Protect Serve Defend Deliver

About PEC Solutions, Inc.

PEC is a professional services firm that helps government clients harness the power of the Internet anc other advanced technologies to improve mission performance. The Company specializes in Web-Enablin Government® by providing secure, interoperable technology solutions for clients in homeland security, criminal justice and intelligence, defense, and civilian agencies within the Federal Government and at state and local levels. PEC is based in Fairfax County, Virginia, with offices around the United States.

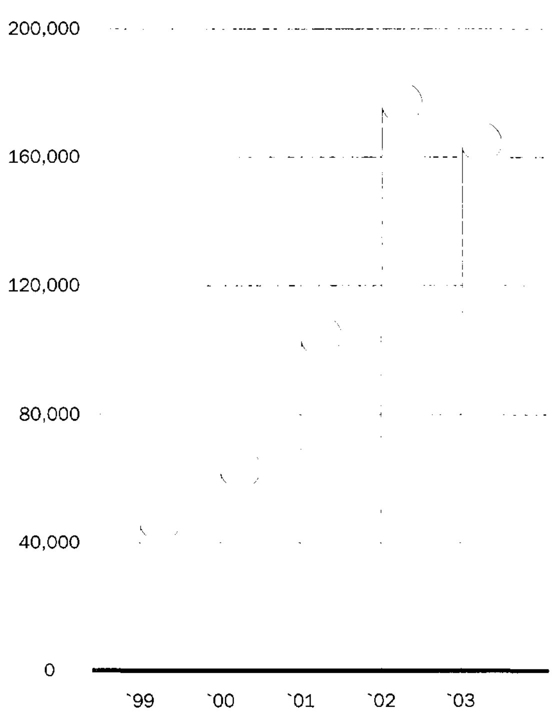
Financial Highlights

All dollar amounts are in thousands, except per share data

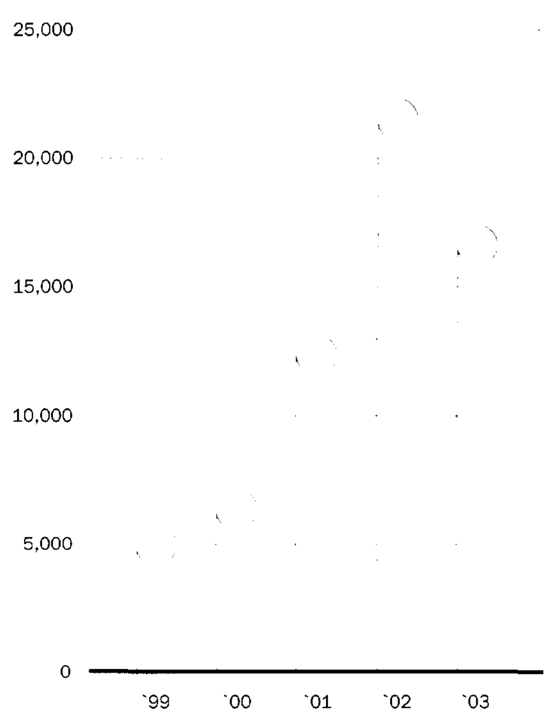
For Years Ending 12/31	1999	2000	2001	2002	**2003**
Revenue	$ 53,202	$ 68,305	$ 109,213	$ 182,185	**$ 172,043**
Operating Income	$ 8,975	$ 10,211	$ 19,262	$ 34,878	**$ 27,922**
Net Income	$ 5,639	$ 7,272	$ 13,067	$ 22,254	**$ 17,241**
Net Income % of Revenue	10.6%	10.6%	12.0%	12.2%	**10.0%**
Diluted Earnings per Share*	$ 0.24	$ 0.30	$ 0.47	$ 0.75	**$ 0.58**
Personnel	473	588	1,248	1,340	**1,223**

*per share data adjusted to reflect stock splits.

In thousands of dollars



Revenue ($000)
Revenues have increased at a compound annual growth rate of 34%



Net Income ($000)
Net Income has increased at a compound annual growth rate of 32%

To Our Stockholders

Dr. David C. Karlgaard
Chairman of the Board
President and CEO

Despite a number of challenges in 2003, PEC achieved strong profit margins and operating cash flow. However, our expectations for growth were affected by declines in our two largest contracts, unusual delays in appropriations cycles, and uncertainties relating to the Federal Government reorganization that created the new Department of Homeland Security (DHS).

Our subcontract for the Navy/Marine Corps Intranet (NMCI) and our mobile biometrics solutions contract relating to hiring of airport security personnel were major contributors to our 67% revenue growth in 2002. Unfortunately, both contracts had significant reductions in 2003 revenue due to natural transitions in the phases of the contracts. Exclusive of these two contracts, the remainder of our business grew organically by approximately 18%.

Our 5-year compound annual revenue growth rate is 34%.

Our operating income for 2003 was $28 million, representing an operating margin of 16% and our net income was $17 million, representing a net income margin of 10%. These are industry-leading margins in our sector, attributable to the high-end nature of our work, high utilization levels of our direct workforce, low-level of cost-reimbursable contracts, and various cost controls throughout the company.

We completed 2003 with $23 million in operating cash flow, $169 million in equity, no bank debt, and $109 million in cash, cash equivalents, short-term and long-term investments which includes an investment of $4 million in our new corporate headquarters building. We have a strong balance sheet that will support continued organic growth as well as growth by acquisition.

During 2003 we witnessed the largest reorganization of the Federal Government in the past 60 years. Twenty-two separate agencies were combined to form the new Department of Homeland Security. Despite the natural delays resulting from this level of organizational change, we were pleased to have announced 11 separate contract awards with the new department. We were most proud of our $60 million award to provide program management office support for the important US-VISIT program. This program will substantially increase the security at our nation's borders.

In addition to the awards at DHS, we also announced a number of new and expanded roles for PEC at the Federal Judiciary, the Drug Enforcement Administration, the U.S. Navy, the U.S. Army, the Federal Aviation Administration, and the Milwaukee Fire Department. We also achieved Software Engineering Institute's Capability Maturity Model levels, which foster repeatable solutions, for both software development and system integration.

Looking forward, the Federal Government remains one of the largest markets for information technology services. Over the next 5 years, it is estimated the Federal Government will spend approximately $15 billion on technology outsourcing. Spending relating to homeland security, public safety, and criminal justice have the fastest growing technology budget in government and will remain a major focus for us. Clearly, the market opportunity remains strong for PEC.

The nation's enduring commitment to protect the homeland remains an important catalyst for PEC's future growth. We are well positioned to capture this growth through our exceptional knowledge of the government market. Further, we are a sought after, leading provider of highly-customized, secure, interoperable technology solutions. We, therefore, expect to continue our vital role of helping clients implement technology initiatives for homeland security, criminal justice, defense, and civilian e-Government.

We appreciate our investor's faith in PEC. Our management team is fully committed to delivering the financial performance expected by our stockholders in the coming year.

David C Karlgaard

Dr. David C. Kaarlgard

The Government Market

— Opportunity Driven by National Priorities

PEC Solutions, Inc. (PEC) has served the government information technology (IT) market for nearly two decades. Our Company's knowledge of government legacy systems, leading-edge engineering capabilities, as well as our history of delivering proven technology solutions, provides the company a strong platform for growth as government addresses our nation's pressing priorities.

PEC is a leading provider of highly-customized systems that deliver key capabilities to government clients. The Company's systems enhance security, improve information sharing, and promote public service and mission effectiveness. Whether using biometric technologies to assist counter-terrorism efforts, building systems that connect tens of thousands of dispersed workers, or developing integrated systems that increase productivity, enhance information sharing, or save money, PEC is at the heart of changes currently affecting government's approach to complex IT systems.

PEC differs from competitors in its long-term focus and understanding of the civilian government mission, its particular domain expertise and knowledge of legacy systems in the criminal justice and homeland security market, and its focus on high-value technologies and services. It is because of this focus that PEC delivers best-of-class operating margins and a well-established brand identity in the government market.

Through our Company's accumulated knowledge of government operations, and our long-term focus on government's unique missions and challenges, we have concentrated on four key government client segments:

Homeland Security – organizations with mission activities relating to the protection and management of our nation's borders, transportation security, emergency preparedness and response, and critical infrastructure protection.

Criminal Justice and Intelligence – organizations with mission activities relating to law enforcement, public safety/first-responders, administrative and criminal courts, corrections, and national intelligence.

Defense – military services and joint commands of the national defense community.

Civilian e-Government – organizations employing information technology to improve government business operations and citizen accessibility of government services.

The following pages profile PEC's involvement in these key market sectors.

Homeland Security – Protecting Our Way of Life

Market Position

Following the attacks on September 11, 2001, the government committed unprecedented resources and focus to protect the nation on Federal, state, and local levels. In the largest government reorganization of the past 50 years, the Department of Homeland Security (DHS) was formed by consolidating 22 separate agencies into a single department responsible for border security and management, transportation security, and first response capabilities. Prior to the formation of DHS, PEC had a long-standing history of working closely with many of the agencies integrated into the new department. Since DHS's inception, PEC has been actively engaged in supporting a number of important homeland security initiatives.

Major Clients

Offices and components of the Department of Homeland Security:

✦ Office of the Chief Information Officer ✦ Border and Transportation Security ✦ Transportation Security Administration ✦ Customs and Border Protection ✦ Immigration and Customs Enforcement ✦ U.S. Coast Guard ✦ U.S. Secret Service

Technologies and Services

PEC brings biometric technology to bear in the positive identification and background validation of employees being placed in positions of public trust. Our expertise and experience in system engineering and software development enable us to be a part of such diverse systems as those designed to facilitate travel to the United States, and prevent illegal entry into our country. Utilizing information-sharing technologies, we have enabled the combination of legacy databases to create new information sources. Our expertise in collaboration has joined thousands of Federal employees from diverse agencies. Our program management and consulting skills are aiding the government in the control of programs designed to keep our borders safe.

Market Opportunity Drivers:

- **Networking and secure messaging**
- **Enhanced collaboration**
- **Credentialing and identity management**
- **Infrastructure enhancements**

Criminal Justice and Intelligence – Serving and Ensuring Public Safety

Market Position

The criminal justice and intelligence market is driven by the need for greater information sharing among law enforcement agencies, courts, and private entities, coupled with initiatives to modernize an aging and disparate technology infrastructure. The market is also driven by the national homeland security agenda due to the highly collateral nature of protection of the homeland and public safety. PEC has designed, built, and deployed large-scale systems that securely connect thousands of dispersed workers, allowing for the immediate, secure access to repositories of criminal and investigative information. These infrastructures support the enforcement, administrative, investigative, and executive functions through common, integrated systems. Other mission systems developed by PEC enable the collaboration and information sharing between law enforcement, prosecutors, courts, corrections and probation officers.

Major Clients

✦ Justice Management Division, Department of Justice ✦ Drug Enforcement Administration ✦ U.S. Marshals Service ✦ Federal Bureau of Investigation ✦ Federal Judiciary ✦ Bureau of Alcohol, Tobacco and Firearms ✦ Intelligence Community ✦ State and local first responders, law enforcement, and courts

Technologies and Services

Our long-standing support of government has positioned us in diverse activities. Our biometric technology and expertise have been utilized in the identification and prosecution of criminals. We have brought the power of technology to the courtroom to more efficiently and correctly handle the growing dockets. We have developed case management systems which link the components of organizations charged with the apprehension and prosecution of criminals. Our subject matter expertise has enabled us to develop systems which unite criminal justice and judicial organizations. Our information assurance experience and knowledge have helped tie together government and private entities in secure and assured collaboration. In addition to the engineering of systems and integration of technologies, PEC deploys critical systems worldwide and provides ongoing support to its clients.

Market Opportunity Drivers:

- ✦ Secure, assured networking
- ✦ Managed infrastructure support
- ✦ Authentication and encryption technologies
- ✦ Information sharing among Federal, state, local, and tribal governments

Defense – Defending the Nation Against Evolving Threats

Market Position

As the Department of Defense (DoD) transforms itself to 21st century warfighting, it continues to promote advanced technologies that improve and refine the interoperability of the Army, Navy, Air Force, and Marines. The DoD desires to modernize and outsource its large information infrastructures, allowing it to focus on its key mission objective of defending the nation. Information technology has become a key force multiplier and is envisioned to span the battle space from the enterprise level to the individual soldier on the battlefield. Immediate access to current intelligence information will provide our forces with new levels of interoperability and lethality. On another front, DoD finds itself having to provide many of the services normally associated with civilian agencies of government – from the rebuilding of criminal justice systems to the provisioning of utilities. PEC provides network operations, program management, litigation, financial reconciliation, and IT support to the medical field, foreign military sales, and base operation missions.

Major Clients

✦ Department of the U.S. Navy ✦ Department of the U.S. Army ✦ U.S. Army Office of the Surgeon General ✦ U.S. Navy Office of the General Counsel

Technologies and Services

PEC brings the knowledge and experience of networking to the DoD arena in the form of network operations and network operations center management. Additionally, we design, consolidate, deploy, and support IT infrastructure for our DoD clients. We bring our program management experience to DoD, providing litigation support and financial analysis and reconciliation. We assist DoD in the implementation of the Health Insurance Portability and Accountability Act of 1996 (HIPAA) compliant processes, systems, and the infrastructure to support them.

Market Opportunity Drivers:

- **Biometrics**
- **Secure wireless communication**
- **Infrastructure consolidation and outsourcing**
- **Secure information sharing**
- **Public safety solutions**
- **Criminal military justice solutions**
- **Secure, integrated communications**

Civilian e-Government – Delivering Service to the Citizen

Market Position

Organizations throughout Federal, state and local governments are investing heavily in information technology to improve effectiveness, enhance productivity, and extend new services to deliver responsive, cost-effective public services. Growth in the market will come from legislative mandates that require agency modernization, resulting in improved citizen services. Concern for the privacy of citizens and protection of sensitive national information continue to place information assurance and system security at the forefront of agency plans. PEC has a long tradition of bringing technical, management, and domain skills together with modern technologies and architectures to provide a total solution supporting clients' mission needs.

Major Clients

✦ Department of the Treasury ✦ Federal Aviation Administration ✦ Bureau of the Census ✦ Department of Transportation ✦ Department of Veterans Affairs ✦ Department of Agriculture

Technologies and Services

PEC's presence within the e-Government sector has allowed us to bring many of our skills to help clients better serve our citizens. The migration of legacy systems to Web-based technology has been coupled with our experience in engineering and development. Our expertise in architecture design and modernization in conjunction with our experience in enterprise management has enabled us to work hand-in-hand with clients to improve the stability and usability of their infrastructure. Our core skills in program, acquisition, and financial management have helped assure our client agencies of project and mission success.

Market Opportunity Drivers:

- ✦ **Information assurance**
- ✦ **Secure information sharing**
- ✦ **Electronic commerce**
- ✦ **Secure networking**
- ✦ **Data warehousing**
- ✦ **Strategic procurement acquisition support**
- ✦ **Infrastructure consolidation and support**

Executive Management Team

From left to right:
Stuart R. Lloyd, Chief Financial Officer
Dr. Alan H. Harbitter, Chief Technology Officer
Paul G. Rice, Chief Operating Officer.
Dr. David C. Karlgaard, President and CEO

Outside Directors

Frank J. Carr
Former Commissioner,
General Services
Administration

R. Jerry Grossman
Managing Director,
Washington, DC
Office of
Houlihan Lokey
Howard & Zukin

Zimri C. Putney
Managing Director and
CEO,
NextGen Capital

John W. Melchner
Former Inspector
General,
U.S. Department of
Transportation;
Former Assistant
Inspector General,
Department of Defense

B. Gary Dando
Retired Partner,
Ernst & Young
Author, *Guide to
Government Contracting
Business Issues*

Officers and Corporate Management

Dr. David C. Karlgaard
President
Chief Executive Officer and Chairman

Paul G. Rice
Chief Operating Officer and Director

Dr. Alan H. Harbitter
Chief Technology Officer and Director

Stuart R. Lloyd
Senior Vice President
Chief Financial Officer and Director

Anthony R. Urreta
Senior Vice President
Business Development

Peter A. Fish
General Counsel

Charles A. Rose
Chief Administrative Officer

General Managers

Christos Bratiotis
Criminal Justice and Intelligence Solutions

John T. Forbus
Defense Solutions

Charles E. Owlett
Civilian Government Solutions

Vice Presidents

Kirit M. Amin
Integrated Systems

John A. Caron
Technology Management

Roy L. Carter
Enterprise Systems

Don V. Celata
Defense Services

Tom M. Dority
Financial Management Services

James K. Dower
Infrastructure Implementation & Integration

William Norrish
Health Information Systems

Ian D. Martin
Infrastructure Outsourcing

William H. Merring
Systems Engineering

Ronald M. Scully
Systems Development

Internet

Users with access to the Internet's World Wide Web can obtain updated information on PEC at www.pec.com.

Corporate Headquarters

PEC Solutions, Inc.
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Fairfax, VA 22033
703.679.4900 voice
703.679.4901 facsimile

Office Locations

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5205 Leesburg Pike
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Falls Church, VA 22041
703.273.9880

5800 Lake Wright Drive
Suite 203
Norfolk, VA 23502
757.893.9050

1225 I Street NW
Suite 910
Washington, DC 20001
703.679.4900

Independent Auditors

PricewaterhouseCoopers, LLP
McLean, Virginia

Outside Legal Counsel

Piper Marbury Rudnick & Wolfe, LLP
Reston, Virginia

Transfer Agent and Registrar

American Stock Transfer & Trust Company
40 Wall Street
New, York, New York 10005
800-937-5449

Annual Meeting

The Annual meeting of Stockholders will be held at 5:30 p.m. EST on Wednesday, May 19, 2004 at:

Hyatt Fair Lakes
12777 Fair Lakes Circle
Fairfax, Virginia 22033
703.818.1234

Investor Inquiries

PEC's Investor Relations office at corporate headquarters handles inquiries from securities analysts, investment professionals and stockholders, including requests for SEC or other stockholder reports.

Stockholder information is also available at PEC's Web site, www.pec.com.

Common Stock

PEC Common Stock trades on The NASDAQ Stock Market under the symbol "PECS."

Safe Harbor

Statements made in this Annual Report that are not historical–including statements regarding PEC management's intentions, hopes, beliefs, expectations, representations, projections, plans, or predictions of the future–are forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. By their nature, all forward-looking statements involve risks and uncertainties.

For a detailed discussion of the risks and uncertainties that may materially affect PEC's operating and financial results and its ability to achieve the objectives discussed in this ANNUAL REPORT, please review PEC's most recent filing with the Securities and Exchange Commission (SEC). These filings are also accessible via www.pec.com.

Special Note: This Annual Report document includes PEC's 2003 Form 10-K, as filed with the SEC (excluding exhibits and certification). The Form 10-K is an integral part of this document and can be found in the back pocket. This document is not complete if the Form 10-K is missing.

Request for Annual Reports

Copies of the Company's 2003 Form 10-K filed with the SEC may be obtained by calling PEC's Investor Relations Department at 703-679-4900 or by sending an email to investor@pec.com.

Equal Employment Opportunity

It is the policy of PEC, to recruit, hire, employ, train and promote persons in all job classifications without regard to race, color, religion, sex, age, national origin, or disability.

Financial Report

Contents

Report of Independent Auditors

To the Board of Directors and Stockholders of
PEC Solutions, Inc.

