\$ (1.52)
Basic and diluted weighted average common shares outstanding	5,209,858	5,123,744

See accompanying notes to condensed consolidated financial statements.

ALION SCIENCE AND TECHNOLOGY CORPORATION
Condensed Consolidated Statements of Cash Flows (unaudited)
(In thousands)

	Three Months Ended	
	December 31,	
	2006	2005
Cash flows from operating activities:		
Net loss	\$(14,112)	\$(7,780)
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation and amortization	5,655	4,790
Accretion of debt to face value	234	221
Amortization of debt issuance costs	408	249
Decrease in value of interest rate cap agreement	76	50
Change in fair value of redeemable common stock warrants	2,024	1,800
Stock-based compensation	3,592	2,756
Gain on disposal of assets	(18)	-
Gain on sale of investments, net	(10)	(25)
Changes in assets and liabilities, net of effect of acquisitions:		
Accounts receivable, net	(32,536)	(11,830)
Other assets	(1,729)	(149)
Trade accounts payable and accruals	10,130	(3,950)
Other liabilities	1,060	(787)
Net cash used in operating activities	(25,226)	(14,655)
Cash flows from investing activities:		
Cash paid for acquisitions, net of cash acquired	(6,560)	-
Capital expenditures	(1,533)	(1,605)
Net cash used in investing activities	(8,093)	(1,605)
Cash flows from financing activities:		
Book overdraft	3,261	-
Repayment of Term B Credit Facility note payable	(655)	(360)
Payment of debt issuance costs	(850)	-
Borrowings under revolving credit facility	20,250	-
Purchase of shares of common stock from ESOP Trust	(92)	(7,592)
Cash received from issuance of common stock to ESOP Trust	8,990	1,693
Net cash provided by (used in) financing activities	30,904	(6,259)
Net decrease in cash	(2,415)	(22,519)
Cash and cash equivalents at beginning of period	2,755	37,778
Cash and cash equivalents at end of period	<u>\$ 340</u>	<u>\$ 15,259</u>
Supplemental disclosure of cash flow information:		
Cash paid for interest	10,038	2,375
Cash paid for taxes	156	19

See accompanying notes to condensed consolidated financial statements.

ALION SCIENCE AND TECHNOLOGY CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

(1) Description and Formation of the Business

Alion Science and Technology Corporation and its subsidiaries (collectively, the Company or Alion) provides scientific and engineering expertise to research and develop technological solutions for problems relating to national defense, homeland security, and energy and environmental analysis. The Company provides these research services primarily to agencies of the federal government and, to a lesser extent, to commercial and international customers.

Alion, a for-profit S Corporation, was formed in October 2001 for the purpose of purchasing substantially all of the assets and certain of the liabilities of IITRI, a not-for-profit membership corporation affiliated with and controlled by Illinois Institute of Technology (IIT). On December 20, 2002, Alion acquired substantially all of the assets and liabilities of IITRI, excluding the assets and liabilities of IITRI's Life Sciences Operation, for aggregate total proceeds of \$127.3 million (the Transaction). Prior to that time, the Company's activities were organizational in nature.

(2) Summary of Significant Accounting Policies

Basis of Presentation and Principles of Consolidation

The accompanying unaudited condensed consolidated financial statements have been prepared pursuant to the rules and regulations of the U.S. Securities and Exchange Commission (SEC) regarding interim financial reporting. Accordingly, they do not include all of the information and notes required by generally accepted accounting principles for complete financial statements and should be read in conjunction with the audited consolidated financial statements included in the Company's Annual Report on Form 10-K for the year ended September 30, 2006, filed with the SEC on December 1, 2006.

The statements are prepared on the accrual basis of accounting and include the accounts of Alion and its wholly-owned subsidiaries from the date of acquisition. All significant inter-company accounts have been eliminated in consolidation.

- Human Factors Application, Inc. (HFA) – acquired November 1998
- Innovative Technology Solution Corporation (ITSC) – acquired October 2003
- Alion - IPS Corporation – acquired February 2004
- Alion - METI Corporation (METI) – acquired February 2005
- Alion - CATI Corporation (CATI) – acquired February 2005
- Alion Canada (US) Corporation – established February 2005
- Alion Science and Technology (Canada) Corporation – established February 2005
- Alion - JJMA Corporation (JJMA) – acquired April 2005
- Alion Technical Services Corporation (Virginia) – established July 2005
- Alion Technical Services Corporation (Delaware) – established May 2006
- Alion - BMH Corporation (BMH) – acquired February 2006
- Washington Consulting, Inc. (WCI) – acquired February 2006
- Alion - MA&D Corporation (MA&D) – acquired May 2006

Fiscal and Quarter Periods

The Company's fiscal year ends on September 30. The Company operates based on a three-month quarter, four-quarter fiscal year. Quarter end dates: December 31, March 31, June 30, and September 30.

Use of Estimates

The preparation of financial statements in conformity with U.S. generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosures of contingent assets and liabilities at the date of financial statements and operating results reported for a given period. Actual results are likely to differ from those estimates; however, we do not believe such differences will materially affect the Company's financial position, results of operations, or cash flows.

ALION SCIENCE AND TECHNOLOGY CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

Reclassifications

Certain items in the condensed consolidated financial statements have been reclassified to conform to the current presentation.

Revenue Recognition

The Company's revenue results from technology services under a variety of contracts, some of which provide for payment for costs plus fees and others of which are fixed-price or time-and-material type contracts. The Company generally recognizes revenue when a contract has been executed, the contract price is fixed or determinable, delivery of the services or products has occurred and collectibility of the contract price is considered reasonably assured.

The Company recognizes revenue on cost-reimbursement contracts as it incurs costs and includes estimated fees earned. The Company recognizes time-and-material contract revenue at negotiated, fixed, contractually billable rates as it delivers labor hours and incurs other direct expenses. The Company uses various performance measures under the percentage of completion method to recognize revenue for fixed-price contracts. The process of estimating contract costs at completion and recognizing revenue appropriately involves significant management estimates. Actual costs may differ from estimated costs and affect estimated profitability and the timing of revenue recognition. From time to time, facts develop that require the Company to revise its estimated total costs or revenues expected. The Company records the cumulative effect of revised estimates in the period in which the facts requiring revised estimates become known. The Company recognizes the full amount of anticipated losses on any type of contract in the period in which they become known. For each of the periods presented, the cumulative effects of revised estimates were immaterial to the financial performance of the Company. Revised estimates did not generate any anticipated losses for any period presented. Further, the Company had no cost overruns on fixed price contracts that materially affected financial performance in any of the periods presented.

Contracts with agencies of the federal government are subject to periodic funding by the contracting agency concerned. A contract may be fully funded at its inception or ratably throughout its period of performance as services are provided. If the Company determines contract funding is not probable, it defers revenue recognition until realization is probable.

Contract costs on federal government contracts are subject to audit by the federal government and adjustment through negotiations between the Company and government representatives. The government considers Alion to be a major contractor and maintains an office on site to perform various audits. The government has audited all of the Company's federal government contract indirect costs through fiscal year 2004. Indirect rates have been negotiated and settled through fiscal year 2003. The Company submitted its fiscal year 2005 indirect expense rates to the government in March 2006 and expects to submit its fiscal year 2006 indirect expense rates to the government in March 2007. The Company has recorded revenue on federal government contracts in amounts it expects to realize.

The Company recognizes revenue on unpriced change orders as it incurs expenses and only to the extent it is probable that the Company will recover such costs. The Company recognizes revenue in excess of costs on unpriced change orders only when management can also estimate beyond a reasonable doubt the amount of excess and experience provides a sufficient basis for recognition. The Company recognizes revenue on claims as expenses are incurred only to the extent it is probable that the Company will recover such costs and it can reliably estimate the amount it will recover.

The Company generates software revenue from licensing software and providing services. In general, professional services are essential to the functionality of the solution sold and the Company applies the percentage of completion method, as prescribed by AICPA SOP 81-1, *Accounting for Performance on Construction-Type and Certain Production-Type Contracts*, to recognize revenue.

Income Taxes

The Company is an S corporation under the provisions of the Internal Revenue Code of 1986, as amended. For federal and certain state income tax purposes, the Company is not subject to tax on its income. The Company's income is allocated to its shareholder, Alion Science and Technology Corporation Employee Stock Ownership, Savings and Investment Trust (the Trust). The Company may be subject to state income taxes in those states that do not recognize S corporations and to additional

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

types of taxes including franchise and business taxes. All of the Company's wholly-owned operating subsidiaries are qualified subchapter S or disregarded entities which, for federal income tax purposes, are not treated as separate corporations.

Cash and Cash Equivalents

The Company considers cash in banks, and deposits with financial institutions with maturities of three months or less at time of purchase and that can be liquidated without prior notice or penalty, to be cash and cash equivalents.

Accounts Receivable and Billings in Excess of Costs and Estimated Earnings on Uncompleted Contracts

Accounts receivable include billed accounts receivable, amounts currently billable and costs and estimated earnings in excess of billings on uncompleted contracts that represent accumulated project expenses and fees which have not been billed or are not currently billable as of the date of the consolidated balance sheet. The costs and estimated earnings in excess of billings on uncompleted contracts are stated at estimated realizable value. Unbilled accounts receivable include revenue recognized for customer-related work performed by the Company on new and existing contracts for which the Company had not received contracts or contract modifications. The allowance for doubtful accounts is the Company's best estimate of the amount of probable losses in the Company's existing billed and unbilled accounts receivable. The Company determines the allowance using specific identification and historical write-off experience based on the age of the receivables. Billings in excess of costs and estimated earnings and advance collections from customers represent amounts received from or billed to customers in excess of project revenue recognized to date.

Property, Plant and Equipment

Leasehold improvements, software and equipment are recorded at cost. Maintenance and repairs that do not add significant value or significantly lengthen an asset's useful life are charged to current operations. Software and equipment are depreciated over their estimated useful lives (the lesser of 5 years or the life of the lease) generally using the straight-line method. Leasehold improvements are amortized on the straight-line method over the shorter of the assets' estimated useful life or the life of the lease. Upon sale or retirement of an asset, costs and related accumulated depreciation are deducted from the accounts, and the gain or loss is recognized in the consolidated statements of operations.

Goodwill and Other Intangibles

As required by SFAS 142, *Goodwill and Other Intangible Assets*, the Company reviews goodwill annually for impairment at the end of each fiscal year or if events or circumstances indicates potential impairment. The Company must recognize an impairment loss if, and to the extent that, goodwill exceeds fair value. The Company completed the fiscal year 2006 annual goodwill impairment analysis in the fourth quarter of fiscal year 2006. Based on this analysis, the Company concluded that no goodwill impairment existed as of September 30, 2006. For the three months ended December 31, 2006, there were no significant events that indicated the existence of goodwill impairment as of December 31, 2006. Intangible assets are amortized over their estimated useful lives of generally one to thirteen years primarily using the straight-line method.

Postretirement Benefits

The Company accounts for postretirement benefits other than pension in accordance with SFAS No. 106 *Employers' Accounting for Postretirement Benefits Other Than Pension* which requires the cost to provide the benefits to be accrued over the employees' period of active service. These costs are determined on an actuarial basis. The Company is amortizing its transition obligation for past service costs relating to these benefits over twenty years. Unrecognized actuarial gains and losses are amortized over the estimated average remaining service period for active employee plans and over the estimated average remaining life for retiree plans. The Company is currently analyzing the impact of adopting SFAS No. 158 *Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans*, which requires an employer to recognize the over- or under-funded status of its defined benefit plan as an asset or liability, and to recognize in income any change in funded status in the year it occurs.

ALION SCIENCE AND TECHNOLOGY CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

Fair Value of Financial Instruments

The following methods and assumptions were used to estimate the fair value of each class of financial instrument for which it is practicable to estimate fair value. It is impracticable for the Company to estimate the fair value of its subordinated debt because the only market for this financial instrument consists of principal to principal transactions. For all of the following items, the fair value is not materially different than the carrying value.

Cash, cash equivalents, accounts payable and accounts receivable

The carrying amount approximates fair value because of the short maturity of those instruments.

Marketable securities

The fair values of these investments are estimated based on quoted or market prices for these or similar instruments.

Senior long-term debt

The carrying amount of the Company's senior debt approximates fair value which is estimated on current rates offered to the Company for debt of the same remaining maturities.

Interest rate caps

The fair value of the Company's financial instruments is estimated based on current rates offered to the Company for contracts with similar terms and maturities.

Redeemable common stock warrants

The Company uses an option pricing model to estimate the fair value of its redeemable common stock warrants.

Alion Stock

The estimated fair value price per share is determined based upon a valuation performed by an independent, third-party firm.

(3) Business Combinations

Fiscal Year 2006 Acquisitions

Acquisition of BMH Associates, Inc. On February 10, 2006, the Company acquired 100 percent of the issued and outstanding stock of BMH, a provider of advanced software, systems engineering and distributed interactive simulations for military training and experimentation, for \$20.0 million (less a \$1.5 million hold back) plus additional contingent earn out obligations over a two year period which can not exceed \$6.0 million. As of December 31, 2006, the Company has recorded approximately \$19.2 million in goodwill relating to this acquisition. In the three months ended December 31, 2006, the Company recognized approximately \$3.0 million in earn out obligations related to BMH. The purchase price allocation is preliminary and subject to change based upon the completion of the valuation of certain intangible assets and other items. The pro forma impact of this acquisition was not significant.

Acquisition of Washington Consulting, Inc. On February 24, 2006, the Company acquired 100 percent of the issued and outstanding stock of WCI, a provider of enterprise IT and management consulting solutions and services to commercial and government customers, for \$18.0 million (less a \$1.5 million hold back) plus additional contingent earn out obligations over a two year period which can not exceed \$2.5 million. As of December 31, 2006, the Company has recorded approximately \$17.5 million in goodwill relating to this acquisition. In the three months ended December 31, 2006, the Company paid approximately \$1.3 million in previously recognized earn out obligations related to WCI. The purchase price allocation is preliminary and subject to change based upon the completion of the valuation of certain intangible assets and other items. The pro forma impact of this acquisition was not significant.

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

Acquisition of Micro Analysis and Design, Inc. On May 19, 2006, the Company acquired 100 percent of the issued and outstanding stock of MA&D, a provider of human factors engineering, modeling and simulation and software development for approximately \$16.9 million (less a \$2.0 million hold back) plus additional contingent earn out obligations over a two year period which can not exceed approximately \$4.1 million. As of December 31, 2006, the Company has recorded approximately \$16.1 million in goodwill relating to this acquisition. The purchase price allocation is preliminary and subject to change based upon the completion of the valuation of certain intangible assets and other items. The pro forma impact of this acquisition was not significant.

Acquisition of certain assets of Anteon Corporation. On June 30, 2006, the Company acquired from Anteon a group of assets consisting primarily of customer contracts for approximately \$221.4 million. As of December 31, 2006, the Company has recorded approximately \$45.0 million for purchased contracts, net of accumulated amortization, and approximately \$174.0 million in goodwill relating to this acquisition. The purchase price allocation is preliminary and subject to change based upon the completion of the valuation of certain intangible assets and other items.

The acquired identifiable intangibles assets in these transactions were as follows:

<u>Amounts in Millions</u>	<u>Estimated Fair Value</u>	<u>Residual Value</u>	<u>Weighted Average Remaining Amortization Period</u>
Purchased contracts	\$54.7	\$ -	4 years

(4) Employee Stock Ownership Plan (ESOP) and Stock Ownership Trust

On December 19, 2001, the Company adopted the Alion Science and Technology Corporation Employee Ownership, Savings and Investment Plan (the Plan) and the Trust. The Plan, a tax qualified retirement plan, includes an ESOP component and a non-ESOP component. On August 9, 2005, the Internal Revenue Service issued a determination letter that the Trust and the Plan, as amended through the Ninth Amendment to the Plan, qualify under Sections 401(a) and 501(a) of the Internal Revenue Code of 1986 (the IRC), as amended. The Company believes that the Plan and Trust have been designed and are currently being operated in compliance with the applicable requirements of the IRC.

(5) Postretirement Benefits

The Company sponsors a medical benefits plan providing certain medical, dental, and vision insurance benefits to eligible employees and former employees. The Company is self-insured and has a stop-loss limit under an insurance agreement. The Company also provides postretirement medical benefits for employees who meet certain age and service requirements. Retiring employees may become eligible for those benefits at age 55 if they have 20 years of service, or at age 60 with 10 years of service. The plan provides benefits until age 65 and requires employees to pay one-quarter of their health care premiums. A small, closed group of employees is eligible for coverage after age 65. These retirees contribute a fixed portion of their health care premium. The estimated annual contribution to premiums from retirees is approximately \$125,000.