In our opinion, the accompanying consolidated balance sheets and the related consolidated statements of income, of cash flows and of stockholders' equity and comprehensive income present fairly, in all material respects, the financial position of PEC Solutions, Inc. (the "Company") and subsidiaries as of December 31, 2002 and 2003, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2003, in conformity with accounting principles generally accepted in the United States of America. These financial statements are the responsibility of the Company's management; our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits of these statements in accordance with auditing standards generally accepted in the United States of America, which require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

/s/ PricewaterhouseCoopers LLP

February 10, 2004
McLean, VA

PEC SOLUTIONS, INC.
CONSOLIDATED BALANCE SHEETS

	As of December 31,	
	2002	2003
ASSETS		
Current assets:		
Cash and cash equivalents	$21,176,200	$33,400,637
Short-term investments	35,551,418	38,273,957
Accounts receivable, net	52,973,589	48,355,689
Other current assets	3,451,936	1,745,317
Total current assets	113,153,143	121,775,600
Property and equipment, net	27,966,613	26,674,096
Investments	26,790,222	37,587,140
Goodwill	16,932,205	16,932,205
Intangibles, net	3,700,033	2,849,239
Other assets	3,748,373	4,553,091
Total assets	$192,290,589	$210,371,371
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable and accrued expenses	$8,415,251	$5,575,565
Advance payments on contracts	1,070,117	438,992
Accrued payroll	6,836,224	5,502,989
Accrued vacation	2,561,626	2,838,940
Other current liabilities	934,312	1,163,405
Total current liabilities	19,817,530	15,519,891
Supplemental retirement program liability	966,097	1,417,329
Deferred rent	1,340,793	1,789,630
Long-term lease obligations	22,822,447	23,062,240
Total long-term liabilities	25,129,337	26,269,199
Total liabilities	44,946,867	41,789,090
Commitments and contingencies		
Stockholders' equity:		
Undesignated capital stock, 10,000,000 shares authorized	–	–
Common stock, $0.01 par value, 75,000,000 shares authorized, 26,792,565, and 27,303,041 shares issued and outstanding, respectively	267,925	273,030
Additional paid-in capital	91,071,248	95,218,903
Retained earnings	56,045,643	73,140,087
Accumulated other comprehensive loss	(41,094)	(49,739)
Total stockholders' equity	147,343,722	168,582,281
Total liabilities and stockholders' equity	$192,290,589	$210,371,371

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

PEC SOLUTIONS, INC.
Consolidated Statements Of Income

	Year ended December 31,		
	2001	2002	2003
Revenues	$109,213,147	$182,184,922	$172,043,014
Operating costs and expenses:			
Direct costs	60,416,152	107,277,020	102,362,227
General and administrative expenses	24,387,296	33,888,208	35,546,407
Sales and marketing expenses	4,371,083	5,372,359	5,361,109
Goodwill and intangible amortization	776,973	768,948	850,794
Total operating costs and expenses	89,951,504	147,306,535	144,120,537
Operating income	19,261,643	34,878,387	27,922,477
Investment and other income	2,153,100	1,385,961	2,328,165
Interest expense	(4,160)	(226,867)	(2,654,398)
Income before income taxes	21,415,583	36,037,481	27,596,244
Provision for income taxes	8,348,472	13,783,916	10,355,467
Net income	$13,067,111	$22,253,565	$17,240,777
Earnings per share:			
Basic	$0.54	$0.84	$0.64
Diluted	$0.47	$0.75	$0.58

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

PEC SOLUTIONS, INC.
Consolidated Statements Of Cash Flows

	Year ended December 31,		
	2001	2002	2003
Cash flows from operating activities:			
Net income	$13,067,111	$22,253,565	$17,240,777
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation and amortization	1,077,602	1,675,287	2,800,266
Amortization of goodwill	720,954	–	–
Amortization of intangibles	56,019	768,948	850,794
Amortization of bond premium and discount, net	72,598	(68,760)	227,258
Write-off of capitalized software	–	289,611	–
Deferred rent	464,527	417,414	448,837
Deferred income taxes	(26,222)	261,690	(84,967)
Bad debt expense	–	–	30,068
(Gain) loss from investment in building	–	85,423	(952,584)
Non-cash related to building	–	–	239,793
Other	6,265	1,877	14,527
Changes in operating assets and liabilities, excluding those acquired:			
Accounts receivable	(12,477,244)	(16,550,869)	4,587,833
Other current assets	(544,696)	1,267,198	1,836,509
Other assets	(178,954)	(777,155)	(428,264)
Accounts payable and accrued expenses	441,505	4,395,542	(2,839,686)
Advance payments on contracts	(483,903)	(219,470)	(631,126)
Retirement plan contribution payable	(1,937)	–	425
Accrued payroll	1,486,400	(181,913)	(1,333,234)
Accrued vacation	523,449	376,700	277,314
Other current liabilities	(763,894)	(1,688,103)	228,669
Supplemental retirement program liability	233,530	202,858	452,853
Other long-term liabilities	(13,702)	–	–
Net cash provided by operating activities	3,659,408	12,509,843	22,966,062
Cash flows from investing activities:			
Purchases of property and equipment	(1,600,368)	(2,869,847)	(1,289,591)
Purchases of short-term investments	(54,728,132)	(71,946,026)	(50,126,134)
Proceeds from sale of short-term investments	44,550,355	67,701,954	47,235,376
Investment in affiliate	(3,000,000)	(1,500,000)	–
Purchase of subsidiary, net of cash acquired	(13,403,772)	–	–
Purchase of assets	–	(5,866,842)	–
Capitalized software	(679,331)	(215,636)	(647,732)
Purchase of long-term investments	(19,809,738)	(13,739,214)	(19,864,221)
Proceeds from sale of long-term investments	9,129,120	2,069,013	9,043,105
Distributions from building investments	–	–	799,958
Other	3,000	25,909	96,149
Net cash used in investing activities	(39,538,866)	(26,340,689)	(14,753,090)
Cash flows from financing activities:			
Proceeds from the issuance of common stock	52,064,129	4,624,894	4,011,465
Payments on note payable and captial lease obligations	(7,743)	(53,613)	–
Common stock offering costs	(396,673)	–	–
Net cash provided by financing activities	51,659,713	4,571,281	4,011,465
Net increase (decrease) in cash	15,780,255	(9,259,565)	12,224,437
Cash and cash equivalents at beginning of period	14,655,510	30,435,765	21,176,200
Cash and cash equivalents at end of period	$30,435,765	$21,176,200	$33,400,637
Income taxes paid	$7,375,475	$12,509,015	$7,863,524
Interest paid	$4,160	$226,867	$2,654,398
Non-cash transactions:			
Mature common stock repurchased and retired in exchange for shares in cashless exercise of stock options	$276,275	$877,523	$205,831

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

PEC SOLUTIONS, INC.
Consolidated Statements of Stockholders' Equity and Comprehensive Income

	Common Stock		Additional Paid-In Capital	Accumulated Other Comprehensive Income (Loss)	Retained Earnings	Total
	Shares	Par Value				
Balance, December 31, 2000	22,345,440	$223,454	$28,692,286	$6,345	$21,777,437	$50,699,522
Issuance of common stock in secondary stock offering, net of offering costs	3,000,000	30,000	47,913,327	–	–	47,943,327
Issuance of common stock in acquisition of Troy Systems, Inc	103,065	1,031	2,998,985	–	–	3,000,016
Issuance of common stock upon exercise of stock options, including tax benefit	551,244	5,512	3,116,457	–	–	3,121,969
Issuance of common stock through employee stock purchase plan	125,725	1,257	877,163	–	–	878,420
Common stock repurchased and retired	(15,825)	(158)	(16,330)	–	(259,787)	(276,275)
Comprehensive income:						
Net income	–	–	–	–	13,067,111	
Unrealized loss on securities, net of taxes	–	–	–	(6,560)	–	
Total comprehensive income						13,060,551
Balance, December 31, 2001	26,109,649	261,096	83,581,888	(215)	34,584,761	118,427,530
Issuance of common stock upon exercise of stock options, including tax benefit	566,163	5,662	4,858,785	–	–	4,864,447
Issuance of common stock through employee stock purchase plan	143,431	1,434	2,715,148	–	–	2,716,582
Common stock repurchased and retired	(26,678)	(267)	(84,573)	–	(792,683)	(877,523)
Comprehensive income:						
Net income	–	–	–	–	22,253,565	
Unrealized loss on securities, net of taxes	–	–	–	(40,879)	–	
Total comprehensive income						22,212,686
Balance, December 31, 2002	26,792,565	267,925	91,071,248	(41,094)	56,045,643	147,343,722
Issuance of common stock upon exercise of stock options, including tax benefit	379,248	3,793	2,289,564	–	–	2,293,357
Issuance of common stock through employee stock purchase plan	140,714	1,407	1,917,459	–	–	1,918,866
Common stock repurchased and retired	(9,486)	(95)	(59,368)	–	(146,333)	(205,796)
Comprehensive income:						
Net income	–	–	–	–	17,240,777	
Unrealized loss on securities, net of taxes	–	–	–	(8,645)	–	
Total comprehensive income						17,232,132
Balance, December 31, 2003	27,303,041	$273,030	$95,218,903	$(49,739)	$73,140,087	$168,582,281

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

1. Summary of Significant Accounting Principles

Company

Performance Engineering Corporation ("PEC") was incorporated June 25, 1985, under the laws of the Commonwealth of Virginia. On January 1, 2000, PEC was reincorporated, under the laws of the state of Delaware, as PEC Solutions, Inc. ("Company"). The Company provides professional technology services that enable government entities to use the Internet to enhance productivity and improve services to the public.

The Company's primary customers are executive agencies and departments of the Federal Government, the Federal Judiciary, and prime contractors to the United States Government. Two of these customers accounted for 20% of the Company's revenue during 2003. For 2001, the Company's contracts and subcontracts were time and materials contracts (71%), fixed-price contracts (13%), and cost reimbursable contracts (16%). For 2002, these contracts and subcontracts were time and materials contracts (62%), fixed-priced contracts (21%), and cost-reimbursable contracts (17%). For 2003, these contracts and subcontracts were time and materials contracts (58%), fixed-priced contracts (24%), and cost-reimbursable contracts (18%).

Principles of Consolidation

The consolidated financial statements include all majority-owned or controlled subsidiaries. All significant intercompany balances and transactions have been eliminated. The financial statements prior to 2002 consolidated the Company's wholly owned subsidiaries Troy Systems, Inc. and Viking Technology, Inc., which were dissolved at the end of 2001 and their operations were combined with other operations of the Company.

Revenue Recognition

The Company's revenue is derived primarily from contracts with the Federal Government. Revenues on time and materials contracts are recognized based on actual hours delivered at the contracted billable hourly rate plus the cost of materials incurred. Revenues on fixed-price contracts are recognized using the percentage-of-completion method based on costs incurred in relation to total estimated costs. However, if the contract has a service element, revenues are recognized on a straight-line basis over the term of the contract. Revenue on cost-type contracts is recognized to the extent of costs incurred plus a proportionate amount of fee earned.

In certain arrangements, we enter into contracts that include the delivery of a combination of two or more of our service offerings. Typically, such multiple-element arrangements incorporate the design, development or modification of systems and an ongoing obligation to manage, staff, maintain, host or otherwise run solutions and systems provided to the client. Such contracts are divided into separate units of accounting and the total arrangement fee is allocated to each unit based on its relative fair value. Revenue is recognized separately, and in accordance with our revenue recognition policy, for each element.

In certain circumstances, revenues are recognized when contract amendments have not been finalized. Prior to agreeing to commence work directed by the customer and before receipt of the written modification or amendment to the existing contract, the Company requires the completion of an internal memo that assesses the probability of the modification being executed in a timely fashion and the Company's ability to subsequently collect payment from the customer.

The fees under certain government contracts may be increased or decreased in accordance with cost or performance incentive provisions that measure actual performance against established targets or other criteria. Such incentive fee awards or penalties are included in revenue at the time the amounts can be reasonably determined. In certain circumstances, revenues are recognized when contract amendments have not been finalized. Provisions for anticipated contract losses are recognized at the time they become known.

Cash and Cash Equivalents
Cash and cash equivalents include cash on hand and in banks. The Company also considers all highly liquid investments with a maturity of three months or less when purchased to be cash equivalents. As of December 31, 2002 and 2003, cash equivalents included money market funds of approximately $4,633,903 and $13,530,203, respectively, and commercial paper, United States Treasury bills, and municipal bonds of approximately $0 and $5,700,000, respectively.

Concentration of Credit Risk
At times during the year, the Company maintains cash balances at financial institutions in excess of Federal Deposit Insurance Corporation ("FDIC") limits. Management believes the risk in these situations to be minimal. In addition, the Company had cash balances of $4,633,903 and $13,530,203 held in money market funds at local financial institutions as of December 31, 2002 and 2003, respectively. The Company also held commercial paper, United States Treasury bills, and municipal bonds in the amount of $57,887,857 and $90,523,889 as of December 31, 2002 and 2003, respectively. These funds are not insured by the FDIC.

Marketable Securities
The Company determines the appropriate classification of marketable securities at the time of purchase and reevaluates such designation as of each balance sheet date. The Company's marketable securities are categorized as available-for-sale and stated at fair value, with unrealized gains and losses, net of tax, recorded in accumulated other comprehensive income. Realized gains and losses and declines in values determined to be other than temporary, if any, will be reported in other income or expense as incurred.

Property and Equipment
Property, plant, and equipment are stated at cost. Major improvements are capitalized while expenditures for maintenance, repairs and minor improvements are charged to expense. When assets are retired or otherwise disposed of, the assets and related accumulated depreciation and amortization are eliminated from the accounts and any resulting gain or loss is reflected in income. Depreciation expense is determined using the straight-line method based on the following useful lives:

Buildings	40 years
Non-structural land improvements	15 years
Property and equipment	3 to 5 years
Leasehold improvements	Shorter of estimated useful life or lease term

Emerging Issues Task Force (EITF) Issue No. 97-10, *The Effect of Lessee Involvement in Asset Construction*, is applicable to entities involved on behalf of an owner-lessor with the construction of an asset that will be leased when construction of the asset is completed. EITF Issue 97-10 requires the Company to be considered the owner (for accounting purposes) of these types of projects during the construction period. Due to the fact that the Company was considered the owner of the building during the construction period, then effectively a sale and leaseback of the building occurred when construction was completed and the lease term began. As a result of the Company's continued involvement in the LLC, the Company fails the sale-leaseback criteria of FAS 98, *Accounting for Leases*, and the building, and offsetting long-term lease obligation, must remain on the books. The building and lease obligation are being amortized to fair value at the end of the lease term, such that if the lease is not extended there will be no gain or loss upon lease termination.

Long-lived Assets
The Company evaluates the recoverability of its long-lived assets in accordance with Statement of Financial Accounting Standards No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*. Based on its most recent analysis, the Company believes that there was no impairment of its long-lived assets as of December 31, 2003.

Goodwill and Intangibles
In June 2001, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards (SFAS) No. 142, *Goodwill and Other Intangible Assets*. Under SFAS No. 142, goodwill and intangible assets with indefinite lives will no longer be amortized but are reviewed annually (or more frequently if

impairment indicators arise) for impairment. Separable intangible assets that are not deemed to have indefinite lives will continue to be amortized over their useful lives but with no maximum life. The Company adopted the provisions of SFAS No. 142 effective January 1, 2002, and upon adoption ceased to amortize goodwill. The Company completed the transitional and annual goodwill impairment test in accordance with the provisions of SFAS 142, and concluded that goodwill was not impaired.

Software Research and Development Costs

The Company capitalizes research and development costs for marketable software incurred from the time the product is determined to be technologically feasible until it is available for sale. It has also acquired marketable software, which it has capitalized. Acquired software and software development costs are amortized and recorded as direct costs using the straight-line method over a period not to exceed three years. As of December 31, 2003, $2,439,714 was capitalized with an accumulated amortization balance of $1,271,129 and is included in other assets. Amortization expense of $212,441, $363,945, and $328,835 was recorded during 2001, 2002 and 2003, respectively.

Contract Advance Payments

The Company invoices the Federal Government for some of its contracts based on provisional indirect cost rates. These invoiced amounts are adjusted when the actual rates have been determined by audit. Other Federal Government contracts are billed periodically independent of the percentage of the contract actually completed which, in some situations, results in funds being advanced to the Company in excess of amounts earned.

Common Stock Splits

Effective January 1, 2000, in connection with its re-incorporation, the Company's common stock was split 3-for-1. Effective March 1, 2000, the Company's common stock was split 2-for-1. All prior share and per share information in the financial statements have been restated to give effect to these stock splits.

Stock-based Compensation

In December 2002, the FASB issued SFAS No. 148, *Accounting for Stock-Based Compensation–Transition and Disclosure, an amendment of FASB Statement No. 123*. SFAS No. 148 provides alternative methods of transition for a voluntary change to the fair-market-value-based method of accounting for stock- based compensation. The Company does not presently expect to make such a voluntary change. In addition, SFAS No. 148 amends the disclosure requirements of SFAS No. 123 to require prominent disclosures in both annual and interim financial statements about the method of accounting for stock-based employee compensation and the effect of the method used on reported results. These amended disclosure requirements have been included below.

The Company uses the Black-Scholes option-pricing model to determine the pro forma impact under SFAS No. 123 to the Company's net income and earnings per share. The model utilizes certain information, such as the interest rate on a risk-free security maturing generally at the same time as the option being valued, and requires certain assumptions, such as the expected amount of time an option will be outstanding until it is exercised or it expires, to calculate the fair value of stock options granted.

This information and the assumptions used for 2003, 2002 and 2001 for the Company's stock option and stock purchase plans are summarized as follows:

	Stock Option Plan			Stock Purchase Plan		
	2001	2002	2003	2001	2002	2003
Volatility	57.31%	48.84%	44.84%	57.31%	48.84%	44.84%
Risk-free interest rate	5.07%	3.83%	4.27%	1.83%	1.23%	1.02%
Dividend yield	0%	0%	0%	0%	0%	0%
Expected lives	10 years	10 years	10 years	0.5 years	0.5 years	0.5 years
Weighted-average fair value per share at grant date	$3.80	$14.46	$13.05	$1.82	$2.82	$1.80

The Company continues to apply the provisions of APB 25 and provide the pro forma disclosures in accordance with the provisions of FAS Nos. 123 and 148. Under APB 25, the Company has not recorded in net income any stock-based employee compensation cost associated with the Company's stock option plan, as all options granted under the plan had an exercise price equal to the market value of the underlying common stock on the date of grant.

The following table illustrates the effect on net income and earnings per share if the Company had applied the fair value recognition provisions of SFAS No. 123 to its stock option plan:

	Years Ended December 31,		
	2001	2002	2003
Net income, as reported	$13,067,111	$22,253,565	$17,240,777
Pro forma compensation expense, net of tax	(1,031,607)	(2,970,848)	(4,732,105)
Pro forma net income	S12,035,504	$19,282,717	$12,508,672
Net income per share:			
Basic–as reported	$0.54	$0.84	$0.64
Basic–pro forma	$0.50	$0.73	$0.46
Diluted–as reported	$0.47	$0.75	$0.58
Diluted–pro forma	$0.43	$0.65	$0.42

Income Taxes

The Company accounts for deferred income taxes using the asset and liability method, under which the expected future tax consequences of differences between the book and tax bases of assets and liabilities are recognized as deferred tax assets and liabilities.

Use of Estimates

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect certain reported amounts and disclosures. Such estimates include reserves for doubtful accounts, valuation allowance for deferred taxes, estimates to complete for contracts, and certain accrued expenses. Accordingly, actual results could differ from those estimates.

Segment Reporting

The Company operates as a single segment and will evaluate additional disclosure requirements as it expands its operations.

Reclassifications

Certain reclassifications have been made to the prior-period financial statements in order to conform to the 2003 presentation.

2. Acquisitions

On November 20, 2001, the Company acquired all of the outstanding common shares of Troy Systems, Inc. (Troy). The results of Troy's operations have been included in the consolidated financial statements since that date. Effective January 1, 2002, Troy was fully integrated into the Company and ceased to exist as a wholly owned subsidiary. Troy derives revenue from system development, networking, engineering, integration services, and information systems security and its primary customer is the Federal Government. The aggregate purchase price was $18.6 million, including acquisition costs of $0.3 million, consisting of $15.3 million of cash and common stock valued at $3.0 million (103,065 shares). The number of shares was determined using the average closing price of the stock for the 5 trading days immediately prior to the acquisition.