There were no plan assets as of December 31, 2006 and September 30, 2006. The Company uses an October 1 measurement date.

(6) Loss Per Share

Basic and diluted loss per share is computed by dividing net loss by the weighted average number of common shares outstanding excluding the impact of warrants, phantom stock and stock appreciation rights described herein as this impact would be anti-dilutive for all periods presented.

(7) Shareholder's Equity

The Company's outstanding common stock is held by the Trust for the benefit of participants in the Plan. The Company provides a put option to any participant or beneficiary who receives a distribution of common stock which permits the participant or beneficiary to sell such common stock to the Company during certain periods, at the estimated fair value per

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

share, which was \$41.02 per share as of December 31, 2006. The estimated fair value per share is determined based upon a valuation performed by an independent, third-party firm. The Company may allow the Trust to purchase shares of common stock tendered to the Company under the put option.

Participants have the right to sell the shares distributed from their accounts that were acquired on the closing date of the Transaction at a value per share equal to the greater of the original purchase price or the estimated fair value price per share of the common stock.

(8) Accounts Receivable

	December 31, 2006	September 30, 2006
	(In thousands)	
Billed receivables	\$ 114,717	\$ 106,310
Unbilled receivables:		
Amounts currently billable	50,825	36,548
Revenues recorded in excess of milestone billings on fixed price contracts	5,881	5,591
Revenues recorded in excess of estimated contract value or funding	14,362	3,354
Retainages and other amounts billable upon contract completion	1,584	2,570
Allowance for doubtful accounts	<u>(4,277)</u>	<u>(3,961)</u>
Total Accounts Receivable	<u>\$ 183,092</u>	<u>\$ 150,412</u>

Revenues recorded in excess of milestone billings on fixed price contracts consist of amounts not expected to be billed within the next month. Amounts currently billable consist principally of amounts to be billed within the next month. Indirect cost rates in excess of provisional billing rates on U.S. government contracts are generally billable at actual rates shortly after the end of each fiscal year. Any remaining unbilled balance including retainage is billable upon contract completion or completion of Defense Contract Audit Agency audits. Revenues recorded in excess of contract value or funding are billable upon receipt of contractual amendments or other modifications. Costs and estimated earnings in excess of billings on uncompleted contracts totaled approximately \$72.7 million as of December 31, 2006 and included approximately \$14.4 million for customer-requested work for which the Company had not received contracts or contract modifications.

(9) Property, Plant and Equipment

Property, Plant and Equipment consist of the following:

	December 31, 2006	September 30, 2006
	(In thousands)	
Leasehold improvements	\$ 3,266	\$ 2,709
Equipment and software	<u>26,125</u>	<u>25,188</u>
Total cost	29,391	27,897
Less accumulated depreciation and amortization	<u>15,153</u>	<u>13,253</u>
Net fixed assets	<u>\$14,238</u>	<u>\$14,644</u>

Depreciation and leasehold amortization expense for property, plant and equipment was approximately \$1.4 million and \$1.3 million for the three months ended December 31, 2006 and 2005, respectively.

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

(10) Goodwill and Intangible Assets

As of December 31, 2006, the Company has recorded goodwill of approximately \$391.2 million. Changes in the carrying amount of goodwill during the three months ended December 31, 2006, in the aggregate, are summarized in the following table:

	<u>Total</u>
	(In thousands)
Balance as of September 30, 2006	\$387,927
Adjustment to initial allocation made during the three months ended December 31, 2006 (earnout obligations)	<u>3,239</u>
Balance as of December 31, 2006	<u><u>\$391,166</u></u>

For the acquisitions completed during the year ended September 30, 2006, the purchase price allocations are preliminary and subject to change based upon the completion of the valuation of certain intangible assets and other items. There were no acquisitions during the three-months ended December 31, 2006.

As of December 31, 2006, the Company has recorded gross intangible assets of approximately \$118.1 million, accumulated amortization of \$46.9 million and net intangible assets of approximately \$71.2 million. Intangible assets consist primarily of contracts purchased in connection with the acquisitions of JJMA, IPS, METI, BMH, WCI and MA&D and the contracts the Company acquired from Anteon Corporation (Anteon Contracts).

	<u>Gross</u>	<u>Accumulated Amortization</u>	<u>Net</u>
		(In thousands)	
Purchased contracts	\$115,246	\$45,986	\$69,260
Internal use software and engineering designs	2,155	498	1,657
Non-compete agreements	650	416	234
Total	<u><u>\$118,051</u></u>	<u><u>\$46,900</u></u>	<u><u>\$71,151</u></u>

The intangible assets have estimated useful lives of generally one to thirteen years and are being amortized primarily using the straight-line method. The weighted-average remaining amortization period of intangible assets was approximately six years at December 31, 2006. Amortization expense was approximately \$4.3 million and \$3.5 million for the three months ended December 31, 2006 and 2005, respectively. Estimated aggregate amortization expense for the remainder of fiscal year 2007 and for each of the next five years and thereafter is as follows:

		<u>(In thousands)</u>
For the remaining nine months:	2007	\$ 12,506
For the year ending September 30:	2008	16,457
	2009	15,273
	2010	14,504
	2011	8,599
	2012	1,049
	and thereafter	<u>2,763</u>
Total:		<u><u>\$71,151</u></u>

(11) Long-Term Debt

The Company entered into various debt agreements (Senior Credit Agreement, Mezzanine Note, and Subordinated Note) on December 20, 2002 to fund its acquisition of substantially all the assets of the IIT Research Institute (IITRI), which was affiliated with and controlled by Illinois Institute of Technology (IIT). In August 2004, the Company entered into a new Term B senior secured credit facility (the Term B Senior Credit Facility) with a syndicate of financial institutions for which

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Credit Suisse serves as arranger, administrative agent and collateral agent, and for which LaSalle Bank National Association serves as syndication agent. In April 2005, the first amendment to the Term B Senior Credit Facility (Amendment One) added \$72.0 million to the Company's total Term B Senior Credit Facility debt. In March 2006, the second amendment to the Term B Senior Credit Facility (Amendment Two) increased the term loan commitment by \$68.0 million, of which the full \$68.0 million has been drawn down by the Company as of December 31, 2006, and increased the revolving credit commitment from \$30.0 million to \$50.0 million. On June 30, 2006, the third amendment to the Term B Senior Credit Facility (Amendment Three) added \$50.0 million in Term B Senior Credit Facility debt.

Term B Senior Credit Facility

The Term B Senior Credit Facility consists of the following balances at December 31, 2006 and September 30, 2006:

	December 31,	September 30,
	<u>2006</u>	<u>2006</u>
	(In thousands)	
Senior term loan	\$258,360	\$259,015
Less: Unamortized debt issuance costs	<u>(3,077)</u>	<u>(4,099)</u>
Term B Senior Credit Facility Note Payable	\$255,283	\$254,916
Less current maturities, net of unamortized debt issue costs	<u>(3,430)</u>	<u>(2,816)</u>
Term B Senior Credit Facility Note Payable, less current maturities	<u><u>\$251,853</u></u>	<u><u>\$252,100</u></u>

The Term B Senior Credit Facility as of December 31, 2006, consists of:

- a senior term loan in the approximate amount of \$258.4 million;
- a \$50.0 million senior revolving credit facility under which approximately \$32.6 million was outstanding as of December 31, 2006, and approximately \$4.5 million of which was allocated for letters of credit and as such is not available to be borrowed; and
- a \$150.0 million uncommitted incremental term loan "accordion" facility.

The Term B Senior Credit Facility requires the Company to repay one percent of the principal balance of the senior term loan during each of the first eight years (fiscal years 2005 through 2012) and the first quarter of fiscal year 2013 in equal quarterly principal installments and the remaining principal balance outstanding during the ninth and final year (2013) in one principal installment. Through the quarter ending December 31, 2012, the Company is currently obligated to pay quarterly principal installments of approximately \$0.7 million. On February 6, 2013, the senior term loan maturity date, the Company is obligated to pay a principal installment of the outstanding balance. (See discussion of debt amendment in Subsequent Events, Note 18).

Under the senior revolving credit facility, the Company may request up to \$40.0 million in letters of credit and may borrow up to \$5.0 million in swing line loans for short-term borrowing needs. The Company must pay all principal obligations under the senior revolving credit facility in full no later than August 2, 2009.

The Company may prepay all or any portion of its senior term loan in minimum increments of \$1.0 million, generally without penalty or premium, except for customary breakage costs associated with pre-payment of Eurodollar-based loans. If the Company issues certain permitted debt, or sells, transfers or disposes of certain assets, it must use all net proceeds to repay any Term B loan amounts outstanding. If the Company has excess cash flow for any fiscal year, it must use 50% of the net proceeds or excess cash flow to repay Term B loan amounts outstanding. If the Company's leverage ratio (which compares the Company's total debt to its Consolidated EBITDA) is less than 2 to 1, it must use only 25% of net proceeds or excess cash flow to repay Term B loan amounts outstanding.

If the Company enters into an additional term loan, including under the uncommitted incremental term loan facility, and certain terms of such loan are more favorable to the new lenders than existing terms under the Term B Senior Credit Facility, the applicable interest rate spread on the senior term loans could increase. As a result, additional term loans could increase the Company's interest expense under its existing term loans. The Company's significant subsidiaries (HFA, CATI,

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METI, JJMA, BMH, WCI and MA&D) have guaranteed the Company's obligations under the Company's Term B Senior Credit Facility.

Use of Proceeds. In March 2006, the Company borrowed \$32.0 million, used approximately \$16.5 million to pay part of the WCI acquisition price, and paid approximately \$13.6 million to redeem the mezzanine warrants held by IIT and the Company's Chief Executive Officer. In May 2006, the Company borrowed \$15.0 million to pay part of the MA&D acquisition price. On June 30, 2006, the Company borrowed \$71.0 million to pay part of the Anteon Contracts acquisition price.

The Term B Senior Credit Facility permits the Company to use the remainder of its senior revolving credit facility for working capital needs, other general corporate purposes, and to finance permitted acquisitions. The Term B Senior Credit Facility permits the Company to use any proceeds from the uncommitted incremental term loan facility to finance permitted acquisitions and for any other purpose permitted by any future incremental term loan.

Security. The Term B Senior Credit Facility is secured by a security interest in all of the Company's current and future tangible and intangible property, as well as all of the current and future tangible and intangible property of many of the Company's subsidiaries.

Interest and Fees. Under the Term B Senior Credit Facility, the senior term loan and the senior revolving credit facility can each bear interest at either of two floating rates. The Company was entitled to elect that the senior term loan bear interest at an annual rate equal to: 1) the applicable alternate base interest rate charged by Credit Suisse plus a 175 basis point spread or, 2) the Eurodollar rate plus a 275 basis point spread. The Company was also entitled to elect that the senior revolving credit facility bear interest at an annual rate dependent on the Company's leverage ratio and whether the Company made a Eurodollar or an alternate base borrowing. The alternate base rate is the greater of Credit Suisse's prime rate or the federal funds effective rate, plus additional basis points corresponding to the Company's leverage ratio at the time.

On April 1, 2005, the Company chose to have the senior term loan bear interest at the Eurodollar rate and the senior revolving credit facility bear interest at the ABR rate based on Credit Suisse's prime rate. As of December 31, 2006, the Eurodollar rate on the senior term loan was 8.11 percent (5.36 percent plus 2.75 percent Eurodollar spread) and the ABR rate was 10.0 percent (8.25 percent plus 1.75 percent spread).

Interest Rate Cap Agreements. The Company has three interest rate cap agreements in place with its senior lenders. The interest rate cap agreements limit the floating component of the Company's total interest rate but do not affect leverage ratio based spreads. The Company's effective interest rate on notional principal in each cap agreement is the sum of the floating component and the applicable spread, which is determined by the Term B Senior Credit Facility. The three interest rate cap agreements will expire on September 30, 2007.

Other Fees and Expenses. Each quarter the Company is required to pay a commitment fee of 50 basis points per year on the prior quarter's daily, unused balance of the revolving credit facility and senior term loan commitment. As of December 31, 2006, the Company had approximately \$32.6 million outstanding on the revolving credit facility and approximately \$4.5 million was allocated for letters of credit; and the senior term loan was fully utilized. For the three months ended December 31, 2006, the Company paid approximately \$0.02 million in commitment fees for the revolving credit facility and nothing for the senior term loan.

The Company is also required to pay an annual agent's fee and a fronting fee not to exceed 25 basis points for each letter of credit issued under the revolving credit facility. Interest is due quarterly in arrears at the applicable revolving credit facility rate for all outstanding letters of credit.

Financial Covenants. The Term B Senior Credit Facility requires the Company to meet certain financial performance measures typical of commercial loans of this type including leverage and interest coverage ratios. The Term B Senior Credit Facility includes other covenants that restrict the Company's ability to take certain actions without the prior consent of senior lenders who extended a majority of the outstanding Term B loans. As of December 31, 2006, the Company was in compliance with the Term B Senior Credit Facility covenants.

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Subordinated Note

On December 20, 2002, the Company issued a \$39.9 million note to IITRI (Subordinated Note) as part of the consideration for Alion's acquisition of substantially all of IITRI's assets. On July 1, 2004, IIT acquired all of IITRI's rights and interests in the Subordinated Note and the related warrant agreement. On June 30, 2006, the Company and IIT entered into an agreement that increased the interest rate on the Subordinated Note for two years from December 21, 2006 through December 20, 2008.

The Subordinated Note bears interest at (i) 6% through December 20, 2006, (ii) approximately 6.4% from December 21, 2006 through December 20, 2007, and (iii) 6.7% from December 21, 2007 through December 20, 2008. Interest is payable quarterly by the issuance of paid-in-kind or PIK notes maturing at the same time as the Subordinated Note. The PIK notes have the effect of deferring the underlying cash interest expense on the Subordinated Note. Beginning in December 2008, the Subordinated Note will bear interest at 16% per year payable quarterly in cash until the note has been repaid in full. Principal on the Subordinated Note is payable in equal installments of \$19.95 million in December 2009 and December 2010. The PIK notes are due in equal installments of approximately \$7.4 million on these same dates.

Bridge Loan Agreement

On June 30, 2006, the Company entered into a Bridge Loan Agreement with Credit Suisse and borrowed \$170.0 million (the Bridge Loan, also called the Initial Loan). Certain of the Company's subsidiaries guaranteed the Bridge Loan. The Initial Loan is due December 31, 2007 and automatically converts to an Extended Loan maturing December 31, 2011, if not repaid by December 31, 2007. The Company expects to refinance the Bridge Loan Agreement before the end of February 2007 through the issuance of up to \$250.0 million of senior unsecured notes expected to mature in 2015. (See discussion of debt amendment in Subsequent Events, Note 18).

Use of Proceeds. The Company used the proceeds from the Bridge Loan to pay part of the cost of acquiring the Anteon Contracts.

Interest and Prepayment. The Bridge Loan bears interest at a floating rate based on the Eurodollar Rate plus an applicable spread that varies over time. The first interest payment was paid on September 30, 2006. Interest is payable quarterly in arrears in cash except that the Company can use PIK notes to pay any interest in excess of 700 basis points over the applicable Eurodollar floating rate, or it can add the excess to the Bridge Loan principal. The Company may prepay all or any portion of the Bridge Loan in minimum increments of \$100,000, with an aggregate minimum of \$1.0 million plus applicable premium (described below) and customary breakage costs associated with pre-payment of Eurodollar-based loans prior to the end of the interest period. Bridge Loan prepayments are subject to an applicable premium percentage based on the prepayment date and vary over the life of the Bridge Loan.

Financial Covenants. The Bridge Loan Agreement requires the Company to meet certain financial performance measures based on our leverage and interest coverage calculated in the same manner as under the Term B Senior Credit Facility. As of December 31, 2006, the Company was in compliance with the covenants set forth in the Bridge Loan.