The following table summarizes the estimated fair values of the assets acquired and liabilities assumed at the date of acquisition. Third party valuations were obtained in determining the allocation of the purchase price for certain intangible assets.

	At November 20, 2001
Current assets, including cash of $1,446,775	$9,602,232
Property and equipment	333,538
Intangible assets	3,025,000
Goodwill	9,921,799
Other assets	1,096,513
Total assets acquired	23,979,082
Current liabilities	(4,297,364)
Long-term liabilities, including capital leases	(1,087,965)
Total liabilities assumed	(5,385,329)
Net assets acquired	$18,593,753

The $3.0 million of acquired intangible assets was assigned to customer contracts and related relationships with a weighted-average useful life of 4.5 years. The transaction resulted in $9.9 million of goodwill, all of which is deductible for tax purposes.

Unaudited pro forma results of operations as if the acquisition has occurred at the beginning of each period presented are as follows:

	Year Ended December 31, 2001 (in thousands except per share)
Total revenue	$138,524
Net income	$13,000
Basic earnings per share	$0.54
Diluted earnings per share	$0.46

The pro forma consolidated results of operations include adjustments to give effect to amortization of goodwill and other adjustments, together with related income tax effects. The unaudited pro forma information is not necessarily indicative of the results of operations that would have occurred had the purchase been made at the beginning of the periods presented or the future results of the combined operations.

On June 14, 2002, the Company acquired the contracts and employees of Vector Research Inc., ("Vector") for $5.7 million cash plus the assumption of $0.1 million in accrued liabilities. The excess of purchase price over fair value of the net assets was approximately $4.3 million. Vector was fully integrated into the Company and its results are incorporated in the Company's financial statements. Vector was a provider of technology development and engineering services to the Federal Government. The aggregate purchase price was $5.8 million. Pro forma results of operations of the Company would not have been materially different assuming the acquisition of Vector occurred on January 1, 2001.

3. Goodwill and Intangibles

Prior to January 1, 2002, the Company amortized goodwill related to the Viking purchase on a straight-line basis over its estimated useful life of 5 years. Goodwill at December 31, 2001 was net of accumulated amortization of $961,296. The Company also recognized goodwill pursuant to its acquisitions of Troy in November 2001 and Vector in June 2002. These acquisitions have been accounted for as purchases pursuant to the guidance Statement of Financial Accounting Standards No. 141 (FAS 141), *Business Combinations*. Therefore, goodwill of $9.9 million and $4.3 million, respectively, are not being amortized.

The changes in the carrying amount of goodwill for the year ended December 31, 2002 is as follows (in millions):

Balance as of December 31, 2001	$12.6
Goodwill acquired during the year	4.3
Balance as of December 31, 2002 and 2003	$16.9

Upon the adoption of FAS 142, the Company discontinued the amortization of goodwill. The following table presents a reconciliation of net income and earnings per share adjusted for the exclusion of goodwill:

	Years Ended December 31, 2001 (dollars in thousands except per share)
Reported net income	$13,067
Add: Goodwill amortization, net of tax	440
Adjusted net income	$13,507
Reported basic earnings per share	$0.54
Add: Goodwill amortization, net of tax	0.02
Adjusted basic earnings per share	$0.56
Reported diluted earnings per share	$0.47
Add: Goodwill amortization, net of tax	0.02
Adjusted diluted earnings per share	$0.49

The Company only has one reporting unit. Non-amortizable intangible assets at December 31, 2003, consist only of goodwill of $16,932,205. The Company's amortizable intangible assets include customer contracts and related relationships purchased in the acquisition of Troy on November 20, 2001 and Vector on June 14, 2002. The intangibles related to the Troy acquisition totaled $3,025,000 and are amortized on a straight-line basis over a 4.5-year period. The intangibles on the Vector purchase totaled $1,500,000 and are being amortized on a straight-line basis over an 8.4-year period. Total accumulated amortization as of December 31, 2002 and 2003 was $824,967 and $1,675,761, respectively.

Amortization expense related to intangibles was $56,019, $768,948, and $850,794 for the years ended December 31, 2001, 2002 and 2003, respectively. Intangibles are amortized on a straight-line basis.

Estimated amortization expense for each of the 5 succeeding calendar years based on the intangible assets as of December 31, 2003 is as follows in thousands:

Year ending December 31,	Amount
2004	$851
2005	851
2006	458
2007	179
2008	179

4. Accounts Receivable

Accounts receivable consisted of the following as of:

	December 31,	
	2002	2003
Billed accounts receivable	$45,411,428	$32,099,688
Unbilled accounts receivable:		
Amounts currently billable	5,855,777	12,033,614
Revenues recorded in excess of contract value or funding	3,098,543	4,775,812
Progress payments	(1,070,117)	(438,992)
	53,295,631	48,470,122
Allowance for doubtful accounts	(322,042)	(114,433)
Accounts receivable, net	$52,973,589	$48,355,689

Unbilled accounts receivable currently billable consist of recognized recoverable costs and accrued profits on contracts for which billings had not been presented to clients as of the balance sheet date. Revenues recorded in excess of contract value or funding are billable upon receipt of contractual amendments. Management anticipates the collection of these amounts within 90 days of the balance sheet date. Payments to the Company on contracts with agencies and departments of the Federal Government are subject to adjustment upon audit by the Federal Government. All years subsequent to 2000 are subject to audit. Management believes that audit adjustments, if any, on periods not yet audited, will not have a material effect on the financial statements.

During 2002 the Company had two customers that each accounted for more than 10% of revenue. For the year, EDS (Navy Marine Corps Intranet) accounted for 16%, or $29.3 million, and our biometric identification system through a subcontract with NCS Pearson, Inc. (Pearson) accounted for 13%, or $23.7 million. At December 31, 2002, there was $3.5 million due from EDS and $15.6 million due from Pearson. Subsequent to

December 31, 2002, we received a payment of approximately $10 million of the $15.6 million Pearson accounts receivable. The Company filed a lawsuit in Federal Court against Pearson in September 2003 to recover full payment on this receivable and expects to receive full payment.

During 2003 the Company had one customer who accounted for more than 10% of revenue. For the year ended December 31, 2003, revenue from the Special Projects Division of the Drug Enforcement Agency was $17.6 million, and as of December 31, 2003, accounts receivable were $4.0 million.

The allowance for doubtful accounts reflects management's best estimate of probable losses based on historical experience, known troubled accounts and other currently available information. Allowances are established for specific receivables when deemed appropriate.

5. Property and Equipment

Property and equipment consisted of the following as of:

	December 31,	
	2002	2003
Leasehold improvements	$937,273	$1,164,225
Property and equipment	6,922,691	6,713,033
Software	933,971	894,678
Building	23,001,600	23,001,600
	31,795,535	31,773,536
Less: accumulated depreciation	(3,828,922)	(5,099,439)
	$27,966,613	$26,674,097

Depreciation expense was $865,158, $1,288,042 and $2,469,768 for the years ended December 31, 2001, 2002 and 2003, respectively.

6. Investments

The Company has an ownership interest in an unconsolidated and affiliated company that owns an office building that the Company leases. The Company's net investments in and advances to this entity totaled $4.4 million and $4.6 million at December 31, 2002 and 2003, respectively, which is included in Investments on the Consolidated Balance Sheet. Summarized financial information for this entity as of December 31, was as follows (in thousands):

	2002	2003
Current assets	$1,244	$472
Non-current assets	29,431	29,111
Current liabilities	717	218
Non-current liabilities	20,500	20,287
Gross revenue	275	3,320
Net gain (loss)	(178)	1,959

The Company has applied equity accounting to its interest in the LLC. The accounting records of the LLC are consistent with the accounting of the Company. The Company recorded equity losses of approximately $85,000 for the year ended December 31, 2002, and equity gains of approximately $853,000 for the year ended December 31, 2003, which are included in investment and other income.

The Company also invests in marketable securities classified as available for sale. As of December 31, 2003, the aggregate fair market value of those securities was $78.9 million. As of December 31, 2003, unrealized gains and losses included in other comprehensive loss were $13,662 and $77,084, respectively. Proceeds from sales of securities during 2003 were $81.1 million with realized gains of $15,032. The Company recognizes gains and losses on the sale of securities using the specific identity method of accounting.

7. Line of Credit

The Company has a loan agreement with Bank of America which provides for a line of credit with a limit of $10,000,000 at the one-month LIBOR rate plus 250 basis points per annum (3.9% and 3.6% as of December 31, 2002 and 2003, respectively). The line is collateralized by the assets of the Company. As of December 31, 2002 and 2003, there were no balances outstanding. The bank has issued Letters of Credit in the amount of $2,782,009 against the line of credit in lieu of rent deposits as of December 31, 2003. The agreement expires June 30, 2005.

8. Other current liabilities

Other liabilities consisted of the following:

	December 31,	
	2002	2003
Employee stock purchase plan	$8,430	$9,883
Amounts due related to Vector acquisition	164,070	–
Employee benefits payable	133,378	64,424
Payroll taxes payable	628,434	520,462
Income taxes payable	–	568,636
	$934,312	$1,163,405

9. Stock Option Plans

On February 1, 1987, the Company established an incentive stock option agreement (the "Agreement"), to attract, retain and reward employees and on January 1, 1995 the Company established a nonqualified stock option plan (the "Plan", collectively, the "Plans") to attract, retain and reward key employees. The Plans are administered by the Board of Directors, which has the authority to determine which officers and key employees are awarded options pursuant to the Plans and the related terms and option prices. The number of options available for grant under the Plans is limited to the number of Company common shares authorized and available

Each stock option granted pursuant to the Plans has an exercise price equal to the fair market value of the underlying commor stock at the date of grant. Each stock option granted under the Agreement has a 5-year term and a 2-year vesting period. Each stock option granted pursuant to the Plan has a 10-year term and no vesting period.

In January 2000, the Company established a stock plan (the "2000 Plan"), which includes both incentive and non-qualified stock options. Under the 2000 Plan, options to purchase 1,500,00(shares of common stock were initially available. Beginning in 2001, the number of options eligible for grant in each year are equal to the sum of 6.25% of the number of outstanding shares on January 1 of that year, plus the number of shares eligible for grant in the prior year that were not granted. No more than 15,000,000 options may be granted during the 10-year term of the 2000 Plan. Each stock option granted pursuant to the 2000 Plan has a 10-yea term and a 2-year vesting period for incentive options and various vesting periods for non-qualified options ranging from immediate vesting to vesting in 4 years.

In January 2000, the Company established an employee stock purchase plan (the "Purchase Plan"). Under the Purchase Plan, employees, through payroll deductions, are granted options to pur chase shares of common stock at a price no less than 85% of the fair market value of the common stock on the first or last trading day of each 6 month option period or the date the shares of common stock are purchased. There initially were 2,000,000 shares of common stock available for purchase under the Purchase Plan. There currently are 1,590,130 shares of common stock available for purchase under the Purchase Plan. On June 30, 2003, a total o 77,771 shares were issued under the plan at prices ranging from $10.22 to $13.69 per share. On December 31, 2003, a total of 62,943 shares were issued under the plan at prices ranging from $12.64 to $13.67 per share.

The following table summarizes the Company's activity for all of its stock option awards granted under the Plans and the 2000 Plan:

	Number of Options	Range of Exercise Price	Weighted Avrage Exercise Price
Balance, December 31, 2000	4,575,855	$0.63-12.00	$2.87
Granted	359,653	7.50-22.10	8.23
Exercised	(551,089)	0.78- 7.50	2.34
Canceled	(38,838)	1.10-12.00	8.22
Balance, December 31, 2001	4,345,581	0.63-22.10	3.34
Granted	1,126,729	18.01-37.61	20.92
Exercised	(566,163)	1.68-37.61	4.93
Canceled	(60,836)	1.68-37.61	23.36
Balance, December 31, 2002	4,845,311	0.63-37.61	6.99
Granted	512,859	14.46-29.90	20.58
Exercised	(379,248)	2.04-29.90	5.23
Canceled	(193,785)	8.13-37.61	21.61
Balance, December 31, 2003	4,785,137	$0.63-37.61	$7.99

The following table summarizes additional information about stock options outstanding as of December 31, 2003:

	Options Outstanding			Options Exercisable	
Range of Exercise Prices	Number of Options	Weighted-Average Remaining Contractual Life (years)	Weighted-Average Exercise Price	Number Exercisable	Weighted-Average Exercise Price
$0.63 to $0.86	450,246	1.88	$0.83	450,246	$0.83
$1.21	951,564	3.00	1.21	951,564	1.21
$1.85 to $3.12	1,484,262	4.47	2.56	1,484,262	2.56
$6.94 to $12.00	481,701	6.62	8.59	456,701	8.68
$14.46 to $20.05	1,127,479	8.80	17.29	10,000	20.05
$21.97 to $37.61	289,885	8.62	32.00	43,306	31.14
	4,785,137	5.42	$7.99	3,396,079	$3.19

10. Basic Earnings Per Share and Diluted Earnings Per Share

Basic net income per common share is computed on the basis of the weighted-average number of common shares outstanding for the periods. Diluted net income per common share includes the weighted-average effect of dilutive options outstanding during the periods. The weighted average number of shares issuable upon the exercise of outstanding stock options assumes that the applicable proceeds from such exercises are used to acquire treasury shares at the average price of common stock during the periods.

Basic and diluted earnings per share for 2001, 2002, and 2003 were determined as follows:

	Years Ended December 31, 2001		
	Net Income	Shares	Per Share
Basic EPS	$13,067,111	24,257,564	$0.54
Effect of dilutive options	–	3,724,486	(0.07)
Diluted EPS	$13,067,111	27,982,050	$0.47

	Years Ended December 31, 2002		
	Net Income	Shares	Per Share
Basic EPS	$22,253,565	26,381,131	$0.84
Effect of dilutive options	–	3,113,089	(0.09)
Diluted EPS	$22,253,565	29,494,220	$0.75

	Years Ended December 31, 2003		
	Net Income	Shares	Per Share
Basic EPS	$17,240,777	27,085,532	$0.64
Effect of dilutive options	–	2,677,683	(0.06)
Diluted EPS	$17,240,777	29,763,215	$0.58

For the years ended December 31, 2002 and 2003, 138,316 and 1,160,043 shares, respectively, attributable to outstanding stock options were excluded from the calculation of diluted earnings per share because the effect was antidilutive. For 2001, shares were not antidilutive.

11. Employee Benefit Plan

During 1985, the Company established a qualified profit sharing plan in accordance with Section 401(k) of the Internal Revenue Service Code. Under the plan, the Company makes contributions out of profits of the Company based on an amount determined at the discretion of the Board of Directors. All employees, except interns and leased employees, are eligible to participate in the plan. Eligibility is restricted for new employees, who are not permitted to participate until the first day of the first calendar quarter following date of hire. The Company contributed $2.7 million, $4.1 million and $2.6 million for 2001, 2002 and 2003, respectively.

12. Supplemental Retirement Program

In December 1998, the Company adopted a funded Executive Supplemental Retirement Program for a select group of management or highly compensated employees. The program allows these employees to defer a portion of their salary and bonus. The Company has the option of adding additional amounts of deferred compensation at its sole discretion. The Company contributions are vested after 5 years. Employee deferrals were $87,045, $109,029, and $241,586 in 2001, 2002, and 2003, respectively. The Company contributed $146,639, $164,083 to the program in 2001and 2002. There were no Company contributions to the program in 2003.

13. Income Taxes

The provision for income taxes consisted of the following:

	Years Ended December 31,		
	2001	2002	2003
Current:			
Federal	$7,109,964	$11,167,206	$8,739,792
State	1,300,217	2,231,229	1,803,124
Total current	8,410,181	13,398,435	10,542,916
Deferred:			
Federal	(55,314)	344,882	(167,707)
State	(6,395)	40,599	(19,742)
Total deferred	(61,709)	385,481	(187,449)
Provision for income taxes	$8,348,472	$13,783,916	$10,355,467

Deferred tax assets were comprised of the following:

	Years Ended December 31,		
	2001	2002	2003
Deferred tax assets (liabilities):			
Accrued vacation	$566,659	$640,924	$738,074
Allowance for doubtful accounts	69,456	2,593	44,809
Property and equipment	(369,547)	(766,167)	(627,104)
Capital loss carryforward	8,021	7,948	–
Deferred rent	360,547	524,532	700,771
Net operating loss carryforward from acquired company (expiring beginning in 2012)	857,607	755,112	655,175
Deferred compensation	253,414	370,085	547,274
Investment in building partnership	–	(186,794)	(513,842)
Other	–	12,441	2,965
Total deferred tax assets, net	$1,746,157	$1,360,674	$1,548,122

A reconciliation between the Company's statutory tax rate and the effective tax rate is as follows:

	Years Ended December 31,		
	2001	2002	2003
Statutory federal rate	35%	35%	35%
State income taxes, net of federal benefits	4%	4%	4%
Federal tax-exempt interest income	–	(1%)	(1%)
Effective tax rate	39%	38%	38%

14. Commitments and Contingencies

During 2001, the Company negotiated an equity position in a limited liability company (the "LLC") that constructed a build-to-suit office building. The Company has contributed cash of $4,500,000 to the LLC and has a 48% ownership interest in the LLC. The Company also entered into a 16-year lease agreement for the building that began on December 1, 2002 and is the primary occupant.

Due to the equity involvement in LLC, the Company was considered to be the owner (for accounting purposes) of the property during the construction period in accordance with Emerging Issues Task Force (EITF) Issue No. 97-10, *The Effect of Lessee Involvement in Asset Construction.* This is the case even though the Company is not obligated to guarantee the non-recourse mortgage obligation, nor was it involved in the management of the LLC. Accordingly, through December 1, 2002, the Company recorded total construction costs of $23.0 million with an offsetting long-term lease obligation. Due to the fact that the Company was considered the owner of the building during the construction period, then effectively a sale and leaseback of the building occurs when construction was complete and the lease term began. As a result of the Company's continued involvement in the LLC, the Company is unable to use sale-leaseback accounting under FAS 98, *Accounting for Leases,* and the building, and offsetting long-term lease obligation, must remain on the Company's financial records.

EITF 97-10 specifically excludes land acquisition costs from total project costs; therefore, the value of the land was not recorded on the Company's accounting records during the construction phase. Therefore, for consistency, the land is also excluded from the failed sales-leaseback and will require that the lease payments be bifurcated between the land and the building. The land portion of the rent is treated as an operating lease. The lease payments were allocated between the land and building based upon their relative fair values. The fair value of the land was determined through a third party appraisal and the fair value of the building was determined based upon total construction costs. The building portion of the lease payment is recast as interest and principal payments on the lease obligation. The building and lease obligation are being amortized to fair value at the end of the lease term, such that if the lease is not extended there will be no gain or loss upon lease termination.

The future minimum lease payments under operating leases includes the land portion of the rent associated with the building, while the remaining balance of the lease payments, and the associated interest, have been included in the capital lease payment table. For purposes of the capital lease payments, payments through December 31, 2018 have been included, at which time the depreciated value of the building and the remaining long-term lease obligation will be equivalent.

The Company leases office facilities and equipment under non-cancelable capital lease agreements, which expire in various years through 2018. The economic substance of such transactions is that the Company is acquiring assets using lease financing. The future minimum lease payments under capital leases as of December 31, 2003, are as follows:

Years Ended December 31,	
2004	$2,470,751
2005	2,557,227
2006	2,646,730
2007	2,739,365
2008	2,835,244
Thereafter through December 31, 2018	34,425,501
Total minimum lease payments	47,674,818
Less: amount representing interest	(35,887,235)
Present value of net minimum lease payments	11,787,583
Less: current portion	–
Residual value	11,274,657
Long-term portion	$23,062,240

At December 31, 2003, building, leasehold improvements and equipment under capital leases of $23,001,600, net of accumulated depreciation of $1,101,931, is included with property and equipment.