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As of December 31, 2006, the remaining fiscal year principal repayments (at face amount before debt discount) for outstanding indebtedness are as follows:

	2007	2008	2009	2010	2011	2012	Thereafter	Total
	(In thousands)							
Senior Secured Term B Loan ⁽¹⁾	\$1,965	\$2,620	\$2,620	\$2,620	\$2,620	\$2,620	\$243,295	\$258,360
Bridge Loan ⁽²⁾	--	--	--	--	--	--	175,100	175,100
Subordinated Seller Note ⁽³⁾	--	--	19,950	19,950	--	--	--	39,900
Subordinated Paid in Kind Note ⁽⁴⁾	--	--	7,402	7,402	--	--	--	14,804
Total principal payments	<u>\$1,965</u>	<u>\$2,620</u>	<u>\$29,972</u>	<u>\$29,972</u>	<u>\$2,620</u>	<u>\$2,620</u>	<u>\$418,395</u>	<u>\$488,164</u>

- (1) The table does not reflect any prepayments of the Term B Senior Credit Facility based on excess cash flow or other conditions as the timing and amount of any such payments are uncertain. The approximate \$255.3 million on the face of the balance sheet (current and long-term portion) includes, as of December 31, 2006, approximately \$3.1 million of unamortized debt issue costs which totaled approximately \$12.3 million. The Company expects that it will need to refinance the Term B Senior Credit Facility before the end of fiscal year 2012.
- (2) The principal amount of \$175.1 million includes \$170.0 million principal at par value plus prepayment premium of \$5.1 million (3% of par). The approximate \$163.8 million on the face of the balance sheet includes, as of December 31, 2006, approximately \$6.2 million in unamortized debt issue costs. The Company expects to refinance the Bridge Loan Agreement before the end of February 2007 through the issuance of up to \$250.0 million of senior unsecured notes expected to mature in 2015. The Company intends to use the net proceeds to repay the Bridge Loan and a portion of the senior term loan. (See discussion of debt amendment in Subsequent Events, Note 18).
- (3) Repayment of \$39.9 million for the face value of the Subordinated Seller Note in two equal payments of \$19.95 million in years 2009 and 2010. The \$39.9 million includes, as of December 31, 2006, approximately \$3.6 million of unamortized debt discount assigned to fair value of the detachable warrants. On December 20, 2002, approximately \$7.1 million was assigned as the fair value of the warrants in accordance with Emerging Issues Task Force Issue No. 00-19, *Accounting for Derivative Financial Instruments Indexed to, and Potentially settled in, a Company's Own Stock*.
- (4) During the eight-year term of the Subordinated Note, approximately \$14.8 million of principal accretes to the note and is included in the principal payments in fiscal years 2009 and 2010. The principal, together with the outstanding balance of the PIK notes will be paid in equal amounts at the end of fiscal years 2009 and 2010.

(12) Redeemable Common Stock Warrants

In connection with the issuance of the Subordinated Note and the Deferred Compensation Agreement described in Note 11, the Company issued 1,080,437 and 22,062, respectively, of detachable redeemable common stock warrants (the Warrants) to IITRI and Dr. Atefi. IITRI subsequently transferred all of its rights, title and interest in the warrants to IIT. The Subordinate Note Warrants have an exercise price of \$10 per share and are exercisable until December 20, 2010. The Warrants permit the holders to sell warrants to the Company, at predetermined times, at the then current fair value of the common stock less the exercise price. The Warrants are classified as debt instruments in accordance with Emerging Issues Task Force Issue No. 00-19, *Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock*. The Company recorded the initial \$10.3 million estimated fair value of the Warrants as a discount to the face value of the notes

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issued and as a liability. The outstanding estimated fair value of the Warrants had an estimated fair value of \$37.3 million as of December 31, 2006. The Company recognizes interest expense for changes in the estimated fair value of the Warrants.

(13) Leases

Future minimum lease payments under non-cancelable operating leases for buildings, equipment and automobiles at December 31, 2006 are set out below. Under these operating leases, the Company subleased some excess capacity to subtenants under non-cancelable operating leases. In connection with the IPS, METI, and JJMA acquisitions, the Company assumed operating leases at above-market rates and recorded a loss accrual of approximately \$4.9 million based on the estimated fair value of the lease liabilities assumed. The loss is being amortized over the lease terms; the remaining unamortized balance was \$2.1 million at December 31, 2006. In connection with the IPS acquisition, the Company also acquired a related sub-lease pursuant to which it receives above-market rates. Based on the estimated fair value of the sublease, the Company recognized an asset of \$0.6 million which is being amortized over the lease term. The remaining asset value was \$0.3 million at December 31, 2006.

Fiscal Years Ending	(In thousands)
2007 (for the remainder of fiscal year)	\$ 19,843
2008	25,488
2009	22,197
2010	16,453
2011	14,309
2012	9,743
and thereafter	22,829
Gross lease payments	\$130,862
Less: non-cancelable subtenant receipts	5,281
Net lease payments	\$125,581

Rent expense under operating leases was \$7.5 million and \$4.0 million for the three months ended December 31, 2006 and 2005, respectively. Sublease rental income under operating leases was \$0.5 million for each of the three months ended December 31, 2006 and 2005, respectively.

(14) Stock Appreciation Rights

As of December 31, 2006, under the 2002 SAR Plan, the Company had granted 236,400 SARs to directors and employees. Under the 2004 SAR Plan, the Company had granted 534,775 SARs to directors and employees. For the three months ended December 31, 2006 and 2005, the Company recognized approximately \$1.2 million and \$0.8 million, respectively, in compensation expense associated with the two SAR plans.

The table below sets out the disclosures and the assumptions used to value a share of Alion common stock and the Company's grants of stock appreciation rights as of December 31, 2006 and September 30, 2006. For grants issued prior to October 1, 2006, the Company uses the intrinsic value method to recognize compensation expense pursuant to SFAS No. 123 *Accounting for Stock-Based Compensation*. For grants issued on or after October 1, 2006, the Company uses a Black-Scholes-Merton option pricing model to recognize compensation expense pursuant to SFAS No. 123(R) *Share-Based Payment*. The Company uses the fair market value of a share of its common stock to recognize expense for grants covered by SFAS 123; therefore no additional disclosures are required for these grants. There is no established public trading market for Alion's common stock. The ESOP is the only holder of our common stock. The Company uses an independent third party valuation firm to determine the fair market value of a share of Alion common stock. Alion does not expect to pay any dividends on its common stock. The terms of the senior credit facility and the subordinated note prohibit us from paying dividends without the consent of the respective lenders. We currently intend to retain future earnings, if any, for use in the operation of our business.

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Alion Science and Technology Corporation Stock-based Compensation Disclosures per FAS 123 Stock Appreciation Rights As of December 31, 2006											
Date of Grant	Shares Granted to Employees	Shares Granted to Directors	Total Shares Granted	Exercise Price	Outstanding at 9/30/06	Outstanding at 12/31/06	Forfeited	Exercised	Expired	Vested at 12/31/06	Exercisable at 12/31/06
December 2002	64,250	-	64,250	\$ 10.00	47,785	43,060	1,060	3,665	-	33,750	18,960
December 2002	-	29,400	29,400	\$ 10.00	-	-	-	-	-	-	-
May 2003	300	-	300	\$ 11.13	240	150	-	90	-	30	30
June 2003	300	-	300	\$ 11.13	300	300	-	-	-	180	60
November 2003	129,550	-	129,550	\$ 14.71	100,466	91,786	1,520	7,160	-	51,418	19,250
November 2003	-	12,600	12,600	\$ 14.71	2,800	2,800	-	-	-	2,800	2,800
November 2004	-	12,600	12,600	\$ 19.94	12,600	12,600	-	-	-	8,400	8,400
February 2005	164,750	-	164,750	\$ 19.94	135,588	129,463	4,575	550	-	28,025	-
March 2005	2,000	-	2,000	\$ 19.94	2,000	2,000	-	-	-	500	-
April 2005	33,000	-	33,000	\$ 29.81	27,500	27,500	-	-	-	5,000	-
June 2005	2,000	-	2,000	\$ 29.81	2,000	2,000	-	-	-	500	-
December 2005	276,675	-	276,675	\$ 35.89	257,900	250,350	7,550	-	-	63,150	-
February 2006	13,000	-	13,000	\$ 35.89	10,250	10,250	-	-	-	-	-
February 2006	7,500	-	7,500	\$ 35.89	7,500	7,500	-	-	-	-	-
May 2006	7,000	-	7,000	\$ 37.06	7,000	7,000	-	-	-	-	-
July 2006	15,000	-	15,000	\$ 37.06	15,000	15,000	-	-	-	-	-
August 2006	1,250	-	1,250	\$ 37.06	1,250	1,250	-	-	-	-	-
Total	716,575	54,600	771,175		630,179	603,009	14,705	12,465	-	193,753	49,500
Wtd Avg Exercise Price	\$ 25.75	\$ 13.38	\$ 24.87		\$ 26.39	\$ 26.64	\$ 26.87	\$ 13.95	\$ -	\$ 22.21	\$ 13.79

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Alion Science and Technology Corporation Stock-based Compensation Disclosures per FAS 123 Stock Appreciation Rights As of December 31, 2006					
Date of Grant	Risk Free Interest Rate	Volatility	Expected Life	Remaining Life (months)	
December 2002	4.06% - 4.49%	60%	5 yrs	10.3	
December 2002	4.06% - 4.49%	60%	3 yrs	0.0	
May 2003	2.70% - 3.30%	55%	5 yrs	15.7	
June 2003	2.70% - 3.30%	55%	5 yrs	16.5	
November 2003	4.06% - 4.49%	60%	5 yrs	22.2	
November 2003	4.06% - 4.49%	60%	3 yrs	0.0	
November 2004	3.10% - 3.60%	45%	3 yrs	10.3	
February 2005	3.10% - 3.60%	45%	4 yrs	24.7	
March 2005	3.10% - 3.60%	45%	4 yrs	25.9	
April 2005	4.10% - 4.20%	45%	4 yrs	26.7	
June 2005	4.10% - 4.20%	45%	4 yrs	28.9	
December 2005	4.20% - 4.20%	40%	4 yrs	35.5	
February 2006	4.20% - 4.20%	40%	4 yrs	37.2	
February 2006	4.20% - 4.20%	40%	4 yrs	37.7	
May 2006	4.82% - 4.83%	35%	4 yrs	40.5	
July 2006	4.82% - 4.83%	35%	4 yrs	41.9	
August 2006	4.82% - 4.83%	35%	4 yrs	43.8	
Wtd Avg Exercise Price				28.5	

(15) Phantom Stock Plans

As of December 31, 2006, under the Initial Phantom Stock Plan, the Company had granted 223,685 shares of phantom stock. Under the Second Phantom Stock Plan, the Company had granted 228,693 shares of retention phantom stock and 207,778 shares of performance phantom stock. Under the Director Phantom Stock Plan, the Company had granted 7,808 shares of phantom stock. For the three months ended December 31, 2006 and 2005, the Company recognized approximately \$2.4 million and \$1.9 million, respectively, in compensation expense associated with all three phantom stock plans.

The table below sets out the disclosures and the assumptions used to value a share of Alion common stock and the Company's grants of phantom stock as of December 31, 2006 and September 30, 2006. For grants issued prior to October 1, 2006, the Company uses the intrinsic value method to recognize compensation expense pursuant to SFAS No. 123 *Accounting for Stock-Based Compensation*. For grants issued on or after October 1, 2006, the Company uses a Black-Scholes-Merton option pricing model to recognize compensation expense pursuant to SFAS No. 123(R) *Share-Based Payment*. The Company uses the fair market value of a share of its common stock to recognize expense for grants covered by SFAS 123; therefore no additional disclosures are required for these grants. There is no established public trading market for Alion's common stock. The ESOP is the only holder of the Company's common stock. The Company uses an independent third party valuation firm to determine the fair market value of a share of Alion common stock. Alion does not expect to pay any dividends on its common stock. The terms of the senior credit facility and the Subordinated Note prohibit paying dividends without the consent of the respective lenders. The Company intends to retain future earnings, if any, for use in the business.

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Alion Science and Technology Corporation
Stock-based Compensation Disclosures per FAS 123
Phantom Stock
as of December 31, 2006

Date of Grant	Shares Granted to Employees	Shares Granted to Directors	Total Shares Granted	Grant Date Price per Share	Outstanding at 9/30/06	Outstanding at 12/31/06	Forfeited	Exercised	Expired	Vested at 12/31/06	Exercisable at 12/31/06
February 2003	171,000	-	171,000	\$ 10.00	85,000	85,000	-	-	-	16,500	16,500
November 2003	52,685	-	52,685	\$ 14.71	32,971	26,513	-	6,458	-	8,158	8,158
February 2005	202,763	-	202,763	\$ 19.94	202,763	202,763	-	-	-	-	-
February 2005	103,414	-	103,414	\$ 19.94	103,414	103,414	-	-	-	-	-
February 2005	5,015	-	5,015	\$ 19.94	5,015	5,015	-	-	-	1,254	-
August 2005	2,960	-	2,960	\$ 33.78	2,960	2,960	-	-	-	987	-
November 2005	66,592	-	66,592	\$ 35.89	66,592	66,592	-	-	-	-	-
November 2005	-	7,808	7,808	\$ 35.89	6,832	6,832	-	-	-	2,277	2,277
November 2005	55,726	-	55,726	\$ 35.89	55,726	55,726	-	-	-	-	-
Total	660,156	7,808	667,964		561,274	554,816	-	6,458	-	29,176	26,935
Wtd Avg Grant Date Fair Value Price per Share	\$ 19.97	\$ 35.89	\$ 20.15		\$ 21.87	\$ 21.95	\$ -	\$ 14.71	\$ -	\$ 14.57	\$ 13.62

Alion Science and Technology Corporation
Stock-based Compensation Disclosures per FAS 123
Phantom Stock
as of December 31, 2006

Date of Grant	Risk Free Interest Rate	Volatility	Expected Life	Remaining Life (months)
February 2003	4.06% - 4.49%	60%	5 yrs	12.7
November 2003	4.06% - 4.49%	60%	5 yrs	21.8
February 2005	3.10% - 3.60%	45%	3 yrs	12.7
February 2005	3.10% - 3.60%	45%	3 yrs	12.7
February 2005	3.10% - 3.60%	45%	4 yrs	24.7
August 2005	3.72% - 3.77%	45%	3 yrs	18.9
November 2005	4.20% - 4.20%	40%	3 yrs	22.1
November 2005	4.20% - 4.20%	40%	3 yrs	22.1
November 2005	4.20% - 4.20%	40%	5 yrs	46.1
Wtd Avg Grant Date Fair Value Price per Share				17.9

(16) Segment Information and Customer Concentration

The Company operates in one segment, delivering a broad array of scientific and engineering expertise to research and develop technological solutions for problems relating to national defense, public health and safety, and nuclear safety and analysis under contracts with the federal government, state and local governments, and commercial customers. The Company's federal government customers typically exercise independent contracting authority, and even offices or divisions within an

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agency or department may directly, or through a prime contractor, use the Company's services as a separate customer so long as that customer has independent decision-making and contracting authority within its organization.

Contract receivables from agencies of the federal government represented approximately \$175.1 million, or 93.5%, of accounts receivable at December 31, 2006 and \$91.3 million, or 94.7%, of accounts receivable at December 31, 2005. Contract revenues from agencies of the federal government represented approximately 94.3% of total contract revenues during the three months ended December 30, 2006 and 98.3% of total contract revenues during the three months ended December 31, 2005. Two prime contracts with the Department of Defense represented approximately 14.7% and 7.9% of revenue for the three months ended December 31, 2006. Two prime contracts with the Department of Defense represented approximately 17.4% and 11.6% of revenue for the three months ended December 31, 2005.

(17) Commitments and Contingencies

Earn Out Commitments

The Company has earn out commitments related to the following acquisitions:

CATI – There is an earn out provision not to exceed \$8.25 million based on the revenue of the business units that formerly comprised CATI. There is a second earn out provision not to exceed \$1.5 million based on attaining certain revenue goals in the commercial aviation industry. The obligations continue until September 2007. In the three months ended December 31, 2006 and 2005, the Company recognized no earn out obligations for CATI.

BMH – There is an earn out provision not to exceed a total of \$6.0 million based on the revenue of the business units that formerly comprised BMH. The obligation continues until December 2007. In the three months ended December 31, 2006, the Company recognized approximately \$3.0 million in earn out obligation related to BMH.

WCI – There is an earn out provision not to exceed a total of \$2.5 million based on the revenue of the business units that formerly comprised WCI. The obligation continues until September 2007. In the three months ended December 31, 2006, the Company paid approximately \$1.3 million in previously recognized earn out obligations related to WCI.

MA&D – There is an earn out provision not to exceed a total of \$2.5 million based on the revenue of the business units that formerly comprised MA&D. The obligation continues until September 2007. In the three months ended December 31, 2006, the Company recognized no earn out obligations related to MA&D.

In the opinion of management, the realization of the amounts due under these arrangements will not have a material adverse effect upon the financial position, results of operations, or the liquidity of the Company.

Legal Proceedings

Estate of Joseph Hudert vs. Alion Science and Technology Corporation; Estate of Frank Stotmeister vs. Alion Science and Technology Corporation.