The Company leases office facilities and equipment under non-cancelable operating agreements, which expire in various years through 2018. Future minimum lease payments under operating leases that have non-cancelable lease terms in excess of one year as of December 31, 2003 are as follows:

Years Ended December 31,	
2004	$7,127,779
2005	6,980,362
2006	6,933,025
2007	6,015,938
2008	5,950,463
Thereafter	42,075,833
	$75,083,400

The total rental expense under operating leases was $5,615,636, $7,389,678, and $7,482,054 for the years ended December 31, 2001, 2002, and 2003, respectively.

During 2001 and 2002, the Company subleased space in one of its facilities. Sublease rental income was $315,658 and $324,736 for the years ended December 31, 2001 and 2002, respectively. The Company had no sublease income for 2003.

In the ordinary course of business, the Company may be party to various legal proceedings. In the opinion of management, the Company's liability, if any, in all pending litigation or other legal proceedings will not have a material effect upon the financial condition, results of operations, or liquidity of the Company.

On and after March 18, 2003, several purported class action complaints were filed against the Company and certain of its officers in the United States District Court for the Eastern District of Virginia. The complaints alleged that between October 22, 2002 and March 14, 2003, the defendants made, or were aware of, false and misleading statements which had the effect of inflating the market price of our stock, in violation of Sections 10(b) and 20(a) of the Securities Exchange Act of 1934. The complaints were consolidated into a single action on June 13, 2003. The complaint was dismissed by the Court on January 28, 2004. Plaintiffs have filed notice of appeal. In addition, a stockholder's legal counsel sent a letter of demand that the Board of Directors investigate the same charges addressed in the class action suit. The Board concluded after its investigation and based on its business judgement to reject the demand letter.

On September 11, 2003, the Company instituted a lawsuit in the United States District Court of Minnesota against NCS Pearson, Inc. for improperly withholding the payment of funds owed to the Company under a subcontract. The Company is seeking recovery of $6.3 million in unpaid receivables plus interest and costs. The proceedings are moving according to schedule.

15. Recent Accounting Pronouncements

In November 2002, the FASB's Emerging Issues Task Force, or EITF, finalized EITF Issue 00-21, *Revenue Arrangements with Multiple Deliverables*. EITF 00-21 addresses how to determine whether an arrangement involving multiple deliverables contains more than one unit of accounting. It also addresses how arrangement consideration should be measured and allocated to the separate units of accounting in an arrangement. EITF 00-21 does not apply to deliverables in arrangements to the extent the accounting for such deliverables are within the scope of other existing higher-level authoritative accounting literature. The Company adopted the provisions of EITF 00-21 for new contracts entered into on or after July 1, 2003 with no material impact on its financial position, results of operations or cash flows, nor would there have been a material impact on prior years. On December 17, 2003, the Securities and Exchange Commission issued Staff Accounting Bulletin No. 104 ("SAB 104"), *Revenue Recognition*, which supercedes SAB 101, Revenue Recognition in Financial Statements. SAB 104's primary purpose is to rescind accounting guidance contained in SAB 101 related to multiple revenue arrangements, superceded as a result of the issuance of EITF 00-21, *Accounting for Revenue Arrangements with Multiple Deliverables*. As the Company had already adopted EITF 00-21, the change has no effect on the Company's financial position.

In November 2002, FASB Interpretation No. 45, *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others, an Interpretation of FASB Statements No. 5, 57, and 107 and Rescission of FASB Interpretation No. 34*, (FIN 45) was issued. FIN 45 clarifies the requirements of SFAS No. 5, *Accounting for Contingencies*, relating to guarantors' accounting for, and disclosure of, the issuance of certain types of guarantees. The disclosure provisions of FIN 45 are applicable to interim or annual periods that ended after December 15, 2002, and did not have an impact on the December 31, 2003 financial statements. The provisions for initial recognition and measurement under FIN 45 are effective on a prospective basis for guarantees that are issued or modified after December 31, 2002. The initial recognition and measurement provisions under FIN 45 did not have any impact on the Company's financial statements.

On January 17, 2003, the Financial Accounting Standards Board ("FASB") issued FASB Interpretation No. 46, (FIN 46), *Consolidation of Variable Interest Entities*. The provisions will be the guidance that determines (1) whether consolidation is required under the "controlling financial interest" model of Accounting Research Bulletin No. 51 (ARB 51), *Consolidated Financial Statements* (or other existing authoritative guidance) or, alternatively, (2) whether the variable interest model under FIN 46 should be used to account for existing and new entities. At this time, the Company does not have any entities that would be covered under FIN 46.

16. Unaudited Selected Quarterly Financial Information

	(in thousands except per share data)			
2002	**First Quarter**	**Second Quarter**	**Third Quarter**	**Fourth Quarter**
Revenues	$38,231	$42,761	$52,844	$48,349
Operating income	$6,135	$7,485	$11,941	$9,232
Net income	$4,046	$4,845	$7,402	$5,961
Earnings per share:				
Basic	$0.15	$0.18	$0.28	$0.22
Diluted	$0.14	$0.16	$0.25	$0.20
Weighted average shares used in computing earnings per share:				
Basic	26,166	26,261	26,463	26,629
Diluted	29,879	29,787	29,566	30,251
2003				
Revenues	$43,466	$44,265	$43,295	$41,017
Operating income	$5,676	$7,633	$7,253	$7,361
Net income	$3,491	$4,638	$4,442	$4,671
Earnings per share:				
Basic	$0.13	$0.17	$0.16	$0.17
Diluted	$0.12	$0.16	$0.15	$0.16
Weighted average shares used in computing earnings per share:				
Basic	26,935	27,047	27,151	27,204
Diluted	29,925	29,491	29,978	29,852

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-K

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

(Mark One)

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

For the fiscal year ended December 31, 2003

OR

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

Commission File No. 000-30271

PEC SOLUTIONS, INC.

(Exact name of registrant as specified in its charter)

Delaware	**54-1339972**
(State or other jurisdiction of incorporation or organization)	(IRS Employer Identification No.)

12730 Fair Lakes Circle, Fairfax, Virginia 22033
(Address of principal executive offices, zip code)

Registrant's telephone number, including area code: (703) 679-4900
Securities registered pursuant to Section 12(b) of the Act: None
Securities registered pursuant to Section 12(g) of the Act:

Common Stock, $0.01 par value
(Title of Each Class)

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

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Exchange Act). Yes ☒ No ☐

The aggregate market value of voting stock held by non-affiliates of the registrant was $198,975,964 based upon the closing price on the Nasdaq National Market on the last business day of the registrant's most recently completed second fiscal quarter (June 30, 2003).

Number of shares of Common Stock outstanding as of February 27, 2004 was: 27,308,207 shares.

Documents Incorporated By Reference:

Part III—Proxy Statement for the 2004 Annual Meeting of Stockholders on May 19, 2004. Such proxy statement will be filed with the Securities and Exchange Commission not later than 120 days after the Registrant's fiscal year ended December 31, 2003.

FORM 10-K
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PART I

Item 1. Business

Overview

PEC Solutions, Inc. (www.pec.com) is a professional services firm providing high-end solutions that help government clients harness the power of the Internet and other advanced technologies to improve mission performance. We specialize in Web-Enabling Government® by providing secure, interoperable technology solutions for clients in homeland security, law enforcement, intelligence, defense, and civilian agencies within the federal government and at state and local levels. As a total solutions provider, we address the full technology lifecycle, including formulating technology strategies, creating business solutions, performing long-term operational management and continuing enhancement of the solution.

Our clients have included every cabinet-level department of the federal government as well as numerous additional entities at the federal, state and local levels. This group includes a cross-section of civil, law enforcement, intelligence and judicial government organizations. Our largest clients include the Drug Enforcement Administration, EDS, the prime contractor for the Navy Marine Corps Intranet ("NMCI") program, the Department of Homeland Security, the Veterans Benefits Administration, the Internal Revenue Service, the Bureau of Alcohol, Tobacco and Firearms, the Department of Defense and the intelligence community. Since 1999, we have provided more than $585 million of services in the government market and have increased revenues at approximately a 34% compound annual growth rate.

PEC Solutions, Inc. was originally incorporated under the laws of the Commonwealth of Virginia as Performance Engineering Corporation ("PEC") on June 25, 1985. On January 1, 2000, PEC was reincorporated under the laws of Delaware as PEC Solutions, Inc.

Industry Background

Government has emerged in recent years as one of the leading purchasers of advanced technology solutions. The federal government's 2004 approved budget allocates $56.3 billion for information technology spending. According to INPUT, a research firm that tracks federal government spending trends, the federal government will spend $13.9 billion on information technology services by 2008, up from $10.3 billion in 2004. This represents a five-year compound annual growth rate of 6.56 percent.

Efforts to Improve Homeland Security and Mount Counter-Terrorism Programs will Stimulate Government Technology Spending

We believe that the events of September 11, 2001, resulted in escalating priorities relating to the needs of the nation's law enforcement infrastructure, and in the broader areas of national defense and homeland security. The President's 2004 budget provides continued strong support for federal information technology spending. Much of the spending focuses on homeland security and electronic government. We believe that high-end technology solutions providers, with strong legacy practices and client bases in the agencies and government verticals relating to homeland security, law enforcement, intelligence and defense, could experience increases in demand as the federal market moves forward.

Government Reform is Driving Growth in Advanced Technology Spending

We believe that political pressures and budgetary constraints are forcing government agencies at all levels to improve their processes and services and to operate more like commercial enterprises. Organizations throughout the federal, state and local governments are investing heavily in information technology to improve effectiveness, enhance productivity and extend new services in order to deliver increasingly responsive and cost-effective public services. We believe that Internet technologies provide an ideal solution to meet government's needs.

Changes over the mid to late 1990's in federal government contract procurement and compliance regulations have streamlined the government's buying practices, resulting in a more commercial approach to the procurement and management of technologies and services. As a result, procurement lead times have decreased and government buyers now have greater flexibility to purchase services on the basis of distinguishing corporate capabilities and successful past performance. Federal government entities now are able to award contracts based on factors other than price alone, if they judge that the government would receive a greater value. In addition, the General Services Administration's extension of basic government-wide contract vehicles for procuring technology components and services, the GSA Schedules, makes purchasing technology services easier and faster. Federal government buyers can now order services directly from pre-approved providers instead of using a time-consuming bid solicitation process. We believe that these changes have improved our ability to successfully pursue business in the government market. There are currently no proposed changes to government procurement regulations that we believe will materially affect our business in the immediate future.

Government's Need to Outsource Technology Programs

Government organizations rely heavily on outside contractors to provide skilled resources to accomplish technology programs. We believe that this reliance will continue to intensify due to political and budgetary pressures in many government agencies and due to the difficulties government faces in recruiting and retaining highly skilled technology professionals in a competitive labor market. In concert with its transition to more commercial practices, government is increasingly outsourcing technology programs as a means of simplifying the implementation and management of the technology, so that government workers can focus on their mission.

Technology Services Providers in the Government Sector

Engagements in the government market can be broadly classified into four categories based on the type of services provided. Many companies provide a mix of services across these categories.

First, at the low end, providing information technology staff augmentation at low hourly rates typically involves placing staff in client facilities. These engagements typically exhibit low operating margins and slow growth.

Second, large-scale systems integration and outsourcing engagements typically involve assuming responsibility for acquiring, assembling and operating large inventories of equipment and software. Major portions of these engagements involve reselling commodity technologies at highly competitive fixed unit prices. These engagements typically exhibit moderate growth, but low operating margins.

Third, large-scale systems development engagements involve providing full-service solutions that combine hardware, software development, system engineering and operations. These engagements typically exhibit moderate growth and operating margins.

Fourth, at the high end, engagements involving high-value management consulting and development and integration of complex systems in core mission areas use specialized or emerging technologies such as the Internet and advanced security. These engagements typically exhibit strong growth and operating margins.

Challenges in the Government Technology Services Sector

Technology services providers face a unique combination of challenges when providing services to the government. These include:

- substantial government investments in legacy systems that are not readily adaptable to evolving technologies;
- extremely large volumes of data collected and retained in government databases;
- large and widely dispersed workforces, often consisting of tens of thousands of knowledge workers located in hundreds of sites throughout the United States and the world;
- heightened security concerns due to the need to protect individual privacy and extraordinarily sensitive information; and
- complex management needs that require a combination of strategic planning capabilities, government domain expertise, public sector procurement savvy and cutting-edge technology skills.

Our Solution

We are a high-end technology solutions provider that addresses the needs and particular challenges of the evolving government market by combining the following key elements in our solutions:

Total Solutions Provider Capabilities

As a total solutions provider, we address the full technology lifecycle through our deep technical capabilities and extensive government domain knowledge. We possess a wide range of the specialized skills needed for government technology engagements including: strategic technology consulting; program management; system architectural design; network engineering; applications development; and systems integration, deployment and operational support. We relieve our clients of the details of the application and management of technologies so they can focus on their core competencies and mission. Our mission-critical solutions integrate an organization's back-office processes and legacy systems with customized applications, and enhance the interoperability and accessibility of critical enterprise data.

Extensive Government Domain Experience

Our founders, who have worked together for more than 20 years in the government marketplace, have substantial technical and management backgrounds. Our management maintains close working relationships with our clients and an active role in our projects, resulting in consistent contract performance and broad recognition of our managers. Our consulting staff is knowledgeable in the government sector application of technology management policy formulation, acquisition strategy, business process re-engineering and best-value procurement methods.

Deep Technology Expertise

We have expertise in the critical underlying infrastructure technologies necessary to support fully web-based enterprises, including security, intranets, applications development and enterprise management. We have direct experience with the legacy automation architectures found in government agencies, allowing us to craft solutions that take advantage of the substantial investments our clients have in legacy systems. Our employees have experience with emerging technologies, web-enabling tools and vendors such as Microsoft, Oracle, Cisco, IBM/Lotus, IBM/Tivoli, Entrust and Linux.

Reusable Solution Sets

For portions of our business, we develop reusable solution sets that can be reapplied to requirements commonly encountered in our markets. We develop the software code and components comprising these reusable solution sets based on our government domain expertise. These solutions enable us to give our clients the benefit of our knowledge and experience in addressing complex mission challenges and to develop and implement solutions more quickly and efficiently. We focus our efforts on customizing solutions to meet our clients' specific needs and to deliver reliable solutions based on components that have been tested and perfected through repeated use.

The PEC Philosophy—Flexibility and Objectivity

We retain the maximum possible flexibility in the systems and components that we use in our solutions by maintaining both strong established product credentials and substantial hands-on experience with emerging products. We focus on providing strategic and high-end technical service contributions to large programs, while assisting our clients to assemble, contract with and manage the vendors of commodity program elements. By remaining independent of specific vendors, we are able to work with providers that best serve the interests of our clients.

Our Strategy

Our strategy is to continue to grow by capitalizing on our leadership position in the government technology solutions market. Our strategies for obtaining this objective include:

Maintaining Our Technology Leadership Position

We will continue to focus on high-end engagements that require specialized knowledge of emerging technologies. We intend to maintain our technology leadership by recruiting employees who will add to our inventory of technology skills and by refining the skills and capabilities of our existing staff through training, certification and hands-on laboratory experimentation. We seek to work closely with our technology partners to share expertise and innovations and to stay well ahead of competitors in the practical aspects of applying and integrating emerging technologies.

Increasing Federal Government Market Penetration

We endeavor to capitalize on our long-term relationships with government clients and our reputation within the government market to cross-sell our full range of services to our existing client base and to expand into organizations in the federal government for which we have not already performed services. We pursue these opportunities through a continued active sales and marketing effort and by continuing to promote the success stories stemming from our aggressive application of government technology solutions. We also strive to leverage our relationships with our technology providers and their sales resources to obtain new federal government clients.

Enhancing the PEC Solutions Brand and Culture

We are implementing an aggressive program to build the identity and awareness of the PEC Solutions brand in order to improve our visibility in the marketplace and to attract the best and brightest employees. We seek to hire and retain outstanding professionals, provide incentives to achieve corporate goals and maintain a culture that fosters innovation. We will continue to emphasize professional development and training of our employees. We maintain an active internal communications program to promote a team culture and foster high employee morale. We also continue to emphasize our corporate technology infrastructure to facilitate the sharing of knowledge among our employees.

Expanding Our Presence in State and Local Government and Selected Commercial Markets

We attempt to leverage our domain expertise and deep technology skills for providing services to state and local governments. We also explore available opportunities to expand our business of web-enabling private sector organizations that operate in highly regulated industries and that have significant interactions with the government agencies with which we work. We believe our existing solution sets, such as case management systems, criminal suspect booking stations, and land and financial records automation, are applicable to projects at the state and local level, as well as at private sector organizations.

Undertaking a Disciplined Acquisition Program

We are seeking to broaden our capabilities and client base and extend our geographic presence in state and local government markets by acquiring select businesses. Acquired businesses will perform similar technical work for organizations outside our current client base, will support solution sets that are consistent with and extend our web-enabling strategy, or will be located in geographic areas strategic to significant state and local governments and programs.

Our Services

As a provider of government technology solutions, we offer a variety of services across the full technology lifecycle. These services include:

Strategy and Design

We help clients develop the operational vision for integrated mission solutions, and formulate the business and execution plans for realizing imaginative, integrated and aggressive technology solutions. We develop sophisticated enterprise architectures—the technology blueprints and systematic guidance that allow enterprises to incrementally develop, migrate to and operate large-scale systems. By re-engineering government processes, we move organizations to an eGovernment environment. We perform economic analyses to weigh the costs of technology investment against the operational benefits expected from such technology implementation. We provide support to organizations that are executing programs to privatize large-scale information systems operations, or are undertaking far-reaching changes in their business models, such as migrating from appropriated to fee-for-service financial models.

Solutions Development and Implementation

We develop, engineer and integrate computer hardware, commercial software, reusable solution sets, custom-built applications and networks to create integrated business solutions for our clients. Our emphasis on Internet technology allows us to combine leading-edge technologies with disciplined and effective system development methodologies. Our methods are designed to ensure that the technology fits with business processes and that users realize process improvement. We distinguish ourselves by addressing the core technical and business challenges in migrating large government enterprises to integrated eGovernment solutions. We build:

- INTEGRATED MISSION APPLICATIONS. We integrate complex back-office business applications and legacy systems with customized mission applications using the information-sharing capabilities of open architectures. We also design, develop and install complex custom application systems that implement knowledge management repositories and tera-byte data warehousing systems allowing government agencies to mine the vast storehouses of records that they collect and maintain.

- LARGE-SCALE INTRANET INFRASTRUCTURES. We deploy and manage complex international network infrastructures: intranets and extranets that deliver the performance, reliability and flexibility needed to support the diverse needs of web-enabled organizations with thousands of widely dispersed knowledge workers.
- BIOMETRIC IDENTIFICATION SYSTEMS. We develop and deploy biometric solution sets that help federal agencies collect and process biometric identification from individuals—such as digital fingerprints, mugshots, and identifying features—for law enforcement and civilian government applicant purposes. This information is then either electronically processed into or vetted against key law enforcement and national security databases.
- LEADING-EDGE AUTHENTICATION AND ENCRYPTION SECURITY APPLICATIONS. We apply advanced security technologies such as: public key infrastructure to manage data encryption systems; biometric authentication to identify individuals by their physical characteristics; and strong encryption to protect sensitive information in highly decentralized systems against unauthorized access and compromised integrity.
- AUTOMATED ENTERPRISE MANAGEMENT SYSTEMS. We develop and deploy processes and automated tools for our clients to centrally manage and operate complex national networks of workstations and servers at reduced cost.

Ongoing Systems Management and Enhancement

We provide long-term, ongoing support for our solutions including the operation, management and enhancement actions necessary to keep solutions up-to-date with evolving business processes and technologies. We use sophisticated tools to reduce the burden and costs of maintaining large complex intranets, and to enhance whole systems without the need to deploy engineers and field service technicians to the operating locations of an enterprise. We operate highly automated enterprise technology management processes that support integration, configuration management, software distribution and user support, and allow clients to outsource the responsibilities for maintaining their technology infrastructures and applications. The results are reduced operating costs for our clients and improved performance and reliability.

Recent Developments

On January 28, 2004, the United States District Court for the Eastern District of Virginia dismissed the class action complaint that had been filed against us and certain of our officers. Plaintiffs have filed notice of appeal. In addition, an independent committee of the Board, which had received a demand letter to investigate the same charges, concluded after its investigation and based on its business judgement to reject the demand letter.

Sales and Marketing

Our marketing efforts are focused on creating awareness of opportunities in government technology innovation, establishing PEC Solutions as a leader in this new category and building the PEC Solutions brand.

We market and sell our services through multiple channels by using our business development staff, leveraging existing client relationships, capitalizing on our task order contracts, responding to competitive solicitations, attending marketing events and engaging in other public relations activities. We employ marketing research services to identify and track potential contract opportunities. We also cultivate relationships with leading-edge technology vendors, such as Microsoft and IBM, and prime contractors, such as EDS, to identify and obtain project leads consistent with our capabilities.

We employ a team selling approach, whereby our business developers collaborate with our service delivery professionals and management to identify prospects, conduct sales and manage client relationships. Our Director of Strategic Programs initiates and coordinates the activities of our business development staff. We allocate business developers to each of our business units who pursue new clients and programs across their market segments. Each current client is assigned to a relationship manager who is responsible for ensuring client satisfaction and successful project performance, and identifying new business opportunities with the client.

Culture, People and Recruiting

We have developed a corporate culture that promotes excellence in job performance, respect for the ideas and judgment of our colleagues and recognition of the value of the unique skills and capabilities of our professional staff. We seek to attract highly qualified and ambitious staff. We strive to establish an environment in which all employees can make their best personal contribution and have the satisfaction of being part of a unique team. We believe that we have successfully attracted and retained highly skilled employees because of the quality of our work environment, the professional challenge of our assignments, and the financial and career advancement opportunities we make available to our staff.

We occupy state-of-the-art facilities that are conducive to highly technical and collaborative work, while providing individual privacy. In our solutions centers, we configure large networks of leading-edge equipment and software, and provide our engineers and developers with advanced tools to evaluate and apply new technologies. We believe that the location, environment and amenities provided by our new Fair Lakes campus facility will contribute to our ability to attract and retain highly skilled employees.

As of December 31, 2003, we had 1,223 personnel. Of our total personnel, 1,107 were consulting and service delivery professionals, and 116 were management and administrative personnel performing corporate marketing, human resources, finance, accounting, legal, internal information systems and administrative functions. None of our personnel is represented by a collective bargaining unit. As of March 15, 2004, comparative numbers were 1,220, 1,101 and 119, respectively.

In addition to standard company benefits, we provide:

- tuition reimbursement for employees pursuing advanced academic degrees;
- professional training programs;
- financial incentives for employees obtaining product competency certifications;
- a bonus program;
- spot cash awards to reward specific employee accomplishments; and
- stock option grants based on job performance.

We invest heavily in technical staff recruiting resources and hiring programs. Each of our business units is staffed with a dedicated recruiter, and we aggressively use a variety of recruiting methods, including advertising, job fairs, open houses and Internet-based career placement services. We also offer substantial awards and recognition to our current employees for referrals, which has been particularly effective in identifying and recruiting talented staff.

We have developed an active and effective college recruiting program that draws on management staff and recent college hires from across our company to attract graduating students with strong academic backgrounds in our core disciplines. We currently target colleges and universities in Washington, D.C., Maryland, and Virginia with this program, and perform on-campus recruiting during the spring and fall recruiting seasons at five universities.

Competition

Our current competitors include, and may in the future include, the following:

- information technology services providers and large government contractors such as American Management Systems, Accenture, Booz, Allen & Hamilton, Computer Sciences Corporation, Electronic Data Systems, Bearing Point, International Business Machines, Science Applications International Corporation, Unisys, Lockheed Martin and Northrop Grumman; and
- Internet professional services providers.

Many of our competitors have long operating histories and strong client relationships, greater financial, technical, marketing and public relations resources, larger client bases and greater brand or name recognition than we have.

We believe that the major competitive factors in our market relate to a company's distinctive technical capabilities, successful past contract performance, reputation for quality and key management and marketing staff. Under best-value procurement methods, price is an important, but secondary, factor in the selection of a technology service provider.

Intellectual Property Rights

Our success is dependent, in part, upon our proprietary processes, components and other intellectual property rights. We do not have any patents or patent applications pending. We rely on a combination of trade secret, nondisclosure and other contractual agreements, and copyright and trademark laws, to protect our proprietary rights. Existing trade secret and copyright laws afford us only limited protection. We enter into confidentiality agreements with our employees and our contractors and limit access to and distribution of our proprietary information. There can be no assurance that the steps we have taken in this regard will be adequate to deter misappropriation of our proprietary information or that we will be able to detect unauthorized use and take appropriate steps to enforce our intellectual property rights.

A portion of our business involves the development of software applications for specific client engagements. Although ownership of client-specific software is generally retained by the client, we retain some rights to the applications, processes and intellectual property developed in connection with client engagements.

Backlog

Our current funded backlog is approximately $76 million. Our contracts typically are funded incrementally, and therefore the funded backlog only represents that portion of the contract value. Funding occurs as work progresses. The federal civilian budget normally is signed before the end of the calendar year. The 2003 and 2004 Federal civilian budgets were not signed until the end of February 2003 and January 2004, respectively, which adversely effected the funding of contracts. Our average contract/task performance period runs between 10 to 12 months. Our backlog is typically subject to large variations from quarter to quarter as existing contracts/tasks are renewed or new contracts are awarded. Additionally, all federal government contracts, whether or not funded, may be terminated at the convenience of the government.

Environmental Issues

We have not incurred any costs associated with environmental issues.

Risk Factors

Risk Factors Related to Our Business

Substantially all of our revenues would be threatened if our relationships with agencies of the federal government were harmed

Our largest clients are agencies of the federal government. If the federal government in general, or any significant government agency, uses less of our services or terminates its relationship with us, our revenues would decline substantially, and our business would be seriously harmed. During 2003, contracts with the federal government and contracts with prime contractors of the federal government accounted for approximately 93% of our revenues. During that same period, our ten largest clients, all agencies of the federal government, generated approximately 61% of our revenues, with the top five clients accounting for 41% of our revenues. We believe that federal government contracts are likely to continue to account for a significant portion of our revenues for the foreseeable future. The volume of work that we perform for a specific client, however, is likely to vary from year to year, and a significant client in one year may not use our services as extensively, or at all, in a subsequent year.

Major changes to the government's fundamental organization could negatively impact revenues

The recent establishment of the Department of Homeland Security, the largest government reorganization since 1947, required new and enhanced oversight of technology spending programs at the numerous and disparate agencies being rolled into the new organization. In some cases, certain technology projects are being temporarily halted until an Office of Management and Budget review can be held to determine that technology spending will not be duplicated and thus wasted. This can materially impact our ability to begin or proceed on work for clients affected by the reorganization. Any future reorganization, or delays in technology spending that might result as the reorganization is implemented, could adversely impact company revenues.

Our government contracts may be terminated prior to their completion, and if we do not replace them, our operating results may be harmed

We derive substantially all of our revenues from government contracts that typically are awarded through competitive processes and span a one year base period and one or more option years. The unexpected termination or non-renewal of one or more of our significant contracts could result in significant revenue shortfalls. Our clients generally have the right not to exercise the option periods. In addition, our contracts typically contain provisions permitting an agency to terminate the contract on short notice, with or without cause.

Following termination, if the client requires further services of the type provided in the contract, there is frequently a competitive re-bidding process. We may not win any particular re-bid or be able to successfully bid on new contracts to replace those that have been terminated. Even if we do win the re-bid, we may experience revenue shortfalls in periods where we anticipated revenues from the contract rather than its termination and subsequent re-bidding. These revenue shortfalls could harm operating results for those periods.

Our lack of long-term contracts with clients and our relatively fixed operating expenses expose us to greater risk of incurring losses

Our clients retain us on an engagement-by-engagement basis, rather than under long-term contracts. We incur costs based on our expectations of future revenues. Our operating expenses are relatively fixed and cannot be reduced on short notice to compensate for unanticipated variations in the number or size of engagements in progress. These factors make it difficult for us to predict our

Additional debt financing could force us to accept contractual limitations that could harm our ability to grow.

Audits of our government contracts may result in a reduction in revenues we receive from those contracts or may result in civil or criminal penalties that could harm our reputation

Federal government agencies routinely audit government contracts. These agencies review a contractor's performance on its contract, pricing practices, cost structure and compliance with applicable laws, regulations and standards. An audit could result in a substantial adjustment to our revenues because any costs found to be improperly allocated to a specific contract will not be reimbursed, while improper costs already reimbursed must be refunded. If a government audit uncovers improper or illegal activities, we may be subject to civil and criminal penalties and administrative sanctions, including termination of contracts, forfeiture of profits, suspension of payments, fines and suspension or debarment from doing business with federal government agencies. In addition, we could suffer serious reputational harm if allegations of impropriety were made against us.

We may be liable for penalties under a variety of procurement rules and regulations, and changes in government regulations could slow our growth or reduce our profitability

We must comply with and are affected by federal government regulations relating to the formation, administration and performance of government contracts. These regulations affect how we do business with our clients and may impose added costs on our business. Any failure to comply with applicable laws and regulations could result in contract termination, price or fee reductions or suspension or debarment from contracting with the federal government. Further, the federal government may reform its procurement practices or adopt new contracting methods relating to the GSA schedule or other government-wide contract vehicles. If we are unable to successfully adapt to those changes, our business could be seriously harmed.

Our failure to adequately protect our confidential information and proprietary rights may harm our competitive position

While our employees execute confidentiality agreements, we cannot guarantee that this will be adequate to deter misappropriation of our confidential information. In addition, we may not be able to detect unauthorized use of our intellectual property in order to take appropriate steps to enforce our rights. If third parties infringe or misappropriate our copyrights, trademarks or other proprietary information, our competitive position could be seriously harmed. In addition, other parties may assert infringement claims against us or claim that we have violated their intellectual property rights. Such claims, even if not true, could result in significant legal and other costs and may be a distraction to management.

Changes to federal government procurement rules and regulations could impact revenues

While the government procurement changes of the mid-1990s generally benefited companies servicing the federal government (such as government agencies being able to award outsourcing contracts based on "best value" over lowest price), any future changes that sought to limit or reduce government outsourcing, perhaps, for example, bringing more technology systems work "in-house," could have a negative impact on company revenues.

Continued involvement in Iraq, or other nations, could impact federal government spending on our civilian and defense programs

Although our work focuses primarily on our clients' mission-critical programs, continued involvement in Iraq or a war in another country could change the federal government's spending

Risk Factors

Risk Factors Related to Our Business

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Our lack of long-term contracts with clients and our relatively fixed operating expenses expose us to greater risk of incurring losses

Our clients retain us on an engagement-by-engagement basis, rather than under long-term contracts. We incur costs based on our expectations of future revenues. Our operating expenses are relatively fixed and cannot be reduced on short notice to compensate for unanticipated variations in the number or size of engagements in progress. These factors make it difficult for us to predict our revenues and operating results. If we fail to predict our revenues accurately, it may seriously harm our financial condition and results of operation.

A reduction in or the termination of our services could lead to underutilization of our employees and could harm our operating results

Our employee compensation expenses are relatively fixed. Therefore, if a client defers, modifies or cancels an engagement or chooses not to retain us for additional phases of a project, our operating results will be harmed unless we can rapidly re-deploy our employees to other engagements in order to minimize underutilization.

Failing to maintain strong relationships with prime contractors could result in a decline in our revenues

We derived approximately 23% of our revenues during 2003 through our relationships with prime contractors, which, in turn, have contractual relationships with end-clients. One of our prime contractors, EDS (NMCI), accounted for approximately 9.5% of our revenues during 2003. We expect to continue to depend on these relationships for a material portion of our revenues in the foreseeable future. If any of these prime contractors eliminate or reduce their engagements with us, or have their engagements eliminated or reduced by their end-clients, we will lose a source of revenues, which, if not replaced, will adversely affect our operating results.

We must recruit and retain qualified professionals to succeed in our labor-intensive business

Our future success depends in large part on our ability to recruit and retain qualified professionals skilled in complex information technology services and solutions, including encryption and other security systems. Such personnel are in great demand and are likely to remain a limited resource in the foreseeable future. Competition for qualified professionals is intense. Any inability to recruit and retain a sufficient number of these professionals could hinder the growth of our business,

We may lose money on fixed-price contracts if we miscalculate the resources we need to complete the contract

We derived approximately 24% of our revenues in 2003 from fixed-price contracts. We anticipate a material portion of our future engagements will continue to be contracted at a fixed price. Unlike time and materials contracts, for which we are reimbursed based on our actual expenditures of resources, fixed-price contracts require us to price our contracts by predicting our expenditures in advance. If we miscalculate the resources we need to complete fixed-price engagements, our operating results could be seriously harmed because we are not compensated for the higher costs.

We could lose revenues and clients and expose our Company to liability if we fail to meet client expectations

We create, implement and maintain technology solutions that are often critical to our clients' operations. If our technology solutions or other applications have significant defects or errors or fail to meet our clients' expectations, we may:

- lose revenues due to adverse client reaction;
- be required to provide additional remediation services to a client at no charge;
- receive negative publicity, which could damage our reputation and adversely affect our ability to attract or retain clients; and
- suffer claims for substantial damages against us, regardless of our responsibility for the failure.

While many of our contracts limit our liability for damages that may arise from negligent acts, errors, mistakes or omissions in rendering services to our clients, we cannot be sure that these contractual provisions will protect us from liability for damages if we are sued. Furthermore, our general liability insurance coverage may not continue to be available on reasonable terms or in sufficient amounts to cover one or more large claims, or the insurer may disclaim coverage as to any future claim. The successful assertion of any large claim against us could seriously harm our business. Even if not successful, such claims could result in significant legal and other costs and may be a distraction to management.

Security breaches in sensitive government systems could result in the loss of clients and negative publicity

Many of the systems we develop involve managing and protecting information involved in law enforcement and other sensitive government functions. A security breach in one of these systems could cause serious harm to our business, could result in negative publicity and could prevent us from having further access to such critically sensitive systems or other similarly sensitive areas for other governmental clients. Losses that we could incur from such a security breach could exceed the policy limits that we have for "errors and omissions" or product liability insurance.

If we cannot obtain the necessary security clearances, we may not be able to perform classified work for the government and our revenues may suffer

Government contracts require us, and some of our employees, to maintain security clearances. If we lose or are unable to obtain security clearances, the client can terminate the contract or decide not to renew it upon its expiration. As a result, to the extent we cannot obtain the required security clearances for our employees working on a particular engagement, we may not derive the revenue anticipated from the engagement, which, if not replaced with revenue from other engagements, could seriously harm our operating results.

We depend on our senior management team, and the loss of any member may adversely affect our ability to obtain and maintain clients

We believe that our success will depend on the continued employment of our senior management team, including David Karlgaard, our Chief Executive Officer, Paul Rice, our Chief Operating Officer and Alan Harbitter, our Chief Technology Officer. This dependence is particularly important to our business because personal relationships are a critical element of obtaining and maintaining client engagements. If one or more members of our senior management team was unable or unwilling to continue in their present positions, such persons would be difficult to replace and our business could be seriously harmed. Furthermore, clients or other companies seeking to develop in-house capabilities may hire away some of our key employees. Employee defections to clients or competitors would not only result in the loss of key employees but could also result in the loss of a client relationship or a new business opportunity. Any losses of client relationships could seriously harm our business.

We may not be able to successfully identify, manage and integrate future acquisitions, which may harm our operating results

We may use a portion of the proceeds from public offerings and operations to acquire companies or businesses that are complementary to ours. However, we have no immediate plans or current agreements to acquire any additional companies or businesses, and we cannot assure you that we will identify appropriate acquisition candidates. If we do identify an appropriate acquisition candidate, we cannot assure you that we would be able to successfully negotiate the terms of an acquisition, finance the acquisition or integrate the acquired business into our existing business. Negotiations of potential acquisitions and the integration of an acquired business could disrupt our business by diverting management away from day-to-day operations. Further, failure to successfully integrate any acquisition may cause significant operating inefficiencies and adversely affect our profitability. Consummating a merger could require us to raise additional funds through additional equity or debt financing. Additional equity financing could result in further dilution of the per share value of your stock.

Additional debt financing could force us to accept contractual limitations that could harm our ability to grow.

Audits of our government contracts may result in a reduction in revenues we receive from those contracts or may result in civil or criminal penalties that could harm our reputation

Federal government agencies routinely audit government contracts. These agencies review a contractor's performance on its contract, pricing practices, cost structure and compliance with applicable laws, regulations and standards. An audit could result in a substantial adjustment to our revenues because any costs found to be improperly allocated to a specific contract will not be reimbursed, while improper costs already reimbursed must be refunded. If a government audit uncovers improper or illegal activities, we may be subject to civil and criminal penalties and administrative sanctions, including termination of contracts, forfeiture of profits, suspension of payments, fines and suspension or debarment from doing business with federal government agencies. In addition, we could suffer serious reputational harm if allegations of impropriety were made against us.

We may be liable for penalties under a variety of procurement rules and regulations, and changes in government regulations could slow our growth or reduce our profitability

We must comply with and are affected by federal government regulations relating to the formation, administration and performance of government contracts. These regulations affect how we do business with our clients and may impose added costs on our business. Any failure to comply with applicable laws and regulations could result in contract termination, price or fee reductions or suspension or debarment from contracting with the federal government. Further, the federal government may reform its procurement practices or adopt new contracting methods relating to the GSA schedule or other government-wide contract vehicles. If we are unable to successfully adapt to those changes, our business could be seriously harmed.

Our failure to adequately protect our confidential information and proprietary rights may harm our competitive position

While our employees execute confidentiality agreements, we cannot guarantee that this will be adequate to deter misappropriation of our confidential information. In addition, we may not be able to detect unauthorized use of our intellectual property in order to take appropriate steps to enforce our rights. If third parties infringe or misappropriate our copyrights, trademarks or other proprietary information, our competitive position could be seriously harmed. In addition, other parties may assert infringement claims against us or claim that we have violated their intellectual property rights. Such claims, even if not true, could result in significant legal and other costs and may be a distraction to management.

Changes to federal government procurement rules and regulations could impact revenues

While the government procurement changes of the mid-1990s generally benefited companies servicing the federal government (such as government agencies being able to award outsourcing contracts based on "best value" over lowest price), any future changes that sought to limit or reduce government outsourcing, perhaps, for example, bringing more technology systems work "in-house," could have a negative impact on company revenues.

Continued involvement in Iraq, or other nations, could impact federal government spending on our civilian and defense programs

Although our work focuses primarily on our clients' mission-critical programs, continued involvement in Iraq or a war in another country could change the federal government's spending priorities for domestic and military programs. Spending on our clients' programs could also be negatively impacted by Congress's unwillingness to pass the necessary appropriation bills required to pay for a war effort.

Risks Factors Related to the Government Technology Solutions Market

Competition could result in price reductions, reduced profitability and loss of market share

Competition in the market for government technology solutions is intense. If we are unable to differentiate our services from those of our competitors, our revenue growth and operating margins may decline. Many of our competitors are larger and have greater financial, technical, marketing and public relations resources, larger client bases and greater brand or name recognition than us. Our larger competitors may be able to provide clients with additional benefits, including reduced prices. We may be unable to meet those prices, which may cause us to lose business and market share. Alternatively, we could decide to meet the lower prices, which could harm our profitability. If we fail to compete successfully, our business could be seriously harmed.