On December 23, 2004, the estate of Joseph Hudert filed an action against Grunley-Walsh Joint Venture, L.L.C. (Grunley-Walsh) and the Company in the District of Columbia Superior Court for damages in excess of \$80 million. On January 6, 2005, the estate of Frank Stotmeister filed an action against the Company in the same court on six counts, some of which are duplicate causes of action, claiming \$30 million for each count. Several other potential defendants may be added to these actions in the future.

The suits arose in connection with a steam pipe explosion that occurred on or about April 23, 2004 on a construction site at 17th Street, N.W. in Washington, D.C. The plaintiffs died, apparently as a result of the explosion. They were employees of the prime contractor on the site, Grunley-Walsh, and the subcontractor, Cherry Hill Construction Company Inc., respectively. Grunley-Walsh had a contract with the U.S. General Services Administration (GSA) for construction on 17th Street N.W. near the Old Executive Office Building in Washington, D.C. Sometime after the award of Grunley-Walsh's construction contract, Alion was awarded a separate contract by GSA. Alion's responsibilities on this contract were non-supervisory monitoring of Grunley-Walsh's activities and reporting to GSA of any deviations from contract requirements.

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The Company intends to defend these lawsuits vigorously. Based on the facts underlying the lawsuits known to the Company at this time, and the Company's non-supervisory monitoring role at the project site, the Company's management believes that the potential for Alion to incur a material loss as a result of the lawsuits is remote. Therefore, the Company's management does not believe that these lawsuits will have a material adverse effect upon the Company, its operations or its financial condition.

Alion's primary provider of general liability insurance, St. Paul Travelers, has assumed defense of these lawsuits. However, since there is some uncertainty as to whether St. Paul Travelers received timely notice of a potential claim by Alion in connection with these lawsuits under its general liability insurance policy, St. Paul Travelers indicated when it assumed defense of the lawsuits, that it was doing so subject to a reservation of rights to deny coverage. Nevertheless, even if St. Paul Travelers is ultimately able to properly deny coverage as a result of late notice of the lawsuits, the Company's management does not believe that the lawsuits will have a materially adverse effect upon the Company, its operations or its financial condition. American International Group, the Company's excess insurance carrier, has also been notified regarding these lawsuits.

The Company is involved in various claims and legal actions arising in the ordinary course of business. In the opinion of management, the ultimate disposition of these matters will not have a material adverse effect upon the Company's business, financial position, operating results or ability to meet its financial obligations.

Government Audits

The amount of federal government contract revenue and expense reflected in the consolidated financial statements attributable to cost reimbursement contracts is subject to audit and possible adjustment by the Defense Contract Audit Agency (DCAA). The federal government considers the Company to be a major contractor and DCAA maintains an office on site to perform its various audits throughout the year. All of the Company's federal government contract indirect costs have been audited through 2004. Indirect rates have been negotiated through fiscal year 2003. Contract revenue on federal government contracts has been recorded in amounts that are expected to be realized upon final settlement.

(18) Subsequent Events

On January 4, 2007, the Company borrowed a total of \$15.0 million in additional term loans under the Term B Senior Credit Facility. Those loan proceeds, less approximately \$300,000 in fees associated with the borrowing, were immediately used to pay down the outstanding balance on the senior revolving credit facility.

On February 6, 2007, the Company entered into an amendment to the Term B Senior Credit Facility, pursuant to which: (i) the maturity date of the senior term loans borrowed under the Term B Senior Credit Facility was extended to February 6, 2013, (ii) the fixed component of the interest rate payable by the Company on the outstanding amounts of senior term loans was reduced by 25 basis points, (iii) the principal repayment schedule was adjusted to require one balloon principal repayment at maturity, (iv) the amount of debt the Company was allowed to incur in connection with the re-financing of the Bridge Loan was increased from \$200.0 million to \$250.0 million; the additional proceeds were used to repay a portion of the amounts outstanding under the Term B Senior Credit Facility; and (v) an incurrence test was added as an additional condition to the Company's ability to incur permitted indebtedness. The extension of the maturity date and the adjustment to the amortization of principal resulted in a change in the timing and the amount of principal of senior term loans the Company must repay. As of February 8, 2007, through the quarter ending December 31, 2012, the Company is obligated to pay quarterly principal installments of \$555,900. On February 6, 2013, the senior term loan maturity date, the Company is obligated to pay a principal installment of approximately \$209.6 million.

On February 8, 2007, the Company issued and sold \$250.0 million of its 10.25% senior unsecured notes due February 1, 2015 (Senior Unsecured Notes) to Credit Suisse, which has informed the Company that it has resold most of the Senior Unsecured Notes to qualified institutional buyers. Interest on the Senior Unsecured Notes will accrue at the rate of 10.25% annually and will be payable semiannually in arrears on February 1 and August 1, commencing on August 1, 2007. The Senior Unsecured Notes rank the same in right of payment with all existing and future senior indebtedness of the Company, including indebtedness outstanding under and which may be borrowed pursuant to the Term B Senior Credit Facility. The proceeds of

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the Senior Unsecured Notes were used to pay off all outstanding amounts under the Bridge Loan Agreement and approximately \$72.0 million of the amounts outstanding under the Term B Senior Credit Facility.

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

The following discussion of Alion's financial condition and results of operations should be read together with the condensed consolidated financial statements and the notes to those statements. The following is intended to update the information contained in the Company's Annual Report on Form 10-K for the year ended September 30, 2006, and presumes that readers have access to, and will have read, "Management's Discussion and Analysis of Financial Condition and Results of Operations" contained in that report.

Overview

We provide scientific, engineering and information technology solutions for problems relating to national defense, homeland security and energy and environmental analysis. We provide these services primarily to agencies of the federal government and, to a lesser extent, to commercial and international customers. Our revenues increased \$79.8 million for the three months ended December 31, 2006 as compared to the three months ended December 31, 2005, through a combination of internal growth and acquisitions. The following table reflects, for each fiscal year indicated, summary results of operations data:

	For the Three Months Ended December 31,	
	2006	2005
	(in millions)	
Revenue	\$181.1	\$101.3
Net loss	(14.1)	(7.8)

The following table summarizes the percentage of revenues attributable to each contract type for the periods indicated.

<u>Contract Type</u>	For the Three Months Ended December 31,			
	2006		2005	
	(in millions)			
Cost-reimbursement	\$124.7	68.9%	\$63.1	62.3%
Fixed-price	30.4	16.7%	19.3	19.0%
Time-and-material	26.0	14.4%	18.9	18.7%
Total	\$181.1	100.0%	\$101.3	100.0%

We contract primarily with the federal government. We expect most of our revenues to continue to come from government contracts and we expect that most of these contracts will be with the U.S. Department of Defense (DoD). The much smaller balance of our revenue comes from a variety of commercial customers, state and local governments, and foreign governments. The following table sets forth, for each period indicated, the percentage of our revenues from our major types of customers.

<u>Customer Type</u>	For the Three Months Ended December 31,			
	2006		2005	
	(in millions)			
U.S. Department of Defense (DoD)	\$163.9	90.5%	\$94.0	92.8%
Other Federal Civilian Agencies	6.9	3.8%	5.6	5.5%
Commercial / State / Local and International	10.3	5.7%	1.7	1.7%
Total	\$181.1	100.0%	\$101.3	100.0%

The increase in percentage of the Commercial/State/Local and International customers for the three months ended December 31, 2006 is primarily a result of the work performed by CATI and WCI (commercial customers), as integrated business units of Alion, which were acquired subsequent to December 31, 2005.

Results of Operations

Three Months Ended December 31, 2006 Compared to Three Months Ended December 31, 2005

For purposes of comparability, the selected financial information provided in the table below reflects the relative financial impact of the BMH, WCI and MA&D acquisitions and for the work performed in support of the contracts acquired from Anteon, which we refer to as the “acquired operations” of Alion, as they relate to the financial performance of Alion for the three months ended December 31, 2006, compared to the financial performance for three months ended December 31, 2005. All operations of Alion, other than those acquired through the above-noted acquisitions are referred to as “non-acquired operations.”

<u>Financial Information</u>	Three Months Ended December 31, 2006						Three Months Ended December 31, 2005	
	Consolidated Operations of Alion		Acquired Operations*		Consolidated Operations Less Acquired Operations		Consolidated Operations of Alion	
	(Dollars in millions)		(Dollars in millions)				(Dollars in millions)	
	%		%		%		%	
	revenue	revenue	revenue	revenue	revenue	revenue	revenue	
Total Revenue	\$181.1		\$79.5		\$101.6		\$ 101.3	
Material and subcontract revenue	78.5	43.3%	38.4	48.3%	40.1	39.5%	32.8	32.4%
Total direct contract expenses	140.1	77.4%	62.7	78.9%	77.4	76.2%	76.3	75.3%
Major components of direct contract expenses								
Direct labor expense	61.2	33.8%	24.1	30.3%	37.1	36.5%	41.4	40.9%
Other direct labor expense (ODC)	4.9	2.7%	1.3	1.6%	3.6	3.5%	2.6	2.6%
Material and subcontract (M&S) expense	74.0	40.9%	37.3	46.9%	36.7	36.1%	32.3	31.9%
Gross profit	41.0	22.6%	16.8	21.1%	24.2	23.8%	25.0	24.7%
Total operating expense	41.0	22.6%	15.2	19.1%	25.7	25.3%	27.8	27.4%
Major components of operating expense								
Indirect personnel and facilities	17.7	9.8%	7.8	9.8%	9.9	9.7%	10.3	10.2%
General and administrative	13.0	7.2%	4.5	5.7%	8.5	8.4%	9.6	9.5%
Stock-based compensation (included in G&A expense)	3.6	2.0%	-	-	3.6	3.5%	2.8	2.8%
Depreciation and amortization	5.6	3.1%	2.9	3.6%	2.7	2.7%	4.8	4.7%
Income (loss) from operations	\$0.0	0.1%	\$1.6	2.0%	\$(1.5)	(1.5)%	\$ (2.8)	(2.8)%

* For the three months ended December 31, 2006, the operations of acquired entities and the operating results generated in support of the acquired Anteon contracts have been fully integrated within Alion on a consolidated basis. The selected financial information provided in the table represent actual results for the acquired and non-acquired operations rounded to the nearest one hundred thousand dollars.

Revenues. Revenues for the three months ended December 31, 2006 increased \$79.8 million, or 78.8%, over the three months ended December 31, 2005. This increase is attributable to the following:

- Increase in revenue generated by the activities of the acquired operations \$ 79.5 million
 - Increase in revenue generated by the activities of the non-acquired operations \$ 0.3 million
- Total: \$ 79.8 million

As a component of revenue, material and subcontract (M&S) revenue for the three months ended December 31, 2006 increased approximately \$45.7 million, or 139.3%, over the three months ended December 31, 2005. The acquired operations generated approximately \$38.4 million of the increase. M&S revenue increased to 43.3% of total revenue from 32.4% of total revenue for the three months ended December 31, 2006 and 2005, respectively. This increase was due primarily to the increase in content of M&S revenue to total revenue from acquired operations, primarily related to WCI and for work provided in support of the Anteon contracts.

Direct Contract Expenses. Direct contract expenses for the three months ended December 31, 2006 increased \$63.8 million, or 83.6%, over the three months ended December 31, 2005. Approximately \$62.7 million and \$1.1 million in increased expenses were from acquired operations and non-acquired operations, respectively. Direct contract expenses were 77.4% and 75.3% of total revenue for the three months ended December 31, 2006 and 2005, respectively.

- Direct labor expense for the three months ended December 31, 2006 increased \$19.8 million, or 47.8%, over the three months ended December 31, 2005. Direct labor expense declined to 33.8% from 40.9% of total revenue for the three months ended December 31, 2006 and 2005, respectively. This decrease was due to the decrease in content of direct labor expense from acquired operations primarily related to WCI and for work provided in support of the Anteon contracts.
- M&S expense for the three months ended December 31, 2006 increased \$41.7 million, or 129.1%, over the three months ended December 31, 2005. M&S expense increased to 40.9% from 31.9% of total revenue for the three months ended December 31, 2006 and 2005, respectively. The percent increase in M&S expense was due to the increase in content of M&S expense to total direct contract expense of the acquired operations, primarily related to WCI and for work provided in support of the Anteon contracts. M&S expense was approximately 94.3% and 98.5% of M&S revenue for the three months ended December 31, 2006 and 2005, respectively.

M&S expense has been increasing relative to direct labor, as a result of contracts obtained in connection with our acquired operations as well as higher levels of M&S related work on contracts in the non-acquired operations. This increased level of M&S expense is expected to continue for at least the next two fiscal years or until backlog on these contracts is expended.

Gross Profit. Gross profit was \$41.0 million and \$25.0 million for the three months ended December 31, 2006 and December 31, 2005, respectively. Gross profit was 22.6% and 24.7% of total revenue for the three months ended December 31, 2006 and 2005, respectively. Gross profit margins decreased due to the relative increase in M&S contract work. M&S contract work typically generates lower profit margins than contract direct labor work.

Operating Expenses. Operating expenses for the three months ended December 31, 2006 increased \$13.2 million, or 47.4%, over the three months ended December 31, 2005. Operating expenses were 22.6% and 27.4% of total revenue for the three months ended December 31, 2006 and 2005, respectively. The changes in major components of operating expenses were:

- Operating expenses for indirect personnel and rental and occupancy expenses for the three months ended December 31, 2006 increased approximately \$7.4 million, or 72.0%, from the three months ended December 31, 2005. Operating expenses for indirect personnel and facilities declined to 9.8% from 10.2% of total revenue for the three months ended December 31, 2006 and 2005, respectively.
- General and administrative (G&A) expense for the three months ended December 31, 2006 increased approximately \$3.4 million, or 35.4%, over the three months ended December 31, 2005. G&A expenses were 7.2% and 9.5% of revenue for the three months ended December 31, 2006 and 2005, respectively. Approximately \$1.2 million of the \$3.4 million increase is due to increased fringe benefit expenses and approximately \$1.0 million was due to third-party legal and accounting fees associated with financing expense and approximately \$0.3 million for third party legal expense for contract protests. These additional expenses represent approximately 1.4% of total revenue. The remaining \$0.9 million increase in G&A expense is associated with infrastructure costs to accommodate recent acquisitions.
- Stock-based compensation expense (included in G&A expense) relates to the SAR and phantom stock plans. This expense for the three months ended December 31, 2006 increased approximately \$0.8 million, or 28.6%, from the three months ended December 31, 2005. The increase in stock-based compensation expense results from the relative change in price of a share in Alion common stock and, to a lesser extent, the increase in the awards granted.
- Depreciation and amortization expense for the three months ended December 31, 2006 increased approximately \$0.8 million, or 16.7%, from the three months ended December 31, 2005. Depreciation expense primarily arises from

fixed assets while amortization expense results primarily from purchase contracts. Depreciation and amortization expense was 3.1% and 4.7% of revenue for the three months ended December 31, 2006 and 2005, respectively.

Income (loss) from Operations. There was operating income of \$43,000 for the three months ended December 31, 2006, compared to an operating loss of \$2.8 million for the three months ended December 31, 2005. Operating loss decreased because of the factors discussed above.

Other Income (Expense). Other income (expense) for the three months ended December 31, 2006 increased approximately \$9.2 million, or 187.2%, over the three months ended December 31, 2005. Interest expense for the three months ended December 31, 2006 increased approximately \$9.0 million, or 163.7%, from the three months ended December 31, 2005, which was attributable to the following:

	Three months Ended December 31,	
	2006	2005
	(In millions)	
Revolving facility	\$ 0.7	\$ ---
Senior term loan	5.7	2.6
Bridge loan	4.6	---
Subordinated Note	1.0	1.0
Accretion of warrants (a)	2.0	1.8
Other	0.4	---
Total	\$ 14.4	\$ 5.4

- (a) Reflects change in value assigned to the detachable warrants associated with Mezzanine and Subordinated notes based on the change in the value of Alion common stock and the number of warrants outstanding.

Income Tax (Expense) Benefit. The Company has filed qualified subchapter S elections for all of its wholly-owned subsidiaries to treat them as disregarded entities for federal income tax purposes. Some states do not recognize the effect of these elections or Alion's S corporation status. For our Canadian subsidiary, Alion Science and Technology (Canada) Corporation, we accrue a tax liability, as required. The Company recorded \$13,000 income tax benefit and \$19,000 income tax expense for the three months ended December 31, 2006 and 2005, respectively.