Our current competitors include, and may in the future include, the following:

- information technology services providers and large government contractors such as American Management Systems, Accenture, Booz-Allen & Hamilton, Computer Sciences Corporation, Electronic Data Systems, Bearing Point, International Business Machines, Science Applications International Corporation, Unisys, Lockheed Martin and Northrop Grumman; and
- Internet professional services providers.

Current and potential competitors also have established or may establish cooperative relationships among themselves or with third parties to increase their ability to address client needs. Accordingly, it is possible that new competitors or alliances among competitors may emerge and rapidly acquire significant market share. In addition, some of our competitors may develop services that are superior to, or have greater market acceptance than, the services that we offer.

Our business will be harmed if government agencies are unwilling to replace or supplement expensive legacy systems

Government agencies have spent substantial resources over an extended period of time to develop computer systems and to train their personnel to use them. These agencies may be reluctant to abandon or supplement these legacy systems with Internet and other advanced technology systems because of the cost of developing them or the additional cost of re-training their personnel. Such reluctance would make it more difficult to acquire new engagements which would harm our business prospects.

Our growth will be harmed if a viable market for government technology services is not sustained

We cannot be certain that a viable government market for Internet and other advanced technology services will be sustainable. If this market is not sustained and we are unable to refocus our services on the private sector market or other in-demand technologies, our growth would be negatively affected. Although government agencies have recently increased focus on and funding for technology initiatives, we cannot be certain that these initiatives will continue in the future. Budget cutbacks or political changes could result in a change of focus or reductions in funding for technology initiatives, which, in turn, could seriously harm our revenues.

Risks Related to the Ownership of Our Common Stock

Our quarterly revenues and operating results could be volatile and may cause our stock price to fluctuate

Our quarterly revenues and operating results may fluctuate significantly in the future. In particular, if the federal government does not adopt a budget for its fiscal year beginning on October 1, federal agencies may be forced to suspend our contracts due to a lack of funding. Consequently, we may realize lower revenues in the quarter ending December 31. Further, the rate at which the Federal government procures technology may be negatively affected following changes in Presidential administrations and in senior government officials. As a result, our operating results could be volatile and difficult to predict and period-to-period comparisons of our operating results may not be a good indication of our future performance.

A significant portion of our operating expenses, such as personnel and facilities costs, are fixed in the short term. Therefore, any failure to generate revenues according to our expectations in a particular quarter could result in reduced income in the quarter. In addition, our quarterly operating results may not meet the expectations of securities analysts or investors, which in turn may have an adverse effect on the market price of our common stock.

Our officers and directors directly own 53.0% of our stock and can control matters submitted to stockholders for their approval

Our directors and executive officers directly own, in the aggregate, 53.0% of our outstanding common stock. As a result, these stockholders will be able to exercise control over all matters requiring stockholder approval, including the election of directors and approval of significant corporate transactions. This concentration of ownership may also have the effect of delaying or preventing a change in control of PEC Solutions.

We have various mechanisms in place that may prevent a change in control that stockholders may consider favorable

Our certificate of incorporation and bylaws may discourage, delay or prevent a change in control of PEC Solutions that stockholders may consider favorable. Our certificate of incorporation and bylaws:

- authorize the issuance of blank check capital stock that could be issued by our board of directors to thwart a takeover attempt;
- classify the board of directors into staggered, three-year terms, which may lengthen the time required to gain control of our board of directors;
- prohibit cumulative voting in the election of directors, which would otherwise allow holders of less than a majority of the stock to elect some directors;
- require super-majority voting to effect amendments to provisions of our bylaws concerning the number of directors;
- limit who may call special meetings of stockholders;
- prohibit stockholder action by written consent, requiring all actions to be taken at a meeting of the stockholders;
- establish advance notice requirements for nominating candidates for election to the board of directors or for proposing matters that can be acted upon by stockholders at stockholder meetings; and
- require that vacancies on the board of directors, including newly-created directorships, be filled only by a majority vote of directors then in office.

In addition, Section 203 of the Delaware General Corporation Law may discourage, delay or prevent a change in control by prohibiting us from engaging in a business combination with an interested stockholder for a period of three years after the person becomes an interested stockholder.

Website Access to Reports

Our filings with the U.S. Securities and Exchange Commission (the "SEC") and other information, including our Ethics Policy, can be found on the PEC Solutions website (*www.pec.com*). Information on our website does not constitute part of this report.

We make available free of charge, on or through our Internet website, as soon as reasonably practicable after they are electronically filed or furnished to the SEC, our annual reports on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K and amendments to those reports filed or furnished pursuant to Section 13(a) or 15(d) of the Exchange Act of 1934.

Item 2. Properties

Our operations occupy approximately 365,000 square feet of space located in Alexandria, Fairfax, Falls Church and Norfolk, Virginia; Baltimore and Columbia, Maryland; Washington, D.C.; San Diego, California; San Antonio, Texas; and Trevose, Pennsylvania. We also have employees working at client sites throughout the United States. The large majority of the space is office space, all of which is leased. For lease commitment information, reference is made to Note 15 in the accompanying consolidated financial statements. Existing facilities are considered to be generally suitable and adequate for our present needs. We have a 48% equity interest in the company that owns our newest building in Fairfax, Virginia. Future contracts may require us to lease additional office space in other cities located in the United States.

Item 3. Legal Proceedings

On and after March 18, 2003, several purported class action complaints were filed against us and certain of our officers in the United States District Court for the Eastern District of Virginia. The complaints allege that between October 22, 2002 and March 14, 2003, the defendants made, or were aware of, false and misleading statements which had the effect of inflating the market price of our stock, in violation of Sections 10(b) and 20(a) of the Securities Exchange Act of 1934. The complaints were consolidated into a single action on June 13, 2003. The complaint was dismissed by the Court on January 28, 2004. Plaintiffs have filed notice of appeal. In addition, a stockholder's legal counsel sent a letter of demand that the Board of Directors investigate the same charges addressed in the class action suit. An independent committee of the Board concluded after its investigation and based on its business judgement to reject the demand letter.

On September 11, 2003, we instituted a lawsuit in the United States District Court of Minnesota against NCS Pearson, Inc. for improperly withholding payment of funds owed to us under a subcontract, we contend that NCS Pearson has no legal basis to justify the withholding of payment and we are seeking recovery of $6.3 million in unpaid receivables plus interest and costs. The proceedings are moving according to schedule.

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

None

PART II

Item 5. Market for the Company's Common Equity and Related Stockholder Matters

At February 27, 2004, we had approximately 7,100 holders of record of our common stock. We had 27,308,207 shares of common stock outstanding. Our stock began trading on the Nasdaq National Market on April 20, 2000 under the symbol "PECS". The following high and low sale prices indicated for our common stock are as reported on the Nasdaq National Market during each of the quarters indicated.

	High	Low
2003 Quarter Ended:		
December 31	$18.760	$13.780
September 30	$22.990	$14.406
June 30	$16.380	$11.730
March 31	$33.140	$ 9.050
2002 Quarter Ended:		
December 31	$38.250	$21.940
September 30	$27.690	$17.050
June 30	$28.690	$18.750
March 31	$44.440	$22.050

In April 2000, we commenced and completed a firm commitment underwritten initial public offering of 3,000,000 shares of our common stock at a price of $9.50 per share. The shares were registered with the Securities and Exchange Commission pursuant to a registration statement on Form S-1 (No. 333-95331), which was declared effective on April 19, 2000. The public offering was underwritten by a syndicate of underwriters led by Donaldson, Lufkin & Jenrette Securities Corporation, Chase Securities Inc., Legg Mason Wood Walker, Incorporated; and DLJdirect Inc. as their representatives. After deducting underwriting discounts and commissions of approximately $2 million and expenses of approximately $0.9 million, we received net proceeds of $25.6 million. We have used approximately $23 million of this amount to fund acquisitions and the balance to fund a portion of our investment in the limited liability company that owns our corporate headquarters building.

We expect to retain future earnings, if any, for use in the operation and expansion of the business and do not anticipate paying any cash dividends in the foreseeable future.

Recent Sales of Unregistered Securities

None

Item 6. Selected Financial Data

Our selected consolidated financial data for the years ended December 31, 2003, 2002, 2001 2000 and 1999 have been derived from our audited consolidated financial statements. The 2003, 2002 and 2001 information should be read in conjunction with "Management's Discussion and Analysis of Financial Condition and Results of Operations" and our consolidated financial statements and the related notes thereto appearing elsewhere in this Annual Report on Form 10-K. Certain reclassifications have been made to the prior period financial statements to conform to the presentation used in our December 31, 2003, consolidated financial statements.

	1999	2000	2001	2002	2003
	(in thousands of dollars, except per share data)				
Operating Results:					
Revenues	$53,202	$68,305	$109,213	$182,185	$172,043
Gross profit (a)	22,793	30,996	48,797	74,908	69,681
Operating income	8,975	10,211	19,262	34,878	27,922
Net income	5,639	7,272	13,067	22,254	17,241
Earnings per share (b)(c)					
Basic	0.33	0.34	0.54	0.84	0.64
Diluted	0.24	0.30	0.47	0.75	0.58
Financial Position:					
Cash and cash equivalents	$ 7,981	$14,656	$ 30,436	$ 21,176	$ 33,401
Working capital	13,311	43,182	83,627	93,336	106,256
Total assets	24,400	61,400	141,707	192,291	210,371
Long-term obligations (including long-term debt and capital leases)	—	—	2,937	22,822	23,062
Total stockholders' equity	15,283	50,700	118,428	147,344	168,582
Cash dividends declared per common share	$ 0.023	—	—	—	—

(a) Gross profit represents revenues less direct costs, which consist primarily of project personnel salaries and benefits and direct expenses incurred to complete projects.

(b) Per share amounts for all periods presented have been adjusted to reflect the 3 for 1 stock split in January 2000 and the 2 for 1 stock split in March 2000.

(c) See footnote 3. "Goodwill and Intangibles" of the financial statements to see the impact of acquisitions on the financial results.

Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations

This Management's Discussion and Analysis of Financial Condition and Results of Operation section includes "forward-looking statements," within the meaning of the Federal Private Securities Litigation Reform Act of 1995. While forward-looking statements sometimes are presented with numerical specificity, they are based on various assumptions made by management regarding future circumstances over many of which we have little or no control. Forward-looking statements may be identified by words including "anticipate," "believe," "estimate," "expect" and similar expressions. We caution readers that forward-looking statements, including without limitation, those relating to future business prospects, revenues, working capital, liquidity, and income, are subject to certain risks and uncertainties that would cause actual results to differ materially from those indicated in the forward-looking statements. Factors that could cause actual results to differ from forward-looking statements include the concentration of our revenues from the U.S. Government and its agencies and departments (the "Government"), risks involved in contracting with the government, difficulties we may have in attracting, retaining and managing professional and administrative staff, fluctuations in quarterly results, risks related to acquisitions, risks related to competition and our ability to continue to win and perform efficiently on Government contracts, and other risks and factors identified from time to time in the reports we file with the U.S. Securities and Exchange Commission ("SEC"), including those identified under the caption "Risk Factors" in this Annual Report on Form 10-K. Should one or more of these risks or uncertainties materialize, or should underlying assumptions prove incorrect, actual results may vary materially from those anticipated, estimated or projected.

Overview

We are a professional services firm specializing in high-end solutions that help government organizations capitalize on the Internet and other advanced technologies. We migrate paper-intensive procedures to web-enabled processes using eGovernment solutions that help our clients enhance their productivity and improve the services they offer to the public. As a total solutions provider, we address the full technology lifecycle, including formulating technology strategies, creating business solutions, performing long-term operational management and continuing enhancement of the solution.

As part of our growth strategy, we have completed acquisitions of Viking Technology, Inc. ("Viking") on August 28, 2000, Troy Systems, Inc. ("Troy") on November 20, 2001 and the contracts and employees of Vector Research, Inc. ("Vector") on June 14, 2002. These business combinations were accounted for as purchases. See "Acquisitions".

In 2003, our revenues were adversely affected by the late passage and signing of both the 2003 and 2004 federal civilian budgets.

We derive substantially all of our revenues from fees for consulting services. We generate these fees from contracts with various payment arrangements, including time and materials contracts, fixed-price contracts and cost-reimbursable contracts. During 2003, revenues from these contract types were approximately 58%, 24% and 18%, respectively, of total revenues. We expect this approximate mix of business to continue in 2004. We typically issue invoices monthly to manage outstanding accounts receivable balances. We recognize revenues on time and materials contracts as the services are provided. We recognize revenues on fixed-price contracts using the percentage of completion method as services are performed over the life of the contract, based on the costs we incur in relation to the total estimated costs. We recognize and make provisions for any anticipated contract losses. However, if the contract has a service element, revenues are recognized on a straight-line basis over the term of the contract. In certain arrangements, we enter into contracts that include the delivery of a combination of two or more of our service offerings. Typically, such multiple-element arrangements incorporate the design, development or modification of systems and an ongoing obligation to manage, staff, maintain, host or otherwise run solutions and systems provided to the client. Such contracts are divided into separate units of accounting and the total arrangement fee is allocated to each unit based on its relative fair value. Revenue is recognized separately, and in accordance with our revenue recognition policy, for each element. Fixed- price contracts are attractive to clients, and while subject to increased risks, provide opportunities for increased margins. We recognize revenue on cost-reimbursable contracts as services are provided. These revenues are equal to the costs incurred in providing these services plus a proportionate amount of the fee earned. While our margins are lower on cost-reimbursable contracts we have historically recovered all of our costs on these contracts, which means we have lower risk.

Our historical revenue growth is attributable to various factors, including an increase in the size and number of projects for existing and new clients. Existing clients from the previous fiscal year generated approximately 93% of our revenues in 2003, approximately 86% of our revenues in 2002 and approximately 71% of our revenues in 2001. We manage our client development efforts through each of our strategic service groups, each having specific client responsibility and focus. As of December 31, 2003, we had 1,223 personnel and on February 27, 2004 we had xx personnel.

In 2003, we derived approximately 23% of our revenue through relationships with prime contractors, which contract directly with the end-client and subcontract with us. With the exception of the EDS (NMCI) subcontract, in most of these engagements, we retain full responsibility for the end-client relationship and direct and manage the activities of our contract staff.

During 2003, we had one customer that accounted for more than 10% of our total revenue. The Drug Enforcement Agency (DEA) Special Projects Division accounted for 11% of the revenue.

Our most significant expense is direct costs, which consist primarily of project personnel salaries and benefits, and direct expenses incurred to complete projects. Our direct costs as a percentage of revenues are also related to the utilization rate of our consulting employees. We manage utilization by frequently monitoring project requirements and timetables. The number of consulting employees assigned to a project will vary according to the size, complexity, duration and demands of the project.

General and administrative expenses consist primarily of costs associated with our executive management, finance and administrative groups, human resources, unassigned consulting employees, employee training, occupancy costs, depreciation and amortization, travel and all other branch and corporate costs.

Sales and marketing expenses include the costs of sales and marketing personnel and costs associated with marketing and bidding on future projects.

Other income consists primarily of interest income earned on our cash, cash equivalents and marketable securities and income from our investment in our corporate headquarters building.

Acquisitions

On August 28, 2000, we acquired all of the outstanding capital stock of Viking for $2.0 million cash plus the assumption of debt in a business combination accounted for as a purchase. Viking was a provider of integrated software and advanced technology solutions to state and local law enforcement, fire, and emergency medical service agencies. The excess of purchase price over the fair value of the net assets was approximately $3.6 million. At the time of the acquisition, Viking had 20 personnel.

On November 20, 2001, we acquired all of the outstanding common shares of Troy for $15.3 million of cash and common stock valued at $3.0 million in a business combination accounted for as a purchase. Troy derived revenue from system development, networking, engineering, integration services, and information systems security and its primary customer was the federal government. The excess of purchase price over the fair value of the net assets was approximately $9.9 million. At the time of the acquisition, Troy had 354 personnel.

On June 14, 2002, we acquired the contracts and employees of Vector for $5.7 million cash plus the assumption of $0.1 million in accrued liabilities. Vector was a provider of technology development and engineering services to the federal government. The excess of purchase price over fair value of the net assets was approximately $4.3 million. At the time of the acquisition, Vector had 41 personnel.

Critical Accounting Policies and Significant Estimates

The preparation of financial statements in conformity with U.S. generally accepted accounting principles requires that management make estimates and assumptions affecting the assets and liabilities (including contingent assets and liabilities) reported at the date of the consolidated financial statements and the revenues and expenses reported for the periods presented. Actual amounts could differ from those estimates. Management bases its estimates on historical experience, current data, information related to performance and on various other assumptions that are believed to be reasonable under the circumstances. Those measurements that are most affected by management's estimates of future events are:

- *Revenue recognition.* Our revenue is derived primarily from contracts with the Federal government. In 2001, 2002 and 2003, 13%, 21%, 24% of our contracts were fixed-priced contracts. Revenues on fixed-price contracts are recognized using the percentage-of-completion method of accounting. Such revenues are recorded based on the percentage of costs incurred in the applicable reporting period compared to the most recent estimates of total costs to complete each contract. Estimating future costs and, therefore, revenues and profits, is a process requiring a high degree of management judgment. In the event of a change in total estimated contract cost or profit, the cumulative effect of such change is recorded in the period the change in estimate occurs. In the event cost estimates indicate a loss on a contract, the total amount of such loss is recorded in the period. However, if the contract has a service element, revenues are recognized on a straight-line basis over the term of the contract. In certain arrangements, we enter into contracts that include the delivery of a combination of two or more of our service offerings. Typically, such multiple-element arrangements incorporate the design, development or modification of systems and an ongoing obligation to manage, staff, maintain, host or otherwise run solutions and systems provided to the client. Such contracts are divided into separate units of accounting and the total arrangement fee is allocated to each unit based on its relative fair value. Revenue is recognized separately, and in accordance with our revenue recognition policy, for each element.

- *Depreciation and amortization periods for long-lived assets, including property and equipment and intangibles.* In accordance with SFAS No. 144, "Accounting for the Impairment of Long-Lived Assets," we review our long-lived assets, including property and equipment and identifiable intangibles, whenever events or changes in circumstances indicate that the carrying amount of the assets may not be fully recoverable. To determine the recoverability of long-lived assets, we evaluate the probability that future estimated undiscounted net cash flows will be less than the carrying amount of the assets. If the future estimated undiscounted net cash flows will be less than the carrying amount of the long-lived assets, then such assets are written down to their fair value. We have not identified any events or circumstances that indicate the carrying value of long-lived assets may not be fully recoverable.

- *Realization values of various assets such as receivables and goodwill.* The allowance for doubtful accounts reflects management's best estimate of probable losses based on historical experience, known troubled accounts and other currently available information. Allowances are established for specific receivables when deemed appropriate. Goodwill is tested for impairment on an annual basis and between annual tests if an event occurs or circumstances change that would more likely than not reduce the fair value of the goodwill below its carrying value. We completed our annual impairment test and concluded goodwill was not impaired. If actual market conditions are less favorable than those we have projected, or if an event occurs, or circumstances change that would more likely than not reduce the fair value of the goodwill below its carrying value, we may be required to recognize goodwill impairment charges.

Results of Operations

The following table sets forth certain financial data as a percentage of total revenues for the periods indicated.

	Year Ended December 31,		
	2001	2002	2003
Statement of Operations Data:			
Revenues	100.0%	100.0%	100.0%
Direct costs	55.3	58.9	59.5
Gross profit (a)	44.7	41.1	40.5
Operating costs and expenses:			
General and administrative expenses	22.3	18.6	20.7
Sales and marketing expenses	4.0	3.0	3.1
Amortization of goodwill and intangibles	0.7	0.4	0.5
Total operating costs and expenses	27.0	22.0	24.3
Operating income	17.7	19.1	16.2
Investment and other income	1.9	0.8	1.3
Interest expense	—	(0.1)	(1.5)
Income before income taxes	19.6	19.8	16.0
Provision for income taxes	7.6	7.6	6.0
Net income	12.0%	12.2%	10.0%

(a) Gross profit represents revenues less direct costs, which consist primarily of project personnel salaries and benefits and direct expenses incurred to complete projects.

2003 Compared with 2002

Revenues. Revenues decreased 5.6% to $172.0 million for 2003 from $182.2 million for 2002. Services to new clients represented approximately 7% of revenues, down from 14% in 2002. Revenues were adversely impacted by the late passage and signing of both the 2003 and 2004 federal civilian agency budgets. We also saw approximately a $13 million reduction in revenue from the EDS (Navy Marine Corps Intranet) subcontract during 2003 as compared to the prior year, as the program went from its initial engineering phase into a production phase. In addition, we saw a reduction of revenue of approximately $20 million related to our mobile biometric solutions work for the hiring of airport security personnel, as the program went from the full implementation phase to the sustaining phase.

Direct Costs. Direct costs decreased 4.6% to $102.4 million for 2003 from $107.3 million for 2002. Direct costs increased as a percentage of revenues to 59.5% for 2003, from 58.9% for 2002. This increase was attributable primarily to the delays related to the passage and signing of the federal civilian budgets and the associated delay of new project startups. New project startups normally allow for the recovery of increases in labor costs, which for us goes into effect on January 1 of each year.

Gross Profit. Gross profit decreased 7.0% to $69.7 million for 2003 from $74.9 million for 2002. Gross profit as a percentage of revenues decreased to 40.5% for 2003 from 41.1% for 2002, because direct costs grew at a faster rate than revenues. As previously indicated, revenues were negatively affected by the late passage and signing of the federal civilian budgets.

General and Administrative Expenses. General and administrative expenses increased 4.9% to $35.5 million for 2003 from $33.9 million for 2002. Facilities costs increased for 2003 over 2002 due to the opening of our new headquarters in Fairfax, VA and an office in Washington, DC. Our total general and administrative headcount decreased to 116 employees as of December 31, 2003, compared to 123 employees as of December 31, 2002.

Sales and Marketing. Sales and marketing expenses were approximately $5.4 million in both 2003 and 2002.

Amortization of Intangibles. For 2003, we incurred $851,000 of amortization expense related to the $4.5 million of intangibles we recorded in connection with the value of contracts and customer relationships acquired in the November 2001 acquisition of Troy, and the June 2002 acquisition of Vector. This compares to $769,000 of amortization expense in 2002.

Operating Income. Operating income decreased 19.9% to $27.9 million for 2003 from $34.9 million for 2002, due to the factors discussed above.

Investment and Other Income. For 2003, we earned $1.4 million of interest income and net gains on sales of securities. We also had $953,000 of income from our investment in our corporate headquarters building. For 2002, we had $1.6 million of interest income and net losses on sales of securities. We also had an $85,000 loss from the investment in our corporate headquarters building. The increase in the gain form the investment in our corporate headquarters was a result of the building going into operation in December 2002.

Interest Expense. For 2003 and 2002, we incurred interest expense of $2.7 million and $227,000, respectively, principally related to our corporate headquarters building.

Environmental Costs. We have not incurred any costs in association with environmental issues.

2002 Compared with 2001

Revenues. Revenues increased 66.8% to $182.2 million for 2002 from $109.2 million for 2001. The increase in revenue primarily reflects increases in the amount of services to existing clients and the mobile biometric solutions work. Approximately 47% of the increase was related to the Troy and Vector acquisitions. Services to new clients represented approximately 14% of revenues.

Direct Costs. Direct costs increased 77.6% to $107.3 million for 2002 from $60.4 million for 2001. The increase was due primarily to an increase in project personnel to 1,219 as of December 31, 2002, as compared to 1,140 as of December 31, 2001. We added 301 personnel related to the Troy acquisition at the end of November 2001. Direct costs increased as a percentage of revenues to 58.9% for 2002, from 55.3% for 2001. The increase was principally related to normal fluctuations in labor, increases in other direct costs and the impact of the Troy and Vector acquisitions.

Gross Profit. Gross profit increased 53.5% to $74.9 million for 2002 from $48.8 million for 2001. Gross profit as a percentage of revenues decreased to 41.1% for 2002 from 44.7% for 2001 because direct costs grew at a faster rate than revenues. This decrease was principally related to normal fluctuations in labor, increase in other direct costs and the impact of the Troy and Vector acquisitions.

General and Administrative Expenses. General and administrative expenses increased 39.3% to $34.0 million for 2002 from $24.4 million for 2001. These costs, such as rent and other facility costs, recruiting expenses and depreciation of equipment purchased, were related to the increase in project personnel. Facilities costs increased for 2002 due to the opening of our new offices in Fairfax, Virginia, Columbia, Maryland and Washington, D.C. Our total general and administrative headcount decreased to 123 employees as of December 31, 2002, compared to 134 employees as of December 31, 2001, consistent with our plans.

Sales and Marketing. Sales and marketing expenses increased 22.9% to $5.4 million in 2002 from $4.4 million in 2001. This increase was due to an increase in our marketing efforts

Amortization of Goodwill. As a result of the adoption of FAS 142, effective January 1, 2002, we incurred no goodwill amortization expense for 2002. For 2001, we incurred $0.7 million of amortization expense related to the $3.6 million of goodwill we recorded in connection with the acquisition of Viking.

Amortization of Intangibles. For 2002, we incurred $0.8 million of amortization of expense related to the $3.0 million of intangibles we recorded in connection with the value of contracts and customer relationships acquired in the November 2001 acquisition of Troy, and $1.5 million of intangibles recorded in connection with the value of contracts and customer relationships acquired in the June 2002 acquisition of Vector. For 2001, we incurred $0.1 million of amortization expense related to the $3.0 million of intangibles we recorded in connection with the value of contracts and customer relationships acquired in the acquisition of Troy.

Operating Income. Operating income increased 80.6% to $34.8 million for 2002 from $19.3 million for 2001. This increase was due primarily to increased revenues and the impact of the Troy and Vector acquisitions.

Investment and Other Income. For 2002, we earned $1.3 million of interest income and net gains on sales of securities. We also had a $85,000 loss from our investment in our corporate headquarters building. For 2001, we had $2.2 million of interest income and net losses on sales of securities. There was no income or loss related to the corporate headquarters building in 2001, since the building was under construction. The decrease in interest income was related to the decreases in interest rates, and the conversion of investments from taxable securities to tax-exempt securities.

Interest Expense. For 2002 and 2001, we incurred interest expense of $227,000 and $4,000, respectively. Interest expense in 2002 was principally related to our corporate headquarters building.

Environmental Costs. We have not incurred any costs in association with environmental issues.

Liquidity and Capital Resources

Prior to our IPO and follow-on offering, we funded our operations primarily through cash generated from operations and the sale of common stock to employees. We currently expect to meet our short-term and long-term cash requirements through funds generated from operations. Net cash provided by operating activities was $23.0 million for the year ended December 31, 2003. Cash provided by operating activities is primarily driven by net income, adjusted for working capital changes, which are principally changes in accounts receivable.

Net cash used by investing activities was $14.8 million for 2003. During 2003, we had $1.3 million of net purchases of property and equipment, $2.9 million of short-term investments and $10.8 million of long-term investments, invested $0.6 million in capitalized software, while receiving $0.8 million of distributions from the investment in the entity that owns our headquarters building. Investing activity is primarily driven by investments in short and long-term securities.

Net cash provided by financing activities was $4.0 million and is primarily driven by proceeds from the sale of common stock to employees upon the exercise of their stock options and purchase of stock through the employee stock purchase plan during 2003.

We expect to retain future earnings, if any, for use in the operation of our business and at this time do not anticipate paying any cash dividends.

We maintain a $10.0 million line of credit with Bank of America, bearing interest at the one-month LIBOR rate plus 250 basis points per annum, which expires on June 30, 2005. As of December 31, 2003, we had no borrowings outstanding under the line of credit. As of December 31, 2003, we had outstanding $2.8 million in letters of credit in lieu of rent deposits.

Under some of our fixed-price contracts, we receive advance payments for work to be performed in future months. If we do not perform the work, the unearned portion of these advances will be returned to our clients. At December 31, 2003, our accounts receivable turnover rate, net of advance payments on contracts, was approximately four times a year.

The following summarizes our obligations associated with leases and other commitments at December 31, 2003, and the effect such obligations are expected to have on our liquidity and cash flow in future periods:

	Total	Less Than One Year	One to Three Years	Three to Five Years	More Than Five Years
Operating leases	$ 75,083,400	$7,127,779	$13,913,387	$11,966,401	$42,075,833
Capital leases	47,674,818	2,470,751	5,203,957	5,574,609	34,425,501
Total	$122,758,218	$9,598,530	$19,117,344	$17,541,010	$76,501,334

Recent Accounting Pronouncements

In November 2002, the FASB's Emerging Issues Task Force, or EITF, finalized EITF Issue 00-21, *Revenue Arrangements with Multiple Deliverables*. EITF 00-21 addresses how to determine whether an arrangement involving multiple deliverables contains more than one unit of accounting. It also addresses how arrangement consideration should be measured and allocated to the separate units of accounting in an arrangement. EITF 00-21 does not apply to deliverables in arrangements to the extent the accounting for such deliverables are within the scope of other existing higher-level authoritative accounting literature. We adopted the provisions of EITF 00-21 for new contracts entered into on or after July 1, 2003 with no material impact on our financial position, results of operations or cash flows, nor would there have been a material impact on prior years. On December 17, 2003, the Securities and Exchange Commission issued Staff Accounting Bulletin No. 104 ("SAB 104"), *Revenue Recognition*, which supercedes SAB 101, *Revenue Recognition in Financial Statements*. SAB 104's primary purpose is to rescind accounting guidance contained in SAB 101 related to multiple revenue arrangements, superceded as a result of the issuance of EITF 00-21, *Accounting for Revenue Arrangements with Multiple Deliverables*. As we had already adopted EITF 00-21, the change has no effect on our financial position.

In November 2002, FASB Interpretation No. 45, *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others, an Interpretation of FASB Statements No. 5, 57, and 107 and Rescission of FASB Interpretation No. 34*, (FIN 45) was issued. FIN 45 clarifies the requirements of SFAS No. 5, *Accounting for Contingencies*, relating to guarantors' accounting for, and disclosure of, the issuance of certain types of guarantees. The disclosure provisions of FIN 45 are applicable to interim or annual periods that end after December 15, 2002, and did not have an impact on the September 30, 2003 financial statements. The provisions for initial recognition and measurement under FIN 45 are effective on a prospective basis for guarantees that are issued or modified after December 31, 2002. The initial recognition and measurement provisions under FIN 45 did not have any impact on our financial statements.

On January 17, 2003, the Financial Accounting Standards Board ("FASB") issued FASB Interpretation No. 46, ("FIN 46"), *Consolidation of Variable Interest Entities*. The provisions will be the guidance that determines (1) whether consolidation is required under the "controlling financial interest" model of Accounting Research Bulletin No. 51 (ARB 51), *Consolidated Financial Statements* 51 (or other existing authoritative guidance) or, alternatively, (2) whether the variable interest model under FIN 46 should be used to account for existing and new entities. At this time, we do not have any entities that would be covered under FIN 46.

Item 7A. Quantitative and Qualitative Disclosures About Market Risk

We invest our cash in a variety of financial instruments, including U.S. Treasury and agency obligations, money market instruments of domestic and foreign issuers denominated in U.S. dollars of commercial paper, bankers' acceptances, certificates of deposit, euro-dollar time deposits and variable rate issues, corporate note and bonds, asset-backed securities, repurchase agreements, municipal notes and bonds and auction rate preferred securities.

Investments in both fixed and floating rate interest earning instruments carry a degree of risk. Fixed securities may have their fair market value adversely impacted because of a rise in interest rates, while floating rate securities may produce less income than expected if interest rates fall. Due in part to these factors, our Company's future investment income may fall short of expectations because of changes in interest rates or we may suffer losses in principal if forced to sell securities which have seen a decline in market value because of changes in interest rates. A 10% change in interest rates could have approximately a $150,000 impact on our interest income.

Our investments are made in accordance with an investment policy approved by the Board of Directors. Under this policy no investment securities can have maturities exceeding two years and the average duration of the portfolio cannot exceed 12 months.

Item 8. Financial Statements and Supplementary Data

The information required by Item 5 of Part II is incorporated herein by reference to the consolidated financial statements and financial statement schedules filed with this report: see Item 15 of Part IV.

Item 9. Changes in and Disagreements with Accountants on Accounting and Financial Disclosure

None.

Item 9A. Controls and Procedures

Our management under the direction and with the participation of David Karlgaard, our Chief Executive Officer, and Stuart Lloyd, our Chief Financial Officer, performed an evaluation of the design and operation of our disclosure controls and procedures (as defined in Rule 13a-15 under the Securities Exchange Act of 1934). Based on that evaluation, Messers. Karlgaard and Lloyd concluded that as of December 31, 2003, our disclosure controls and procedures are effective. There have been no significant changes in our internal control or in factors that could significantly affect internal controls subsequent to the date we carried out this evaluation.

PART III

Item 10. Directors and Executive Officers of the Registrant

The information required by this item will be included in our proxy statement for the annual meeting of stockholders to be held on May 19, 2004 (the "Proxy Statement") under the sections entitled "Election of Directors," "The Board of Directors and Committees," "Executive Officers," "Audit Committee Report," "Section 16(a) Beneficial Ownership Reporting Compliance," and "Code of Ethics," and is incorporated herein by reference. The Proxy Statement will be filed with the SEC no later than 120 days afer December 31, 2003.

Item 11. Executive Compensation

The information required by this item will be included in the Proxy Statement under the sections entitled "Executive Compensation," "Employment Arrangements" and "Compensation Committee Report" and is incorporated herein by reference.

Item 12. Security Ownership of Certain Beneficial Owners and Management

The information required by this item will be included in our Proxy Statement under the section entitled "Principal Stockholders" and is incorporated herein by reference.

Item 13. Certain Relationships and Related Transactions

The information required by this item will be included in our Proxy Statement under the section entitled "Certain Relationships and Related Transactions" and is incorporated herein by reference.

Item 14. Principal Accounting Fees and Services

The information required by this item will be included in our Proxy Statement under the section entitled "Principal Accounting Fees and Services" and is incorporated herein by reference.

PART IV

Item 15. Exhibits, Financial Statement Schedules, and Reports on Form 8-K

(a) Documents filed as part of the report:

All schedules except the one listed above have been omitted because they are not applicable or not required or because the required information is included elsewhere in the financial statements in this filing.

3. Exhibits

The following exhibits are filed or incorporated by reference, as state below:

Exhibit Number	Description
3.1*	Certificate of Incorporation of PEC Solutions, Inc.
3.2*	By-Laws
10.1*	Office Lease Agreement between Building IV Associates L.P. and PEC Solutions, Inc.
10.2*	Amendment No. 1 to Office Lease Agreement between Building IV Associates L.P. and PEC Solutions, Inc.
10.3*	Office Lease Agreement between Building V Associates L.P. and PEC Solutions, Inc.
10.4*	Employment Agreement between PEC Solutions, Inc. and David C. Karlgaard., dated January 1, 2000
10.4.1******	Key Executive Severance Plan between Registrant and David C. Karlgaard, dated July 23, 2003
10.5*	Employment Agreement between PEC Solutions, Inc. and Paul G. Rice, dated January 1, 2000
10.5.1******	Key Executive Severance Plan between Registrant and Paul G. Rice, dated July 23, 2003
10.6*	Employment Agreement between PEC Solutions, Inc. and Alan H. Harbitter, dated January 1, 2000
10.6.1******	Key Executive Severance Plan between Registrant and Alan H. Harbitter, dated July 23, 2003
10.7*	Employment Agreement between PEC Solutions, Inc. and Stuart R. Lloyd, dated December 31, 1998
10.7.1*******	Amendment to Employment Agreement between the Registrant and Stuart R. Lloyd, dated September 30, 2003
10.8*	2000 Stock Incentive Plan
10.9*	1995 Nonqualified Stock Option Plan
10.10*	1987 Stock Option Agreement, as amended
10.11*	Nonqualified Executive Supplemental Retirement Program Agreement dated December 1998
10.12*	2000 Employee Stock Option Plan
10.13*	Amended and Restated Loan Agreement between PEC Solutions, Inc. and NationsBank, N.A. (Bank of America)
10.14**	Amendment No. 2 to Office Lease Agreement between Building IV Associates L.P. and PEC Solutions, Inc.
10.15**	Amendment No. 3 to Office Lease Agreement between Building IV Associates L.P. and PEC Solutions, Inc.
10.16**	Office Lease Agreement between Building VI L.C. and PEC Solutions, Inc.
10.17***	First Amendment to Lease Agreement between Building VI L.C. and PEC Solutions, Inc.
10.18***	Second Amendment to Lease Agreement between Building VI L.C. and PEC Solutions, Inc.
10.19***	Operating Agreement between Building VI Investment L.C. and PEC Solutions, Inc.
10.20***	First Amendment to Operating Agreement between Building VI L.C. and PEC Solutions, Inc.
10.21***	Bank of America Financing and Security Agreement
10.22***	Bank of America Promissory Note
10.23***	Bank of America Revolving Note
10.24*****	Amendment to Bank of America Promissory Note

Exhibit Number	Description
10.25*****	Amendment to Bank of America Revolving Note
10.26******	Amended and Restated Bank of America Revolving Credit Note
10.27******	Amended and Restate Bank of America Financing and Security Agreement
10.28******	Key Executive Severance Plan between Registrant and Christos Bratiotis, dated July 23, 2003
10.29******	Key Executive Severance Plan between Registrant and John T. Forbus, dated July 23, 2003
10.30*******	Key Executive Severance Plan between Registrant and Charles E. Owlett, dated July 23, 2003
21.1****	Subsidiaries of PEC Solutions, Inc.
23.1	Consent of PricewaterhouseCoopers LLP
31.1	Section 302 Certification of Chief Executive Officer
31.2	Section 302 Certification of Chief Financial Officer
32.1	Section 906 Certification of Chief Executive Officer
32.2	Section 906 Certification of Chief Financial Officer

* Incorporated herein by reference to the Company's Registration Statement on Form S-1. No. 333-95331.

** Incorporated herein by reference to the Company's Annual Report on Form 10-K/A filed April 19, 2001.

*** Incorporated herein by reference to the Company's Quarterly Report on Form 10-Q for the quarter ended June 30, 2001, filed August 13, 2001.

**** Incorporated herein by reference to the Company's Annual Report on Form 10-K filed on March 29, 2002.

***** Incorporated herein by reference to the Company's Quarterly Report on Form 10-Q/A filed on May 14, 2003.

****** Incorporated herein by reference to the Company's Quarterly Report filed on Form 10-Q filed on August 14,2003.

******* Incorporated herein by reference to the Company's Quarterly Report filed on Form 10-Q filed on November 14, 2003.

(b) On October 27, 2003, we filed an Items 7, 9 and 12 current report on Form 8-K announcing our financial results for the quarter ended September 30, 2003.

(c) Exhibits

See (a) (3) above.

(d) Financial statement schedules and financial statements

See (a) (1) and (a) (2) above.

SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) 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.

PEC SOLUTIONS, INC.