Net Loss. The net loss for the three months ended December 31, 2006 increased approximately \$6.3 million, or 81.4%, from the three months ended December 31, 2005, because of the factors discussed above.

Liquidity and Capital Resources

The Company's primary liquidity requirements are for debt service, working capital, capital expenditures, and acquisitions. The Company's principal working capital need is to fund accounts receivable, which increases with the growth of the business. The Company is funding present operations, and intends to fund future operations, primarily through cash provided by operating activities and through use of a revolving credit facility.

The following discussion relates to the cash flow of Alion for the three months ended December 31, 2006 and 2005.

Operating activities used approximately \$25.2 million and \$14.7 million in net cash for the three months ended December 31, 2006 and 2005, respectively. The \$10.5 million increase in use of cash is primarily attributable to the approximate \$6.3 million increase in net loss and \$20.7 million increase in use of cash to fund growth in accounts receivable, which was offset by the approximate \$15.9 million decrease in payments of trade accounts payable and other liabilities.

Net cash used in investing activities was approximately \$8.1 million and \$1.6 million for the three months ended December 31, 2006 and 2005, respectively. During the three months ended December 31, 2006, the Company paid approximately \$6.6 million in acquisition related obligations (termination payments and earn out) for JJMA, WCI and MA&D. The Company spent approximately \$1.5 million for capital expenditures unrelated to acquisitions.

Net cash provided by financing activities was approximately \$30.9 million for the three months ended December 31, 2006, compared to net cash used in financing activities of \$6.3 million for the three months ended December 31, 2005. During

the three months ended December 31, 2006, Alion borrowed approximately \$20.3 million under the revolving credit facility for working capital needs and received \$9.0 million from the issuance of common stock under the ESOP. During the three months ended December 31, 2005, the Company used cash to pay for increased distributions under the ESOP in the net amount of \$5.9 million.

Discussion of Debt Structure

Term B Senior Credit Facility

As of December 31, 2006, the Term B Senior Credit Facility consisted of:

- a senior term loan in the approximate amount of \$258.4 million;
- a \$50.0 million senior revolving credit facility under which approximately \$32.6 million was outstanding as of December 31, 2006, and approximately \$4.5 million of which was allocated for letters of credit and as such is not available to be borrowed; and
- a \$150.0 million uncommitted incremental term loan “accordion” facility.

The discussion below describes the Term B Senior Credit Facility, as modified by Amendments One, Two, Three, Increment Four and Amendment Four; certain of the initial debt agreements (and other related instruments) used to finance the Transaction; and the Senior Unsecured Notes issued and sold by the Company in order to re-finance the amounts outstanding under the previously effective Bridge Loan Agreement and to repay amounts outstanding under the Term B Senior Credit Facility.

On August 2, 2004, the Company entered into a new Term B Senior Credit Facility with a syndicate of financial institutions for which Credit Suisse serves as arranger, administrative agent and collateral agent, and for which LaSalle Bank National Association serves as syndication agent. On April 1, 2005, the Company entered into an incremental term loan facility and an amendment to the Term B Senior Credit Facility (Amendment One), which added \$72.0 million in term loans to the Company’s total indebtedness under the Term B Senior Credit Facility. On March 24, 2006, the Company entered into a second incremental term loan facility and second amendment to the Term B Senior Credit Facility (Amendment Two), which increased the term loan commitment under the Term B Senior Credit Facility by \$68.0 million. Amendment Two also increased the revolving credit commitment under the senior revolving credit facility from \$30.0 million to \$50.0 million. On June 30, 2006, the Company entered into a third incremental term loan facility and amendment to the Term B Senior Credit Facility (Amendment Three), which added \$50.0 million in term loans to our total indebtedness under the Term B Senior Credit Facility. On January 4, 2007, the Company entered into a fourth incremental term loan facility (Increment Four), which added \$15.0 million in term loans to our total indebtedness under the Term B Senior Credit Facility. On February 6, 2007, the Company entered into a fourth amendment to the Term B Senior Credit Facility (Amendment Four).

The Term B Senior Credit Facility requires the Company to repay one percent of the principal balance of the senior term loan during each of the first eight years (fiscal years 2005 through 2012) and the first quarter of fiscal year 2013 in equal quarterly principal installments and the remaining principal balance outstanding during the ninth and final year (2013) in one principal installment. As of December 31, 2006, through the quarter ending September 30, 2008, the Company was obligated to pay quarterly principal installments of approximately \$0.7 million. As of February 6, 2007, through the quarter ending December 31, 2012, the Company is currently obligated to pay quarterly principal installments of \$683,400. On February 6, 2013, the senior term loan maturity date, the Company is obligated to pay a principal installment of the outstanding balance.

Under the senior revolving credit facility, the Company may request up to \$40.0 million in letters of credit and may borrow up to \$5.0 million in swing line loans for short-term borrowing needs. The Company must pay all principal obligations under the senior revolving credit facility in full no later than August 2, 2009.

The Company may prepay all or any portion of its Term B debt in minimum increments of \$1 million, generally without penalty or premium, except for customary breakage costs associated with pre-payment of Eurodollar-based loans. If the Company issues certain permitted debt, or sells, transfers or disposes of certain assets, it must use all net proceeds to repay any Term B loan amounts outstanding. If the Company issues certain kinds of equity or has excess cash flow for any fiscal year, it must use 50% of the net proceeds or excess cash flow to repay Term B loan amounts outstanding. If the Company’s

leverage ratio is less than 2.00 to 1.00, it must use only 25% of net proceeds or excess cash flow to repay Term B loan amounts outstanding.

If the Company borrows any additional term loan, including under the uncommitted incremental term loan facility, and certain terms of such loan are more favorable to the new lenders than existing terms under the Term B Senior Credit Facility, the applicable interest rate spread on the senior term loans can increase. As a result, additional term loans could increase the Company's interest expense under its existing term loans. Certain of the Company's subsidiaries (HFA, CATI, METI, JJMA, BMH, WCI and MA&D) guaranteed the Company's obligations under the Company's Term B Senior Credit Facility.

Use of Proceeds. On August 2, 2004, the Company borrowed \$50.0 million through the senior term loan under the Term B Senior Credit Facility and used approximately \$47.2 million to retire its then outstanding senior term loan and revolving credit facility administered by LaSalle Bank including principal and accrued unpaid interest and paid approximately \$2.8 million in transaction fees. In October 2004, the Company borrowed approximately \$22.0 million of the senior term loan to retire its existing \$19.6 million mezzanine note and to pay approximately \$2.4 million in accrued unpaid interest and prepayment premium. On April 1, 2005, the Company borrowed \$72.0 million in an incremental term loan under the Term B Senior Credit Facility. The Company used approximately \$58.7 million of the incremental term loan proceeds to pay a portion of the JJMA acquisition price, and approximately \$1.3 million to pay transaction fees associated with the incremental term loan. The Company used approximately \$12.0 million to pay a portion of the BMH acquisition price. On March 24, 2006, the Company entered into Amendment Two which made available to the Company \$68.0 million in additional incremental term loans. The Company used approximately \$16.5 million of these incremental term loan proceeds to pay a portion of the WCI acquisition price, and approximately \$13.6 million to redeem the mezzanine warrants held by IIT and the Company's Chief Executive Officer. On May 15, 2006, the Company borrowed \$15.0 million of the incremental term loans made available under Amendment two in order to pay a portion of the MA&D acquisition price. On June 30, 2006, the Company borrowed \$21.0 million of the incremental term loans made available under Amendment Two and \$50.0 million in incremental term loans under Amendment Three in order to pay a portion of the acquisition price for the Anteon Contracts. On January 4, 2007, the Company borrowed \$15.0 million of the incremental term loans made available under Increment Four. Those loan proceeds, less approximately \$0.3 million in fees associated with the borrowing, were immediately used to pay down the outstanding balance on the senior revolving credit facility.

The Term B Senior Credit Facility permits the Company to use the remainder of its senior revolving credit facility for working capital needs, other general corporate purposes, and to finance permitted acquisitions. The Term B Senior Credit Facility permits the Company to use any proceeds from the uncommitted incremental term loan facility to finance permitted acquisitions and for any other purpose permitted by any future incremental term loan.

Security. The Term B Senior Credit Facility is secured by a security interest in all of the Company's current and future tangible and intangible property, as well as all of the current and future tangible and intangible property of the Company's subsidiaries, HFA, CATI, METI, JJMA, BMH, WCI, and MA&D.

Interest and Fees. Under the Term B Senior Credit Facility, the senior term loan and the senior revolving credit facility can each bear interest at either of two floating rates. As of December 31, 2006, the Company was entitled to elect that interest be payable on the Company's senior term loan at an annual rate equal to either: 1) the applicable alternate base interest rate charged by Credit Suisse plus a 175 basis point spread or, 2) the Eurodollar rate plus a 275 basis point spread. As of February 6, 2007, the spread associated with the alternate base interest rate charged by Credit Suisse from time to time was lowered to 150 basis points, and the spread associated with the Eurodollar rate in effect from time to time was lowered to 250 basis points. The Company was also entitled to elect that interest be payable on the senior revolving credit facility at an annual rate dependent on the Company's leverage ratio and whether the borrowing is a Eurodollar or an alternate base rate (ABR) borrowing. As of February 6, 2007, under the Term B Senior Credit Facility, if the Company were to elect a Eurodollar borrowing under its senior revolving credit facility, interest would be payable at an annual rate equal to the Eurodollar rate plus additional basis points as reflected in the table below under the column "Eurodollar Spread" corresponding to the Company's leverage ratio at the time. Under the Term B Senior Credit Facility, if the Company were to elect an ABR borrowing under its senior revolving credit facility, the Company would pay interest at an alternate base interest rate based on the greater of Credit Suisse's prime rate or a federal funds effective rate, plus additional basis points reflected in the table below under the columns "Prime Rate ABR Spread" or "Federal Funds ABR Spread" corresponding to the Company's leverage ratio at the time.

Leverage Ratio	Eurodollar Spread (in basis points)	Federal Funds ABR Spread (in basis points)	Prime Rate ABR Spread (in basis points)
Category 1 Greater than or equal to 3.00 to 1.00	275	225	175
Category 2 Greater than or equal to 2.50 to 1.00 but less than 3.00 to 1.00	250	200	150
Category 3 Greater than or equal to 2.00 to 1.00 but less than 2.50 to 1.00	225	175	125
Category 4 Less than 2.00 to 1.00	200	150	100

On April 1, 2005, the Company elected to have the senior term loan bear interest at the Eurodollar rate and the senior revolving credit facility bear interest at the ABR rate based on Credit Suisse's prime rate. As of December 31, 2006, the Eurodollar rate on the senior term loan was 8.11 percent (5.36 percent plus 2.75 percent Eurodollar spread) and the ABR rate was 10.0 percent (8.25 percent plus 1.75 percent spread).

Interest Rate Cap Agreements. The Term B Senior Credit Facility required us to maintain interest rate hedge agreements acceptable to Credit Suisse to cap our interest expense on at least 40% of our long-term senior debt for a period of at least two years from the date the first such agreement was put into place. This covenant expired on August 16, 2006. We currently have three interest rate cap agreements in place with our senior lenders.

The interest rate cap agreements cap the floating component of the total interest rate we pay, but do not affect spreads based on leverage ratio. The actual effective rate of interest that we pay on principal subject to each cap agreement is equal to the floating component (which is capped) plus the applicable spread. The applicable interest rate spread in the Term B Senior Credit Facility is added to the applicable capped interest rate to determine our effective interest rate on the notional principal subject to the interest rate cap agreement.

In August 2004, we paid approximately \$319,000 to cap our rate at 6.64% (3.89% floating rate cap plus 2.75% spread) on \$36.9 million in notional principal from September 2004 through September 2005 and 7.41% (4.66% floating rate cap plus 2.75% spread) from September 2005 through September 2007. The notional principal declines over time to \$34.5 million at September 2007. In April 2005, Amendment One reduced the Eurodollar spread to 225 basis points, such that the total interest payable with respect to the principal amount covered by the first cap agreement was reset to 6.91% (4.66% floating rate cap plus 2.25% spread). In March 2006, Amendment Two increased the Eurodollar spread to 250 basis points, such that the total interest payable with respect to the principal amount covered by the first cap agreement was reset to 7.16% (4.66% floating rate cap plus 2.50% spread). In June 2006, Amendment Three increased the Eurodollar spread to 275 basis points, such that the total interest payable with respect to the principal amount covered by the first cap agreement was reset to 7.41% (4.66% floating rate cap plus 2.75% spread). In January 2007, Amendment Four decreased the Eurodollar spread to 250 basis points, such that the total interest payable with respect to the principal amount covered by the first cap agreement was reset to 7.16% (4.66% floating rate cap plus 2.50% spread).

In April 2005, we paid approximately \$117,000 to cap our interest rate at 7.25% (5.00% floating rate cap plus 2.25% spread) on an additional \$28.0 million in notional principal through September 2007. In March 2006, Amendment Two increased the Eurodollar spread to 250 basis points, such that the total interest payable with respect to the principal amount covered by the second cap agreement was reset to 7.50% (5.00% floating rate cap plus 2.50% spread). In June 2006, Amendment Three increased the Eurodollar spread to 275 basis points, such that the total interest payable with respect to the principal amount covered by the second cap agreement was reset to 7.75% (5.00% floating rate cap plus 2.75% spread). In January 2007, Amendment Four decreased the Eurodollar spread to 250 basis points, such that the total interest payable with respect to the principal amount covered by the second cap agreement was reset to 7.50% (5.00% floating rate cap plus 2.50% spread).

In April 2006, we paid approximately \$43,600 to cap our interest rate at 8.00% (5.50% floating rate cap plus 2.50% spread) on an additional \$30.0 million in notional principal through September 2007. In June 2006, Amendment Three increased the Eurodollar spread to 275 basis points, such that the total interest payable with respect to the principal amount covered by the third cap agreement was reset to 8.25% (5.50% floating rate cap plus 2.75% spread). In January 2007, Amendment Four decreased the Eurodollar spread to 250 basis points, such that the total interest payable with respect to the principal amount covered by the third cap agreement was reset to 8.00% (5.50% floating rate cap plus 2.50% spread).

Other Fees and Expenses. Each quarter the Company is required to pay a commitment fee equal to 50 basis points per year on the prior quarter's daily unused balance of the revolving credit facility and the senior term loan. As of December 31, 2006, there was approximately \$32.6 million outstanding on the revolving credit facility and there was no unused balance on the senior term loan. For the three months ended December 31, 2006, the Company paid a commitment fee of approximately \$20,000 for the revolving credit facility and no commitment fee for the senior term loan.

In addition to issuance and administrative fees, the Company is required to pay a fronting fee not to exceed 25 basis points for each letter of credit issued under the revolving credit facility. Each quarter the Company is required to pay interest in arrears at the revolving credit facility rate for all outstanding letters of credit. In addition to other fees and expenses under the Term B Senior Credit Facility, the Company is required to pay an annual agent's fee.

Financial Covenants. The Term B Senior Credit Facility requires the Company to meet certain financial performance measures over the life of the facility. These financial measures are used by the Company's lenders in evaluating the Company's leverage capacity, debt service ability and liquidity that result from the calculation of leverage ratio and interest coverage ratio as required by the terms of the Term B Senior Credit Facility. As defined below, both the leverage ratio and interest coverage ratios refer to the non-GAAP terms "EBITDA" and "Consolidated EBITDA" as defined in the Term B Senior Credit Facility. EBITDA and consolidated EBITDA have been calculated by management in accordance with the financial covenants and have not been audited. The definition, calculation and reconciliation of the differences between these non-GAAP financial measures to the most comparable financial measures calculated and presented in accordance with GAAP in this quarterly report on Form 10-Q are included in the schedules that follow.

a) Consolidated EBITDA — Definition

Consolidated EBITDA is defined in the Term B Senior Credit Facility as: (a) the Company's consolidated net income (or loss), as defined therein, plus (b) without duplication, to the extent deducted from net income or included in the net loss, the sum of: (i) interest expense; (ii) provision for income taxes; (iii) depreciation and amortization, including amortization of other intangible assets; (iv) cash contributions to the ESOP in respect of the repurchase liability of the Company under the ESOP Plan; (v) any non-cash charges or expenses (other than the write-down of current assets) including (A) non-cash expenses associated with the recognition of the difference between the fair market value of the remaining outstanding Warrants (see Note 12 "Redeemable Common Stock Warrants") and the exercise price of those Warrants, (B) non-cash expenses with respect to the stock appreciation rights and phantom stock plans, and the remaining outstanding Warrants and accretion of those Warrants and (C) non-cash contributions to the ESOP, (vi) any extraordinary losses and (vii) any nonrecurring charges and adjustments treated as such by the third-party valuation firm that prepares valuation reports in connection with the ESOP, minus (c) without duplication, (i) all cash payments made on account of reserves, restructuring charges and other non-cash charges added to net income (or included in net loss) pursuant to clause (b)(v) above in a previous period and (ii) to the extent included in net income (or net loss), any extraordinary gains and all non-cash items of income, all determined on a consolidated basis in accordance with GAAP.

In addition, the Term B Senior Credit Facility adjusts consolidated EBITDA for purposes of calculating compliance with certain financial covenants in the event that the Company acquires another business pursuant to pre-approved procedures and requirements which the Term B Senior Credit Facility refers to as a "Permitted Acquisition" and in cases where the Company sells certain significant assets. In those cases, consolidated EBITDA will be adjusted for a particular accounting period so that consolidated EBITDA takes into account the pro forma effect of such acquisition or asset sale as if it had taken place at the beginning of that particular accounting period.

Consolidated EBITDA has limitations as an analytical tool, and is not to be considered in isolation or as a substitute for analysis of the Company's financial performance or liquidity as reported under GAAP. Some of these limitations are:

- Consolidated EBITDA does not reflect the Company's cash expenditures, or future requirements for capital expenditures or contractual commitments;
- Consolidated EBITDA does not reflect changes in, or cash requirements for, the Company's working capital needs;
- Consolidated EBITDA does not reflect interest expense, or the cash requirements necessary to service interest or principal payments, on the Company's debt; and although depreciation and amortization are non-cash charges, the assets being depreciated and amortized will often have to be replaced in the future, and Consolidated EBITDA does not reflect any cash requirements for such replacements.

The calculation and reconciliation to the most comparable financial measure calculated and presented in accordance with GAAP is included in the table below.

Alion Science and Technology Corporation
Non-GAAP Measures — EBITDA and Consolidated EBITDA
For the Twelve Months Ended December 31, 2006 and 2005

<u>Calculation of EBITDA</u>	<u>2006</u>	<u>2005</u>
	(Dollars in thousands)	
Net loss	\$ (37,447)	\$ (42,054)
Plus: Interest expense	38,604	37,148
Plus: Income tax expense (benefit)	(6)	34
Plus: Depreciation and amortization expense	17,431	19,073
EBITDA	<u>\$ 18,582</u>	<u>\$ 14,201</u>
<u>Calculation of Consolidated EBITDA</u>	<u>2006</u>	<u>2005</u>
	(Dollars in thousands)	
EBITDA	\$ 18,582	\$ 14,201
Plus: Cash contributions to ESOP in respect of the repurchase liability	-	-
Plus: Non-cash expenses with respect to the stock appreciation rights and phantom stock plans (Stock-based compensation less cash settlements)*	11,574	12,927
Plus: Non-cash contributions to the ESOP (including Company 401-k match)*	8,796	5,980
Plus: Nonrecurring charges and adjustments by third-party valuation firm that prepares valuation reports in connection with the ESOP	17,340	4,425
Consolidated EBITDA	<u>\$56,292</u>	<u>\$ 37,533</u>

*Non-cash expenses with respect to the stock appreciation rights and phantom stock plans and non-cash contributions to the ESOP constitute all the non-cash charges and expenses that are included in the calculation of Consolidated EBITDA.

Leverage Ratio. As of December 31, 2006, the Company's leverage ratio was calculated by dividing the total outstanding amount of all of the Company's consolidated indebtedness, but excluding the amount owed under the Company's Subordinated Note and the aggregate amount of letters of credit issued on the Company's behalf other than drawings which have not been reimbursed, by the Company's Consolidated EBITDA for the previous four fiscal quarters on a rolling basis. The maximum total leverage ratio is measured as of the end of each of our fiscal quarters. As of December 31, 2006, for each of the following time periods, the Company was permitted to maintain a maximum leverage ratio not greater than the following:

Period	Ratio
June 30, 2006 through September 30, 2007	6.50 to 1.00
October 1, 2007 through June 30, 2008	6.00 to 1.00
July 1, 2008 through June 30, 2009	5.75 to 1.00
Thereafter	5.25 to 1.00

The calculation of the Company's leverage ratio for the twelve months ended December 31, 2006 and 2005 is set forth in the table below.

Alion Science and Technology Corporation
Computation of Leverage Ratio
Under the Term B Senior Credit Facility
For the Twelve Months Ended December 31, 2006 and 2005

	<u>2006</u>	<u>2005</u>
	(Dollars in thousands)	
<u>Numerator:</u>		
Revolving credit facility	\$ 33,404	\$ -
Term B Senior Credit facility debt outstanding, at face value	258,360	142,560
Bridge loan	<u>170,000</u>	<u>-</u>
Total debt outstanding	<u>\$461,764</u>	<u>\$142,560</u>
<u>Denominator:</u>		
Consolidated EBITDA	\$ 56,292	\$ 37,533
Plus: Acquisition-related pro forma adjustment	<u>17,229</u>	<u>3,550</u>
Consolidated EBITDA with pro forma effect of acquisitions	<u>\$ 73,521</u>	<u>\$ 41,083</u>
Leverage ratio:	6.28	3.47

The Company's leverage ratio covenant was converted into a senior secured leverage ratio covenant pursuant to Amendment Four. Beginning February 6, 2007, the Company's senior secured leverage ratio will be calculated by dividing the total outstanding amount of all of the Company's consolidated indebtedness secured by a lien, but excluding the Senior Unsecured Notes and the amount owed under the Company's Subordinated Note and the aggregate amount of letters of credit issued on the Company's behalf other than drawings which have not been reimbursed, by the Company's Consolidated EBITDA for the previous four fiscal quarters on a rolling basis. The maximum total senior secured leverage ratio is measured as of the end of each of our fiscal quarters. Beginning as of February 6, 2007, for each of the following time periods, the Company will be permitted to maintain a maximum senior secured leverage ratio not greater than the following:

Period	Ratio
February 6, 2007 through September 30, 2007	4.00 to 1.00
October 1, 2007 through September 30, 2008	3.75 to 1.00
October 1, 2008 through September 30, 2009	3.25 to 1.00
Thereafter	3.00 to 1.00

Interest Coverage Ratio. As of December 31, 2006, the Company's interest coverage ratio was calculated by dividing the Company's consolidated EBITDA, less amounts the Company spends attributable to property, plant, equipment and other

fixed assets, by the Company's consolidated interest expense. As of December 31, 2006, for each of the following time periods, the Company was required to maintain a minimum interest coverage ratio not less than the following:

Period	Ratio
June 30, 2006 through September 30, 2007	1.65 to 1.00
October 1, 2007 through September 30, 2008	1.75 to 1.00
Thereafter	2.00 to 1.00

The calculation of the Company's interest coverage ratio for the twelve months ended September 30, 2006 and 2005 is set forth in the table below.

Alion Science and Technology Corporation
Computation of Interest Coverage Ratio
Under the Term B Senior Credit Facility
For the Twelve Months Ended December 31, 2006 and 2005

<u>Numerator:</u>	<u>2006</u>	<u>2005</u>
	(Dollars in thousands)	
Consolidated EBITDA	\$ 56,292	\$ 37,533
Plus: Acquisition-related pro forma adjustment	<u>17,229</u>	<u>3,550</u>
Consolidated EBITDA with pro forma effect of acquisitions	73,521	41,083
Less: Capital expenditures	<u>5,155</u>	<u>3,238</u>
Consolidated EBITDA with pro forma effect of acquisitions less capital expenditures	<u><u>\$ 68,366</u></u>	<u><u>\$ 37,845</u></u>
	<u>2006</u>	<u>2005</u>
	(Dollars in thousands)	
<u>Denominator:</u>		
Consolidated interest expense	\$ 27,012	\$ 8,680
Interest coverage ratio	2.53	4.36

The Company's interest coverage ratio was modified pursuant to Amendment Four. Beginning February 6, 2007, in order for the Company to remain in compliance with this covenant, the interest coverage ratio for any period of four consecutive quarters, in each case taken as one accounting period, can not be less than 1.35 to 1.00.

The Term B Senior Credit Facility includes other covenants which, among other things, restrict the Company's ability to do the following without the prior consent of syndicate bank members that have extended more than 50 percent or more of the aggregate amount of all loans then outstanding under the Term B Senior Credit Facility:

- incur additional indebtedness other than permitted additional indebtedness after satisfying a leverage based incurrence test;
- consolidate, merge or sell all or substantially all of the Company's assets;
- make certain loans and investments including acquisitions of businesses, other than permitted acquisitions;
- pay dividends or distributions other than distributions needed for the ESOP to satisfy its repurchase obligations and for certain payments required under the Company's equity based incentive plans;
- enter into certain transactions with the Company's shareholders and affiliates;
- enter into certain transactions not permitted under ERISA;
- grant certain liens and security interests;
- enter into sale and leaseback transactions;

- change lines of business;
- repay subordinated indebtedness before it is due and redeem or repurchase certain equity;
- pay certain earn outs in connection with permitted acquisitions; or
- use the proceeds of the Company's borrowings other than as permitted by the Term B Senior Credit Facility.

Events of Default. The Term B Senior Credit Facility contains customary events of default including, without limitation:

- payment default;
- breach of representations and warranties;
- uncured covenant breaches;
- default under certain other debt exceeding an agreed amount;
- bankruptcy and insolvency events;
- notice of debarment, suspension or termination under a material government contract;
- certain ERISA violations;
- unstayed judgments in excess of an agreed amount;
- failure of the subordinated note to be subordinated to the Term B Senior Credit Facility;
- failure of any guarantee of the Term B Senior Credit Facility to be in effect;
- failure of the security interests to be valid, perfected first priority security interests in the collateral;
- failure of the Company to remain an S-corporation;
- imposition on the ESOP Trust of certain taxes in excess of an agreed amount;
- final determination that the ESOP is not a qualified plan;
- incurrence of a civil or criminal liability in excess of \$5 million of the Company or any subsidiary arising from a government investigation;
- the actual termination of a material contract due to alleged fraud, willful misconduct, negligence, default or any other wrongdoing; or
- change of control (as defined below).

For purposes of the Term B Senior Credit Facility, a change of control generally occurs when, before the Company lists its common stock to trade on a national securities exchange and the Company obtains net proceeds from an underwritten public offering of at least \$30.0 million, the ESOP Trust fails to own at least 51 percent of the Company's outstanding equity interests, or, after the Company has such a qualified public offering, any person or group other than IIT or the ESOP Trust owns more than 37.5 percent of the Company's outstanding equity interests. A change of control may also occur if a majority of the seats (other than vacant seats) on the Company's board of directors shall at any time be occupied by persons who were neither nominated by the Company's board nor were appointed by directors so nominated. A change of control may also occur if a change of control occurs under any of the Company's material indebtedness including the Company's subordinated note and the warrants issued with the Company's subordinated note.

For the years ended December 31, 2006 and 2005, the Company was in compliance with the financial covenants set forth in the Term B Senior Credit Facility.

Bridge Loan Agreement

On June 30, 2006, the Company entered into a Bridge Loan Agreement with Credit Suisse and borrowed \$170.0 million (the Bridge Loan). Certain of the Company's subsidiaries guaranteed the Bridge Loan Agreement. The Company used the proceeds from the Bridge Loan to pay part of the cost of acquiring the Anteon Contracts. On February 8, 2007, the Company used a majority of the proceeds of the issuance and sale of the Senior Unsecured Notes to repay all amounts outstanding under the Bridge Loan Agreement.

The Bridge Loan Agreement required the Company to meet certain financial performance measures and to comply with certain other covenants. As of December 31, 2006, the Company was in compliance in all material respects with the covenants set forth in the Bridge Loan Agreement.

Subordinated Note

On December 20, 2002, the Company issued a \$39.9 million note to IITRI (Subordinated Note) as part of the consideration for Alion's acquisition of substantially all of IITRI's assets. On July 1, 2004, IIT acquired all of IITRI's rights and interests in the Subordinated Note and the related warrant agreement. On June 30, 2006, the Company and IIT entered into an agreement that increased the interest rate on the Subordinated Note for two years from December 21, 2006 through December 20, 2008.

The Subordinated Note bears interest at (i) 6% through December 20, 2006, (ii) approximately 6.4% from December 21, 2006 through December 20, 2007, and (iii) 6.7% from December 21, 2007 through December 20, 2008. Interest is payable quarterly by the issuance of paid-in-kind or PIK notes maturing at the same time as the Subordinated Note. The PIK notes have the effect of deferring the underlying cash interest expense on the Subordinated Note. Beginning in December 2008, the Subordinated Note will bear interest at 16% per year payable quarterly in cash until the note has been repaid in full. Principal on the Subordinated Note is payable in equal installments of \$19.95 million in December 2009 and December 2010. The PIK notes are due in equal installments of approximately \$7.4 million on these same dates.

Senior Unsecured Notes

On February 8, 2007, the Company issued and sold \$250.0 million of its 10.25% senior unsecured notes due February 1, 2015 (Senior Unsecured Notes) to Credit Suisse, which has informed the Company that it resold most of the Senior Unsecured Notes to qualified institutional buyers.

Use of Proceeds. The proceeds of the Senior Unsecured Notes were used to pay off all outstanding amounts under the Bridge Loan Agreement and approximately \$72.0 million of the amounts outstanding under the Term B Senior Credit Facility.

Security. The Senior Unsecured Notes are currently guaranteed by HFA, CATI, METI, JJMA, BMH, WCI and MA&D and will be guaranteed by certain of the Company's future subsidiaries.

Ranking. The Senior Unsecured Notes are senior unsecured obligations of the Company and rank the same in right of payment with all existing and future senior indebtedness of the Company including future indebtedness under the Term B Senior Credit Facility. However, all of the Company's secured debt and other obligations in effect from time to time, including the amounts outstanding under the Term B Senior Credit Facility, are effectively senior to the Senior Unsecured Notes to the extent of the value of the assets securing such debt or other obligations. The Senior Unsecured Notes rank senior in right of payment to all existing and future subordinated indebtedness, including the subordinated notes.

Interest and Fees. The Senior Unsecured Notes bear interest at 10.25% per year, payable semi-annually in arrears on February 1 and August 1, commencing on August 1, 2007. The Company will make each interest payment to the holders of record on the immediately preceding January 15 and July 15. The Company will pay interest on overdue principal at 11.25% per annum and will pay interest on overdue installments of interest at 11.25% per annum to the extent lawful.

Optional Redemption. Prior to February 1, 2011, the Company may redeem all, but not less than all, of the Senior Unsecured Notes at a redemption price equal to 100% of the principal amount of the Senior Unsecured Notes plus accrued and unpaid interest to the redemption date plus an applicable make-whole premium as of the redemption date.

In addition, any time prior to February 1, 2010, subject to certain conditions, the Company may use the proceeds of a qualified equity offering to redeem Senior Unsecured Notes in an aggregate principal amount not to exceed \$87.5 million at a redemption price equal to the sum of 110.25% of the aggregate principal amount of the notes actually redeemed, plus accrued and unpaid interest to the redemption date.

On or after February 1, 2011, the Company may redeem all or a portion of the Senior Unsecured Notes at the redemption prices set forth below (expressed in percentages of principal amount on the redemption date), plus accrued and unpaid interest to the redemption date, if redeemed during the 12-month period commencing on February 1 of the years set forth below:

<u>Period</u>	<u>Redemption Price</u>
2011	105.125%
2012	102.563%
2013 and thereafter	100.000%

Covenants. The Indenture governing the Senior Unsecured Notes contains covenants that, among other things, limit the Company's ability and the ability of certain of its subsidiaries to:

- incur or guarantee additional indebtedness;
- pay dividends on capital stock or redeem, repurchase or retire capital stock or subordinated indebtedness, except in certain circumstances for the junior subordinated notes and junior warrants;
- repurchase or redeem shares of Company stock in connection with distributions and diversifications from the ESOP component of the KSOP;
- transfer or sell assets including shares of stock of certain subsidiaries of the Company outside the ordinary course of business;
- make investments other than certain permitted investments;
- engage in business unrelated to the Company's existing business;
- incur certain liens and enter into sale/leaseback transactions;
- enter into certain transactions with affiliates;
- restrict the ability of subsidiaries to pay dividends and make their distributions and loans to the Company; and
- merge or consolidate with other companies.

Events of Default. The Indenture contains customary events of default, including:

- payment default;
- uncured covenant breaches;
- default under an acceleration of certain other debt exceeding \$30 million;
- certain bankruptcy and insolvency events;
- a judgment for payment in excess of \$30 million entered against the Company or any material subsidiary that remains outstanding for a period of 60 days and is not discharged, waived or stayed; and
- failure of any guarantee of the Senior Unsecured Notes to be in effect or the denial or disaffirmation by any subsidiary guarantor of its guaranty obligations.

Exchange Offer; Registration Rights. Under a registration rights agreement executed in connection with the Senior Unsecured Notes, the Company, subject to certain exceptions, has agreed to:

- file a registration statement with the SEC with respect to a registered offer to exchange the Notes for publicly registered notes, within 90 days after the issue date of the Senior Unsecured Notes;
- use reasonable best efforts to cause the registration statement to be declared effective under the Securities Act within 240 days after the issue date of the Notes;
- commence the exchange offer as soon as practicable after the effectiveness of the registration statement; and
- keep the exchange offer open for not less than 30 days after the date notice of the exchange offer is mailed to the holders of the Notes.

The Company has agreed to pay additional interest on the Senior Unsecured Notes if the Company does not comply with these or certain other of its obligations under the registration rights agreement.

Change of Control. Upon the occurrence of any of the following events, each holder of Senior Unsecured Notes has the right to require that the Company repurchase such holder's notes at a purchase price in cash equal to 101 percent of the principal amount of such holder's notes plus accrued and unpaid interest:

- subject to certain exceptions, a person, other than the ESOP Trust, is or become the beneficial owner, directly or indirectly, of more than 35% of the total voting power or voting stock of the Company;
- individuals who on the date of issuance of the Senior Unsecured Notes constituted the board of directors of the Company, cease for any reason to constitute a majority of the board of directors of the Company;
- the adoption of a plan relating to the liquidation or dissolution of the Company; and

- subject to certain exceptions, the merger or consolidation of the Company with or into another person or the merger of another person with or into the Company, or the sale of all or substantially all the assets of the Company to another person.

During the remainder of fiscal year 2007 and the next six fiscal years, at a minimum, we expect that we will have to make the estimated interest and principal payments set forth below. These estimates include the effects of the following financing transactions subsequent to December 31, 2006 (see discussion of debt amendment in Note 18 – Subsequent Events in the Notes to the Condensed Consolidated Financial Statements):

- Additional borrowings of \$15.0 million of senior term loans on January 4, 2007, under the Term B Senior Credit Facility;
- Extension of the maturity date of the senior term loans outstanding under the Term B Senior Credit Facility to February 6, 2013;
- Issuance of \$250.0 million in Senior Unsecured Notes on February 8, 2007;
- Repayment of the entire outstanding balance of the Bridge Loan on February 8, 2007; and
- Re-payment of \$51.0 million in outstanding principal of senior term loans on February 8, 2007, under the Term B Senior Credit Facility.

	6-Fiscal Year Period (\$ In thousands)						
	2007*	2008	2009	2010	2011	2012	Thereafter
Bank revolving credit facility							
- Interest ⁽¹⁾	\$ 386	\$ 250	\$ 250	\$ 250	\$ 250	\$ 250	\$750
Senior Secured Term B Loan							
- Interest ⁽²⁾	12,979	16,398	16,274	16,292	16,554	16,712	8,482
- Principal ⁽³⁾	1,668	2,224	2,224	2,224	2,224	2,224	209,574
Senior Unsecured Notes							
- Interest ⁽⁴⁾	12,216	25,625	25,625	25,625	25,625	25,625	64,063
- Principal ⁽⁴⁾	-	-	-	-	-	-	250,000
Subordinated note							
- Interest ⁽⁵⁾	-	-	6,384	3,192	-	-	-
- Principal ⁽⁵⁾	-	-	27,352	27,352	-	-	-
Total cash - Pay interest	25,581	42,273	48,533	45,359	42,429	42,587	73,295
Total cash - Pay principal	1,668	2,224	29,576	29,576	2,224	2,224	459,574
Total	<u>\$ 27,249</u>	<u>\$ 44,497</u>	<u>\$ 78,109</u>	<u>\$ 74,935</u>	<u>\$ 44,653</u>	<u>\$ 44,811</u>	<u>\$532,869</u>

* Estimated interest and principal payments for the remainder of fiscal year 2007.

(1) The Company anticipates accessing, from time to time, its \$50.0 million bank revolving credit facility to finance the Company's ongoing working capital needs. The remaining term of the revolving credit facility is approximately two years; however, the Company expects to access a revolving credit facility as an on-going requirement to fund working capital at least through 2012. For the remainder of fiscal year 2007, the average balance drawn on the Company's then revolving credit facility is projected to be approximately \$2.0 million. For the fiscal years 2008 through 2012, the Company anticipates the balance drawn on the revolving credit facility will be minimal. As of December 31, 2006, the Company has borrowed approximately \$32.5 million under the revolving credit facility, approximately \$4.5 million of which was allocated for letters of credit and as such is not available to be borrowed. Interest expense value includes an estimate for the unused balance fee on the \$50.0 million revolving credit facility.

(2) The projected average annual senior term loan balance the Company estimates will be drawn under the Term B Senior Credit Facility is as follows: \$227.6 million, \$219.6 million, \$217.4 million, \$215.1 million, \$212.9 million, and \$210.7 million for the remainder of fiscal year 2007 and for fiscal years ending September 30, 2008 through 2012, respectively. The Company expects it will need to refinance the Term B Senior Credit Facility before the end of fiscal year 2012 and expects interest expense to continue at levels similar to prior years. Based on an estimated LIBOR rate plus the Credit Suisse Eurodollar spread, the effective annual interest rate for the remainder of fiscal year 2007, and for fiscal years ending September 30, 2008 through 2012 is estimated to be approximately 7.6%, 7.5%, 7.5%, 7.6%, 7.8%, and 7.9%, respectively. The effective interest rate takes into account the interest rate cap agreements which limit the interest rate on a portion, but not all, of the outstanding principal balance of the Term B Senior Credit Facility. The cap agreements expire in September 2007. Outstanding principal balances not under the cap agreements had interest based on the Eurodollar rate. The senior term loan matures February 6, 2013. The approximate impact of a 1% increase in the interest rate, as applied to principal balances drawn under the senior term loan not covered by the current interest rate cap agreements would be \$1.4 million, \$2.2 million, \$2.2 million, \$2.2 million, \$2.1 million, and \$2.1 million for the remainder of fiscal year 2007 and for fiscal years ending September 30, 2008 through 2012, respectively. Estimated interest expense includes an estimate for the commitment fee on the senior term loan.

(3) The Term B Senior Credit Facility requires the Company to repay approximately 1.0 percent of the principal balance outstanding under the senior term loan annually. Approximately 6.0 percent of the principal will be paid during fiscal years 2007 through 2012 and the first quarter of fiscal year 2013 and the remaining principal balance will be repaid on February 6, 2013, the senior term loan maturity date. The table reflects the balance drawn of \$258.4 million as of December 31, 2006, plus the \$15.0 million in additional term loans drawn under the Term B Senior Credit Facility on January 4, 2007, less a \$51.0 million repayment of the Term B Senior loan on February 8, 2007 from the proceeds of sale of \$250.0 million Senior Unsecured Notes, resulting in expected aggregate annual principal payments of approximately \$1.7 million for the remainder of fiscal year 2007 and approximately \$2.2 million in each of fiscal years 2008 through 2012. The remaining principal balance of approximately \$209.6 million is to be paid on February 6, 2013. The Term B Senior Credit Facility also requires the Company to make mandatory prepayments of principal depending upon whether the Company generates certain excess cash flow in a given fiscal year, issues or incurs certain debt or sells certain assets. As of December 31, 2006, no mandatory prepayments are due.

(4) The table reflects the issuance of \$250.0 million of Senior Unsecured Notes on February 8, 2007. The principal amount of \$250.0 million is due and payable on February 1, 2015.

(5) The Subordinated Note bears interest at (i) 6.0% through December 20, 2006, (ii) approximately 6.4% from December 21, 2006 through December 20, 2007, and (iii) 6.7% from December 21, 2007 through December 20, 2008. Interest is payable quarterly by the issuance of paid-in-kind or PIK notes maturing at the same time as the Subordinated Note. The issuance of the PIK notes has the effect of deferring the underlying cash interest expense on the Subordinated Note. Commencing December 2008, the Subordinated Note will bear interest at 16.0% per year payable quarterly in cash through the time of repayment in full of the Subordinated Note. Principal on the Subordinated Note will be payable in equal installments of \$19.95 million in December 2009 and December 2010; the PIK notes are also due in equal installments of approximately \$7.4 million on these same dates.

Other Obligations

Earn outs

The Company has earn out commitments related to the following acquisitions:

CATI – There is an earn out provision not to exceed \$8.25 million based on the revenue of the business units that formerly comprised CATI. There is a second earn out provision not to exceed \$1.5 million based on attaining certain revenue goals in the commercial aviation industry. The obligations continue until September 2007. In the three months ended December 31, 2006 and 2005, the Company recognized no earn out obligations for CATI.

BMH – There is an earn out provision not to exceed a total of \$6.0 million based on the revenue of the business units that formerly comprised BMH. The obligation continues until December 2007. In the three months ended December 31, 2006, the Company recognized approximately \$3.0 million in earn out obligation related to BMH.

WCI – There is an earn out provision not to exceed a total of \$2.5 million based on the revenue of the business units that formerly comprised WCI. The obligation continues until September 2007. In the three months ended December 31, 2006, the Company paid approximately \$1.3 million in previously recognized earn out obligations related to WCI.

MA&D – There is an earn out provision not to exceed a total of \$2.5 million based on the revenue of the business units that formerly comprised MA&D. The obligation continues until September 2007. In the three months ended December 31, 2006, the Company recognized no earn out obligations related to MA&D.

Lease Payments

The Company’s remaining minimum lease payment obligations under non-cancelable operating leases for the remainder of fiscal year 2007 and fiscal years ending 2008 through 2012 are \$19.8 million, \$25.5 million, \$22.2 million, \$16.5 million, \$14.3 million and \$9.7 million, respectively. The remaining aggregate obligations on these leases thereafter are approximately \$22.8 million. Commercial facility lease expenses are included in these amounts. These commercial facility lease obligations are currently reimbursable costs under the Company’s government contracts.

Other contingent obligations which will impact the Company’s cash

Other contingent obligations which will impact the Company’s cash flow include:

- Obligations relating to deferred compensation programs for senior managers;
- Obligations related to the holder’s put rights associated with the Subordinated Note warrants;
- Obligations relating to the Company’s stock based compensation plans; and
- Repurchase obligations under the KSOP.

As of December 31, 2006, the Company has spent a cumulative total of \$29.0 million to repurchase shares of its common stock in order to satisfy redemption obligations under the KSOP to former employees.

<u>Date</u>	<u>Number of Shares Repurchased</u>	<u>Share Price</u>	<u>Total Value Purchased</u> (in thousands)
June 2003	5,248	\$11.13	\$ 58
July 2003	2,696	\$11.13	30
December 2003	50,031	\$14.71	736
May 2004	117	\$16.56	2
June 2004	727	\$16.56	12
June 2004	743	\$16.56	12
July 2004	48,309	\$16.56	800
December 2004	46,816	\$19.94	934
March 2005	5,691	\$19.94	113
June 2005	45,846	\$29.81	1,367
August 2005	1,090	\$33.78	37
September 2005	170,657	\$33.78	5,765
December 2005	211,537	\$35.89	7,592
June 2006	273,800	\$37.06	10,147
July 2006	32,420	\$37.06	1,201
August 2006	1,695	\$37.06	63
December 2006	2,243	\$41.02	92
Total			<u>\$28,961</u>

The Company believes that cash flow from operations and cash available under its revolving credit facility will provide it with sufficient capital to fulfill its current business plan and to fund its working capital needs for at least the next 24 months. Although the Company expects to have positive cash flow from operations, it will need to generate significant additional revenues beyond its current revenue base and to earn net income in order to repay principal and interest on the

indebtedness it assumed under the Term B Senior Credit Facility, Senior Unsecured Notes and the remaining outstanding indebtedness it incurred to fund the Transaction.

The Company's business plan calls for it to continue to acquire companies with complementary technologies. The Term B Senior Credit Facility allows the Company to make certain permitted acquisitions, and the Company intends to use a portion of the financing available to it under the Term B Senior Credit Facility to make permitted acquisitions.

The Company also expects that it will need to refinance the Term B Senior Credit Facility before the end of fiscal year 2012. The Company's cash from operations will be insufficient to satisfy all of its obligations and it cannot be certain that it will be able to refinance on terms that will be favorable to the Company, if at all. Moreover, if the Company's plans or assumptions change, if its assumptions prove inaccurate, if it consummates additional or larger investments in or acquisitions of other companies than are currently planned, if it experiences unexpected costs or competitive pressures, or if its existing cash and projected cash flow from operations prove insufficient, it may need to obtain greater amounts of additional financing and sooner than expected. While it is the Company's intention only to enter into new financing or refinancing that it considers advantageous, it cannot be certain that such sources of financing will be available to the Company in the future, or, if available, that financing could be obtained on terms favorable to the Company.

On February 8, 2007, the Company issued and sold \$250.0 million of its 10.25% senior unsecured notes (Senior Unsecured Notes) to Credit Suisse, which has informed the Company that it has resold most of the Senior Unsecured Notes to qualified institutional buyers. The Senior Unsecured Notes will mature on February 1, 2015. Interest on the Senior Unsecured Notes will accrue at the rate of 10.25% annually and will be payable semiannually in arrears on February 1 and August 1, commencing on August 1, 2007. The Senior Unsecured Notes rank the same in right of payment with all existing and future senior indebtedness of the Company, including indebtedness outstanding under and which may be borrowed pursuant to the Term B Senior Credit Facility. The proceeds of the Senior Unsecured Notes were used to pay off all outstanding amounts under the Bridge Loan Agreement and approximately \$72.0 million of the amounts outstanding under the Term B Senior Credit Facility.

Contract performance — Joint Spectrum Center Contract

During the Company's fiscal year ended September 30, 2006, the support services contract to the JSC underwent a full and open competition for the follow-on support contract that was to commence beginning October 2005. Following rounds of protest filings in 2005 and 2006, it was finally determined in October 2006 that we would not receive the follow-on contract. The Company's performance under the JSC contract ended in December 2006.

Summary of Critical Accounting Policies

Revenue Recognition

The Company's revenue results from technology services under a variety of contracts, some of which provide for reimbursement of costs plus fees and others of which are fixed-price or time-and-material type contracts. The Company generally recognizes revenue when a contract has been executed, the contract price is fixed or determinable, delivery of the services or products has occurred and collectibility of the contract price is considered probable.

The Company recognizes revenue on cost-reimbursement contracts as it incurs costs and includes estimated fees earned. The Company recognizes time-and-material contract revenue at negotiated, fixed, contractually billable rates as it delivers labor hours and incurs other direct expenses. The Company uses various performance measures under the percentage of completion method to recognize revenue for fixed-price contracts. The process of estimating contract costs at completion and recognizing revenue appropriately involves significant management estimates. Actual costs may differ from estimated costs and affect estimated profitability and the timing of revenue recognition. From time to time, facts develop that require the Company to revise its estimated total costs or revenues expected. The Company records the cumulative effect of revised estimates in the period in which the facts requiring revised estimates become known. The Company recognizes the full amount of anticipated losses on any type of contract in the period in which they become known. For each of the periods presented, the cumulative effects of revised estimates were immaterial to the financial performance of the Company. Revised estimates did not generate any anticipated losses for any period presented. Further, the Company had no cost overruns on fixed price contracts that materially affected financial performance in any of the periods presented.

Contracts with agencies of the federal government are subject to periodic funding by the contracting agency concerned. A contract may be fully funded at its inception or ratably throughout its period of performance as services are provided. If the Company determines contract funding is not probable, it defers revenue recognition until realization is probable.

Contract costs on federal government contracts are subject to audit by the federal government and adjustment through negotiations between the Company and government representatives. The government considers Alion to be a major contractor and maintains an office on site to perform various audits. The government has audited all of the Company's federal government contract indirect costs through fiscal year 2004. Indirect rates have been negotiated and settled through fiscal year 2003. The Company submitted its fiscal year 2005 indirect expense rates to the government in March 2006 and expects to submit its fiscal year 2006 indirect expense rates to the government in March 2007. The Company has recorded revenue on federal government contracts in amounts it expects to realize.

The Company recognizes revenue on unpriced change orders as it incurs expenses and only to the extent it is probable that the Company will recover such costs. The Company recognizes revenue in excess of costs on unpriced change orders only when management can also reliably estimate the amount of excess and experience provides a sufficient basis for recognition. The Company recognizes revenue on claims as expenses are incurred only to the extent it is probable that the Company will recover such costs and it can reliably estimate the amount it will recover.

The Company generates software revenue from licensing software and providing services. In general, professional services are essential to the functionality of the solution sold and the Company applies the percentage of completion method, as prescribed by AICPA SOP 81-1, *Accounting for Performance on Construction-Type and Certain Production-Type Contracts*, to recognize revenue.

Goodwill and Intangible Assets

The purchase price that we pay to acquire the stock or assets of an entity must be assigned to the net assets acquired based on the estimated fair value of those net assets. The purchase price in excess of the estimated fair value of the tangible net assets and separately identified intangible assets acquired represents goodwill. The purchase price allocation related to acquisitions involves significant estimates and management judgments that may be adjusted during the purchase price allocation period.

The Company accounts for goodwill and other intangible assets in accordance with the provisions of SFAS No. 142, which requires, among other things, the discontinuance of goodwill amortization. In addition, goodwill is to be reviewed at least annually for impairment or more frequently if events and circumstances indicate that the asset might be impaired. The Company has elected to perform this review annually at the end of each fiscal year. An impairment loss would be recognized to the extent that the carrying amount exceeds the asset's fair value. The process of evaluating any impairment to goodwill involves significant management estimates. These annual reviews have resulted in no adjustments. The Company's review consists of two steps. First, the Company estimates its fair value using an estimate of the fair value of its common stock based upon a valuation performed by an independent, third-party firm and compares it to its carrying amount. Second, if the carrying amount exceeds its fair value, an impairment loss is recognized for any excess of the carrying amount of goodwill over the implied fair value of that goodwill. The implied fair value of goodwill is determined by allocating the fair value in a manner similar to a purchase price allocation, in accordance with FASB Statement No. 141, *Business Combinations*. The residual fair value after this allocation is the implied fair value of the goodwill.

As of December 31, 2006, the Company has goodwill of approximately \$391.2 million, subject to annual impairment review. As of December 31, 2006, the Company has a recorded a net intangible asset balance of approximately \$71.2 million, comprised primarily of purchased contracts which were acquired in connection with the Transaction and the ITSC, IPS, Countermeasures, METI, CATI, JJMA, BMH, WCI, MA&D and Anteon Contract acquisitions. The intangible assets have an estimated useful life of one to thirteen years and are amortized using the straight-line method.

The Company completed a goodwill impairment analysis in the fourth quarter of fiscal year 2006 and determined that an impairment charge to earnings was not required. As required by the accounting rules, the Company will perform a similar review in the fourth quarter of fiscal year 2007. For the three months ended December 31, 2006, there were no events that indicated goodwill impairment as of December 31, 2006.

Forward Looking Statements

This discussion contains forward-looking statements that involve risks and uncertainties. These statements relate to our future plans, objectives, expectations and intentions and are for illustrative purposes only. These statements may be identified by the use of words such as “believe,” “expect,” “intend,” “plan,” “anticipate,” “likely,” “will,” “pro forma,” “forecast,” “projections,” “could,” “estimate,” “may,” “potential,” “should,” “would,” and similar expressions.

The factors that could cause actual results to differ materially from those anticipated include, but are not limited to, the following:

- changes to the ERISA laws related to the Alion Science and Technology Corporation Employee Ownership, Savings and Investment Plan;
- changes to the tax laws relating to the treatment and deductibility of goodwill, the Company’s subchapter S status, or any change in the Company’s effective tax rate;
- additional costs associated with compliance with provisions of the Sarbanes-Oxley Act of 2002, including any changes in the SEC’s rules, and other corporate governance requirements;
- failure of government customers to exercise options under contracts;
- funding decisions relating to U.S. Government projects;
- government contract procurement (such as bid protest) and termination risks;
- competitive factors such as pricing pressures and/or competition to hire and retain employees;
- the results of current and/or future legal proceedings and government agency proceedings which may arise out of our operations (including our contracts with government agencies) and the attendant risks of fines, liabilities, penalties, suspension and/or debarment;
- undertaking acquisitions that could increase our costs or liabilities or be disruptive;
- taking on additional debt to fund acquisitions;
- failure to adequately integrate acquired businesses;
- material changes in laws or regulations applicable to the Company’s businesses;
- as well as other risk factors discussed in the Company’s annual report on Form 10-K for the year ended September 30, 2006 filed with the SEC on December 1, 2006.

Readers are cautioned not to place undue reliance on these forward-looking statements, which reflect management’s view only as of February 14, 2007. The Company undertakes no obligation to update any of the forward-looking statements made herein, whether as a result of new information, future events, changes in expectations or otherwise. This discussion addresses only our continuing operations.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

The Company's exposure to interest rate risk is primarily due to the debt it incurred to finance the Transaction, the subsequent refinancing of a portion of that debt in August 2004 and additional financing undertaken by the Company in October 2004, April 2005, March 2006, June 2006, January 2007 and February 2007. The Subordinated Note has a stated fixed interest rate, and therefore presents no risk of change to interest charges as a result of an increase in market interest rates.

The balance drawn under the \$50.0 million senior revolving credit facility bears interest at variable rates based on Credit Suisse's prime rate plus a maximum spread of 225 basis points. The balance on the Senior Secured Term B Loan bears interest at variable rates tied to the Eurodollar rate. Such variable rates increase the risk that interest charges will increase materially if market interest rates increase. The balance drawn under the Senior Unsecured Notes bears interest at a stated fixed rate of 10.25%. As of December 31, 2006, the Company has reduced, in part, the maximum total amount of variable interest rate risk on the Senior Secured Term B Loan by entering into three interest rate cap agreements that cover the first \$92.5 million, or approximately 35.8% of currently outstanding principal borrowed. See the Discussion of Debt Structure in Item 2 for a discussion of the three interest rate cap agreements.

The approximate impact of a 1% increase in the interest rate, as applied to principal balances drawn under the Senior Secured Term B Credit Facility that are not covered by the current interest rate cap agreement, would be \$1.2 million, \$2.2 million, \$2.2 million, \$2.2 million, \$2.1 million and \$2.1 million for the remainder of fiscal year 2007 and for the fiscal years ending September 30, 2008, 2009, 2010, 2011 and 2012, respectively.

The Company does not use derivatives for trading purposes. It invests its excess cash in short-term, investment grade, and interest-bearing securities.

Foreign currency risk

The Company's expenses and revenues from its international contracts are generally denominated in U.S. dollars. The Company does not believe that its operations are subject to material risks associated with currency fluctuations.

Risk associated with the value of Alion common stock

The Company has exposure to change in the fair market value of Alion's common stock as the economic basis for the estimate of contingent obligations relating to the holder's put rights associated with the Subordinated Note warrants. The value of this obligation would increase by approximately \$4.4 million if the price of the Company's stock were to increase by 10% and would decrease by approximately \$4.4 million if the price of the Company's stock were to decrease by 10%.

The Company also has exposure to change in the fair market value of Alion's stock as the economic basis for the estimate of contingent obligations relating to its repurchase obligations under the KSOP and obligations relating to stock appreciation rights and phantom stock programs. The amount of such exposure will depend upon a number of factors including but not limited to, the number of employees who might exercise their rights under the stock appreciation and phantom stock programs during any particular time period.

Item 4. Controls and Procedures

(a) *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 Rule 15d-15(e) under the Securities Exchange Act of 1934, as amended (the "Exchange Act"), as of the end of the period covered by this quarterly report. Based on such evaluation, the Company's Chief Executive Officer and Chief Financial Officer have concluded that, as of the end of such period, the Company's disclosure controls and procedures are effective in recording, processing, summarizing and reporting, on a timely basis, information required to be disclosed by us in the reports that the Company files or submits under the Exchange Act.

(b) *Internal Control Over Financial Reporting.* There have not been any changes in the Company's internal control over financial reporting (as such term is defined in Rule 15d-15(f) under the Exchange Act) during the fiscal quarter to which this report relates that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

PART II — OTHER INFORMATION

Item 1. *Legal Proceedings*

See Footnote 16 to the Condensed Consolidated Financial Statements. Other than the actions discussed in Footnote 16, the Company is not involved in any legal proceeding other than routine legal proceedings occurring in the ordinary course of business. The Company believes that these routine legal proceedings, in the aggregate, are not material to its financial condition and results of operations.

As a government contractor, the Company may be subject from time to time to federal government inquiries relating to its operations and audits by the Defense Contract Audit Agency. Contractors found to have violated the False Claims Act, or which are indicted or convicted of violations of other federal laws, may be suspended or debarred from federal government contracting for some period. Such an event could also result in fines or penalties.

Item 1A. *Risk Factors*

Our substantial leverage may limit our operational flexibility and negatively affect the value of your investment in us.

We have a significant amount of indebtedness. We have, after giving effect to the Senior Unsecured Notes issuance and the repayment in full of the Bridge Loan and approximately \$72.0 million of the amounts outstanding under the Term B Senior Credit Facility with proceeds from the notes issuance, approximately \$557.8 million of total outstanding debt, including debt subordinated to our Term B Senior Credit Facility and the Senior Unsecured Notes, and fiscal year 2007 debt service payment obligations of approximately \$48.6 million.

Our substantial debt could have important consequences to you, including:

- making it more difficult for us to satisfy our obligations with respect to our debt, and any failure to comply with the obligations of any of our debt instruments, including restrictive and financial covenants, could result in an event of default under the agreements governing our debt;
- making it more difficult for us to satisfy our repurchase obligations to ESOP participants;
- increasing our vulnerability to general adverse economic and industry conditions by making it more difficult for us to react to changing conditions;
- limiting our ability to obtain additional financing to fund future working capital, capital expenditures, acquisitions and other business opportunities, introductions of new technologies and other general corporate requirements;
- requiring a substantial portion of our cash flow from operations for the payments of interest on our debt and reducing our ability to use our cash flow to fund future working capital, capital expenditures, acquisitions and other business opportunities, introductions of new technologies and other general corporate requirements;
- exposing us to risks inherent in interest rate fluctuations because some of our borrowings will be at variable rates of interest, which could result in higher interest expense in the event of increases in interest rates;
- limiting our flexibility in planning for, or reacting to, changes in our business and the industry in which we operate; and
- placing us at a competitive disadvantage compared with our competitors that have less debt.

Despite current indebtedness levels, we and our subsidiaries may still be able to incur more debt. This could further exacerbate the risks associated with our substantial leverage.

We have the capacity to issue additional indebtedness, including the ability to raise up to \$135.0 million of additional senior secured indebtedness under our Term B Senior Credit Facility, subject to limitations imposed by the covenants in our Term B Senior Credit Facility and the Indenture governing the Senior Unsecured Notes. Although our Term B Senior Credit Facility and the Indenture governing the Senior Unsecured Notes contain restrictive covenants, these restrictive covenants do not and will not fully prohibit us from incurring additional debt.

Our Term B Senior Credit Facility and the Indenture governing the Senior Unsecured Notes will restrict our operations.

Our Term B Senior Credit Facility and the Indenture governing the Senior Unsecured Notes will, and our future debt agreements may, contain covenants that may restrict our ability to engage in activities that may be in our long-term best interest, including financing future operations or capital needs or engaging in other business activities. Our Term B Senior Credit Facility and the Indenture will restrict, among other things, our ability and the ability of our subsidiaries to:

- incur additional debt other than permitted additional debt;
- pay dividends or distributions on our capital stock or purchase, redeem or retire our capital stock other than distributions necessary for the ESOP to satisfy its repurchase obligations and certain payments required under our equity based compensation plans;
- make acquisitions and investments other than permitted acquisitions and permitted investments;
- issue or sell preferred stock of subsidiaries;
- make acquisitions and investments;
- create liens on our assets;
- enter into certain transactions with affiliates;
- merge or consolidate with another company; and
- transfer and sell assets outside the ordinary course of business.

Our Term B Senior Credit Facility requires and our future debt agreements may require us to maintain specified financial ratios relating to, among other things, our interest coverage and leverage coverage levels. Our ability to satisfy these financial ratios can be affected by events beyond our control, and we cannot guaranty that we will meet these ratios. Default under our Term B Senior Credit Facility could allow lenders to declare all amounts outstanding under both our Term B Senior Credit Facility and the Senior Unsecured Notes to be immediately due and payable. We have pledged substantially all of our assets to secure the debt under our Term B Senior Credit Facility. If the lenders declare amounts outstanding under the Term B Senior Credit Facility to be due, the lenders could proceed against those assets. Any event of default, therefore, could have a material adverse effect on our business, financial condition and results of operations if the creditors determine to exercise their rights.

From time to time we may require consents or waivers from our lenders to permit actions that are prohibited by our Term B Senior Credit Facility or our Indenture. If, in the future, these lenders refuse to provide waivers of our Term B Senior Credit Facility's restrictive covenants and/or financial ratios, then we may be in default under the terms of the Term B Senior Credit Facility and/or our Indenture, and we may be prohibited from undertaking actions that are necessary or desirable to maintain or expand our business. There is no guarantee we will be able to obtain consents or waivers from our lenders.

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

None, other than sales of securities already reported by the Company in current reports on Form 8-K.

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*

Exhibit No.	Description
4.16	Indenture dated as of February 8, 2007, among Alion Science and Technology Corporation, certain subsidiary guarantors and Wilmington Trust Company, as trustee. (1)
4.17	Form of 10.25% Senior Notes due 2015 (included as Exhibit 1 to Exhibit 4.16 of this quarterly report on Form 10-Q) (1)
10.80	Amendment No. 1 to the Bridge Loan Agreement dated as of December 11, 2006, by and among Alion Science and Technology Corporation, certain subsidiary guarantors, Credit Suisse, and the lenders party thereto. (2)
31.1	Certification of Chief Executive Officer of Alion Science and Technology Corporation pursuant to Rule 15d-14(a) promulgated under the Securities Exchange Act of 1934, as amended.
31.2	Certification of Chief Financial Officer of Alion Science and Technology Corporation pursuant to 15d-14(a) promulgated under the Securities Exchange Act of 1934, as amended.
32.1	Certification of Chief Executive Officer of Alion Science and Technology Corporation, 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 Chief Financial Officer of Alion Science and Technology Corporation, pursuant to 18 U.S.C. Section 1350 as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

- (1) Incorporated by reference to the corresponding exhibit previously filed as an exhibit to the Company's Form 8-K filed with the Securities and Exchange Commission on February 8, 2007.
- (2) Incorporated by reference to the corresponding exhibit previously filed as an exhibit to the Company's Form 8-K filed with the Securities and Exchange Commission on December 14, 2006.

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.

ALION SCIENCE AND TECHNOLOGY CORPORATION

Date: February 14, 2007

Name: John M. Hughes
Title: Chief Financial Officer

(Principal Financial and Accounting Officer
and Duly Authorized Officer)

**CERTIFICATION PURSUANT TO SECTION 302
OF THE SARBANES-OXLEY ACT OF 2002
FOR THE CHIEF EXECUTIVE OFFICER**

I, Bahman Atefi, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Alion Science and Technology Corporation;
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)) for the registrant and we 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) [Reserved]
 - 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: February 14, 2007

Name: Bahman Atefi
Title: Chief Executive Officer

**CERTIFICATION PURSUANT TO SECTION 302
OF THE SARBANES-OXLEY ACT OF 2002
FOR THE CHIEF FINANCIAL OFFICER**

I, John M. Hughes, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Alion Science and Technology Corporation;
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)) for the registrant and we have:
 - e) 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;
 - f) [Reserved]
 - g) 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
 - h) 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):
 - c) 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
 - d) 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: February 14, 2007

Name: John M. Hughes
Title: Chief Financial Officer

CERTIFICATION OF CHIEF EXECUTIVE OFFICER
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 of Alion Science and Technology Corporation (the "Corporation") on Form 10-Q for the three months ending December 31, 2006 as filed with the Securities and Exchange Commission on the date hereof (the "Report"), I, Bahman Atefi, Chief Executive Officer of the Corporation, certify, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that, to the best of my 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 result of operations of the Corporation.

Date: February 14, 2007

Name: Bahman Atefi
Title: Chief Executive Officer

CERTIFICATION OF CHIEF FINANCIAL OFFICER
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 of Alion Science and Technology Corporation (the "Corporation") on Form 10-Q for the three months ending December 31, 2006 as filed with the Securities and Exchange Commission on the date hereof (the "Report"), I, John M. Hughes, Chief Financial Officer of the Corporation, certify, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that, to the best of my 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 result of operations of the Corporation.

Date: February 14, 2007

Name: John M. Hughes
Title: Chief Financial Officer