By: /s/ DAVID C. KARLGAARD

David C. Karlgaard, Ph.D.,
President and Chief Executive Officer

Date: March 15, 2004

POWER OF ATTORNEY

KNOW ALL PERSONS BY THESE PRESENTS, each person whose signature appears below in so signing also makes, constitutes and appoints David C. Karlgaard and Nancy A. Spangler, and each of them acting alone, his true and lawful attorney-in-fact, with full power of substitution, for him in any and all capacities, to execute and cause to be filed with the Securities and Exchange Commission any and all amendments to this Report, with exhibits thereto and other documents in connection therewith, and hereby ratifies and confirms all that said attorney-in-fact or his substitute or substitutes may do or cause to be done by virtue hereof

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the registrant and in the capacities and on the date indicated.

Name	Title	Date
/s/ DAVID C. KARLGAARD David C. Karlgaard, Ph. D.	Chief Executive Officer, President and Chairman of the Board of Directors (Principal Executive Officer)	March 15, 2004
/s/ STUART R. LLOYD Stuart R. Lloyd	Senior Vice President and Chief Financial Officer and Director (Principal Financial and Accounting Officer)	March 15, 2004
/s/ PAUL G. RICE Paul G. Rice	Chief Operating Officer and Director	March 15, 2004
/s/ ALAN H. HARBITTER Alan H. Harbitter, Ph. D.	Chief Technology Officer and Director	March 15, 2004

Name	**Title**	**Date**
/s/ FRANK J. CARR Frank J. Carr	Director	March 15, 2004
/s/ R. JERRY GROSSMAN R. Jerry Grossman	Director	March 15, 2004
/s/ ZIMRI C. PUTNEY Zimri C. Putney	Director	March 15, 2004
/s/ JOHN W. MELCHNER John W. Melchner	Director	March 15, 2004
/s/ B. GARY DANDO B. Gary Dando	Director	March 15, 2004

Report of Independent Auditors

To the Board of Directors and Stockholders of
PEC Solutions, Inc.

In our opinion, the accompanying consolidated balance sheets and the related consolidated statements of income, of cash flows and of stockholders' equity and comprehensive income present fairly, in all material respects, the financial position of PEC Solutions, Inc. (the "Company") and subsidiaries as of December 31, 2002 and 2003, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2003, in conformity with accounting principles generally accepted in the United States of America. These financial statements are the responsibility of the Company's management; our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits of these statements in accordance with auditing standards generally accepted in the United States of America, which require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

/s/ PricewaterhouseCoopers LLP

February 10, 2004
McLean, VA

PEC SOLUTIONS, INC.
CONSOLIDATED BALANCE SHEETS

	As of December 31, 2002	As of December 31, 2003
ASSETS		
Current assets:		
Cash and cash equivalents	$ 21,176,200	$ 33,400,637
Short-term investments	35,551,418	38,273,957
Accounts receivable, net	52,973,589	48,355,689
Other current assets	3,451,936	1,745,317
Total current assets	113,153,143	121,775,600
Property and equipment, net	27,966,613	26,674,096
Investments	26,790,222	37,587,140
Goodwill	16,932,205	16,932,205
Intangibles, net	3,700,033	2,849,239
Other assets	3,748,373	4,553,091
Total assets	$192,290,589	$210,371,371
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable and accrued expenses	$ 8,415,251	$ 5,575,565
Advance payments on contracts	1,070,117	438,992
Accrued payroll	6,836,224	5,502,989
Accrued vacation	2,561,626	2,838,940
Other current liabilities	934,312	1,163,405
Total current liabilities	19,817,530	15,519,891
Supplemental retirement program liability	966,097	1,417,329
Deferred rent	1,340,793	1,789,630
Long-term lease obligations	22,822,447	23,062,240
Total long-term liabilities	25,129,337	26,269,199
Total liabilities	44,946,867	41,789,090
Commitments and contingencies		
Stockholders' equity:		
Undesignated capital stock, 10,000,000 shares authorized	—	—
Common stock, $0.01 par value, 75,000,000 shares authorized, 26,792,565 and 27, 303,041 shares issued and outstanding, respectively	267,925	273,030
Additional paid-in capital	91,071,248	95,218,903
Retained earnings	56,045,643	73,140,087
Accumulated other comprehensive income (loss)	(41,094)	(49,739)
Total stockholders' equity	147,343,722	168,582,281
Total liabilities and stockholders' equity	$192,290,589	$210,371,371

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

PEC SOLUTIONS, INC.
CONSOLIDATED STATEMENTS OF INCOME

	Year ended December 31,		
	2001	2002	2003
Revenues	$109,213,147	$182,184,922	$172,043,014
Operating costs and expenses:			
Direct costs	60,416,152	107,277,020	102,362,227
General and administrative expenses	24,387,296	33,888,208	35,546,407
Sales and marketing expenses	4,371,083	5,372,359	5,361,109
Goodwill and intangible amortization	776,973	768,948	850,794
Total operating costs and expenses	89,951,504	147,306,535	144,120,537
Operating income	19,261,643	34,878,387	27,922,477
Investment and other income	2,158,100	1,385,961	2,328,165
Interest expense	(4,160)	(226,867)	(2,654,398)
Income before income taxes	21,415,583	36,037,481	27,596,244
Provision for income taxes	8,348,472	13,783,916	10,355,467
Net income	$ 13,067,111	$ 22,253,565	$ 17,240,777
Earnings per share:			
Basic	$ 0.54	$ 0.84	$ 0.64
Diluted	$ 0.47	$ 0.75	$ 0.58

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

PEC SOLUTIONS, INC.
CONSOLIDATED STATEMENTS OF CASH FLOWS

	Year ended December 31, 2001	2002	2003
Cash flows from operating activities:			
Net income	$13,067,111	$22,253,565	$17,240,777
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation and amortization	1,077,602	1,675,287	2,800,266
Amortization of goodwill	720,954	—	—
Amortization of intangibles	56,019	768,948	850,794
Amortization of bond premium and discounts, net	72,598	(68,760)	227,258
Write-off of capitalized software	—	289,611	—
Deferred rent	464,527	417,414	448,837
Deferred income taxes	(26,222)	261,690	(84,967)
Bad debt expense	—	—	30,068
(Gain) loss from investment in building	—	85,423	(952,584)
Non-cash charge related to building	—	—	239,793
Other	6,265	1,877	14,527
Changes in operating assets and liabilities, excluding those acquired:			
Accounts receivable	(12,477,244)	(16,550,869)	4,587,833
Other current assets	(544,696)	1,267,198	1,836,509
Other assets	(178,954)	(777,155)	(428,264)
Accounts payable and accrued expenses	441,505	4,395,542	(2,839,686)
Advance payments on contracts	(483,903)	(219,470)	(631,126)
Retirement plan contribution payable	(1,937)	—	425
Accrued payroll	1,486,400	(181,913)	(1,333,234)
Accrued vacation	523,449	376,700	277,314
Other current liabilities	(763,894)	(1,688,103)	228,669
Supplemental retirement program liability	233,530	202,858	452,853
Other long-term liabilities	(13,702)	—	—
Net cash provided by operating activities	3,659,408	12,509,843	22,966,062
Cash flows from investing activities:			
Purchases of property and equipment	(1,600,368)	(2,869,847)	(1,289,591)
Purchases of short-term investments	(54,728,132)	(71,946,026)	(50,126,134)
Proceeds from sale of short-term investments	44,550,355	67,701,954	47,235,376
Investment in affiliate	(3,000,000)	(1,500,000)	—
Purchase of subsidiary, net of cash acquired	(13,403,772)	—	—
Purchase of assets	—	(5,866,842)	—
Capitalized software	(679,331)	(215,636)	(647,732)
Purchases of long-term investments	(19,809,738)	(13,739,214)	(19,864,221)
Proceeds from sale of long-term investments	9,129,120	2,069,013	9,043,105
Distributions from building investment	—	—	799,958
Other	3,000	25,909	96,149
Net cash used in investing activities	(39,538,866)	(26,340,689)	(14,753,090)
Cash flows from financing activities:			
Proceeds from the issuance of common stock	52,064,129	4,624,894	4,011,465
Payments on note payable and capital lease obligations	(7,743)	(53,613)	—
Common stock offering costs	(396,673)	—	—
Net cash provided by financing activities	51,659,713	4,571,281	4,011,465
Net increase (decrease) in cash	15,780,255	(9,259,565)	12,224,437
Cash and cash equivalents at beginning of period	14,655,510	30,435,765	21,176,200
Cash and cash equivalents at end of period	$30,435,765	$21,176,200	33,400,637
Income taxes paid	$ 7,375,475	$12,509,015	$ 7,863,524
Interest paid	$ 4,160	$ 226,867	$ 2,654,398
Non-cash transactions:			
Mature common stock repurchased and retired in exchange for shares in cashless exercise of stock options	$ 276,275	$ 877,523	$ 205,831

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

PEC SOLUTIONS, INC.
CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY AND COMPREHENSIVE INCOME

	Common Stock		Additional Paid-In Capital	Accumulated Other Comprehensive Income (Loss)	Retained Earnings	Total
	Shares	Par Value				
Balance, December 31, 2000	22,345,440	$223,454	$28,692,286	$ 6,345	$21,777,437	$ 50,699,522
Issuance of common stock in secondary stock offering, net of offering costs	3,000,000	30,000	47,913,327	—	—	47,943,327
Issuance of common stock in acquisition of Troy Systems, Inc	103,065	1,031	2,998,985	—	—	3,000,016
Issuance of common stock upon exercise of stock options, including tax benefit	551,244	5,512	3,116,457	—	—	3,121,969
Issuance of common stock through employee stock purchase plan	125,725	1,257	877,163	—	—	878,420
Common stock repurchased and retired	(15,825)	(158)	(16,330)	—	(259,787)	(276,275)
Comprehensive income:						
Net income	—	—	—	—	13,067,111	
Unrealized loss on securities, net of taxes	—	—	—	(6,560)	—	
Total comprehensive income						13,060,551
Balance, December 31, 2001	26,109,649	261,096	83,581,888	(215)	34,584,761	118,427,530
Issuance of common stock upon exercise of stock options, including tax benefit	566,163	5,662	4,858,785	—	—	4,864,447
Issuance of common stock through employee stock purchase plan	143,431	1,434	2,715,148	—	—	2,716,582
Common stock repurchased and retired	(26,678)	(267)	(84,573)	—	(792,683)	(877,523)
Comprehensive income:						
Net income	—	—	—	—	22,253,565	
Unrealized loss on securities, net of taxes	—	—	—	(40,879)	—	
Total comprehensive income						22,212,686
Balance, December 31, 2002	26,792,565	267,925	91,071,248	(41,094)	56,045,643	147,343,722
Issuance of common stock upon exercise of stock options, including tax benefit	379,248	3,793	2,289,564	—	—	2,293,357
Issuance of common stock through employee stock purchase plan	140,714	1,407	1,917,459	—	—	1,918,866
Common stock repurchased and retired	(9,486)	(95)	(59,368)	—	(146,333)	(205,796)
Comprehensive income:						
Net income	—	—	—	—	17,240,777	
Unrealized loss on securities, net of taxes	—	—	—	(8,645)	—	
Total comprehensive income						17,232,132
Balance, December 31, 2003	27,303,041	$273,030	$95,218,903	$(49,739)	$73,140,087	$168,582,281

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

PEC SOLUTIONS, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

1. Summary of Significant Accounting Principles

Company

Performance Engineering Corporation ("PEC") was incorporated June 25, 1985, under the laws of the Commonwealth of Virginia. On January 1, 2000, PEC was reincorporated, under the laws of the state of Delaware, as PEC Solutions, Inc. ("Company"). The Company provides professional technology services that enable government entities to use the Internet to enhance productivity and improve services to the public.

The Company's primary customers are executive agencies and departments of the federal government, the federal Judiciary, and prime contractors to the United States government. Two of these customers accounted for 20% of the Company's revenue during 2003. For 2001, the Company's contracts and subcontracts were time and materials contracts (71%), fixed-price contracts (13%), and cost reimbursable contracts (16%). For 2002, these contracts and subcontracts were time and materials contracts (62%), fixed-priced contracts (21%), and cost-reimbursable contracts (17%). For 2003, these contracts and subcontracts were time and materials contracts (58%), fixed-priced contracts (24%), and cost-reimbursable contracts (18%).

Principles of Consolidation

The consolidated financial statements include all majority-owned or controlled subsidiaries. All significant intercompany balances and transactions have been eliminated. The financial statements prior to 2002 consolidated the Company's wholly owned subsidiaries Troy Systems, Inc. and Viking Technology, Inc. which were dissolved at the end of 2001 and their operations were combined with other operations of the Company.

Revenue Recognition

The Company's revenue is derived primarily from contracts with the federal government. Revenues on time and materials contracts are recognized based on actual hours delivered at the contracted billable hourly rate plus the cost of materials incurred. Revenues on fixed-price contracts are recognized using the percentage-of-completion method based on costs incurred in relation to total estimated costs. However, if the contract has a service element, revenues are recognized on a straight-line basis over the term of the contract. Revenue on cost-type contracts is recognized to the extent of costs incurred plus a proportionate amount of fee earned.

In certain arrangements, we enter into contracts that include the delivery of a combination of two or more of our service offerings. Typically, such multiple-element arrangements incorporate the design, development or modification of systems and an ongoing obligation to manage, staff, maintain, host or otherwise run solutions and systems provided to the client. Such contracts are divided into separate units of accounting and the total arrangement fee is allocated to each unit based on its relative fair value. Revenue is recognized separately, and in accordance with our revenue recognition policy, for each element.

In certain circumstances, revenues are recognized when contract amendments have not been finalized. Prior to agreeing to commence work directed by the customer and before receipt of the written modification or amendment to the existing contract, the Company requires the completion of an internal memo that assesses the probability of the modification being executed in a timely fashion and the Company's ability to subsequently collect payment from the customer.

The fees under certain government contracts may be increased or decreased in accordance with cost or performance incentive provisions that measure actual performance against established targets or other criteria. Such incentive fee awards or penalties are included in revenue at the time the amounts can be reasonably determined. In certain circumstances, revenues are recognized when contract amendments have not been finalized. Provisions for anticipated contract losses are recognized at the time they become known.

Cash and Cash Equivalents

Cash and cash equivalents include cash on hand and in banks. The Company also considers all highly liquid investments with a maturity of three months or less when purchased to be cash equivalents. As of December 31, 2002 and 2003, cash equivalents included money market funds of approximately $4,633,903 and $13,530,203, respectively, and commercial paper, United States Treasury bills and municipal bonds of approximately $0 and $5,700,000 respectively.

Concentration of Credit Risk

At times during the year, the Company maintains cash balances at financial institutions in excess of Federal Deposit Insurance Corporation ("FDIC") limits. Management believes the risk in these situations to be minimal. In addition, the Company had cash balances of $4,633,903 and $13,530,203 held in money market funds at local financial institutions as of December 31, 2002 and 2003, respectively. The Company also held commercial paper, United States Treasury bills and municipal bonds in the amount of $57,887,857 and $90,523,889 as of December 31, 2002 and 2003, respectively. These funds are not insured by the FDIC.

Marketable Securities

The Company determines the appropriate classification of marketable securities at the time of purchase and reevaluates such designation as of each balance sheet date. The Company's marketable securities are categorized as available-for-sale and stated at fair value, with unrealized gains and losses, net of tax, recorded in accumulated other comprehensive income. Realized gains and losses and declines in values determined to be other than temporary, if any, will be reported in other income or expense as incurred.

Property and Equipment

Property, plant and equipment are stated at cost. Major improvements are capitalized while expenditures for maintenance, repairs and minor improvements are charged to expense. When assets are retired or otherwise disposed of, the assets and related accumulated depreciation and amortization are eliminated from the accounts and any resulting gain or loss is reflected in income. Depreciation expense is determined using the straight-line method based on the following useful lives:

Buildings	40 years
Non-structural land improvements	15 years
Property and equipment	3 to 5 years
Leasehold improvements	Shorter of estimated useful life or lease term

Emerging Issues Task Force (EITF) Issue No. 97-10, *The Effect of Lessee Involvement in Asset Construction*, is applicable to entities involved on behalf of an owner-lessor with the construction of an asset that will be leased when construction of the asset is completed. EITF Issue 97-10 requires the Company to be considered the owner (for accounting purposes) of these types of projects during the construction period. Due to the fact that the Company was considered the owner of the building during the construction period, then effectively a sale and leaseback of the building occurred when construction was completed and the lease term began. As a result of the Company's continued involvement in the LLC, the Company fails the sale-leaseback criteria of FAS 98, *Accounting for Leases,* and the building, and offsetting long-term lease obligation, must remain on the books. The building and lease obligation are being amortized to fair value at the end of the lease term, such that if the lease is not extended there will be no gain or loss upon lease termination.

Long-lived Assets

The Company evaluates the recoverability of its long-lived assets in accordance with Statement of Financial Accounting Standards No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets.* Based on its most recent analysis, the Company believes that there was no impairment of its long-lived assets as of December 31, 2003.

Goodwill and Intangibles

In June 2001, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards (SFAS) No. 142, *Goodwill and Other Intangible Assets*. Under SFAS No. 142, goodwill and intangible assets with indefinite lives will no longer be amortized but are reviewed annually (or more frequently if impairment indicators arise) for impairment. Separable intangible assets that are not deemed to have indefinite lives will continue to be amortized over their useful lives but with no maximum life. The Company adopted the provisions of SFAS No. 142 effective January 1, 2002, and upon adoption ceased to amortize goodwill. The Company completed the transitional and annual goodwill impairment test in accordance with the provisions of SFAS 142, and concluded that goodwill was not impaired.

Software Research and Development Costs

The Company capitalizes research and development costs for marketable software incurred from the time the product is determined to be technologically feasible until it is available for sale. It has also acquired marketable software, which it has capitalized. Acquired software and software development costs are amortized and recorded as direct costs using the straight-line method over a period not to exceed three years. As of December 31, 2003, $2,439,714 was capitalized with an accumulated amortization balance of $1,271,129 and is included in other assets. Amortization expense of $212,441, $363,945, and $328,835 was recorded during 2001, 2002 and 2003 respectively.

Contract Advance Payments

The Company invoices the federal government for some of its contracts based on provisional indirect cost rates. These invoiced amounts are adjusted when the actual rates have been determined by audit. Other Federal government contracts are billed periodically independent of the percentage of the contract actually completed which, in some situations, results in funds being advanced to the Company in excess of amounts earned.

Common Stock Splits

Effective January 1, 2000, in connection with its re-incorporation, the Company's common stock was split 3-for-1. Effective March 1, 2000, the Company's common stock was split 2-for-1. All prior share and per share information in the financial statements have been restated to give effect to these stock splits.

Stock-based Compensation

In December 2002, the FASB issued SFAS No. 148, *Accounting for Stock-Based Compensation—Transition and Disclosure, an amendment of FASB Statement No. 123.* SFAS No. 148 provides alternative methods of transition for a voluntary change to the fair market value based method of accounting for stock-based compensation. The Company does not presently expect to make such a voluntary change. In addition, SFAS No. 148 amends the disclosure requirements of SFAS No. 123 to require prominent disclosures in both annual and interim financial statements about the method of accounting for stock-based employee compensation and the effect of the method used on reported results. These amended disclosure requirements have been included below.

The Company uses the Black-Scholes option-pricing model to determine the pro forma impact under SFAS No. 123 to the Company's net income and earnings per share. The model utilizes certain information, such as the interest rate on a risk-free security maturing generally at the same time as the option being valued, and requires certain assumptions, such as the expected amount of time an option will be outstanding until it is exercised or it expires, to calculate the fair value of stock options granted.

This information and the assumptions used for 2003, 2002 and 2001 for the Company's stock option and stock purchase plans are summarized as follows:

	Stock Option Plan			Stock Purchase Plan		
	2001	2002	2003	2001	2002	2003
Volatility	57.31%	48.84%	44.84%	57.31%	48.84%	44.84%
Risk-free interest rate	5.07%	3.83%	4.27%	1.83%	1.23%	1.02%
Dividend yield	0%	0%	0%	0%	0%	0%
Expected lives	10 years	10 years	10 years	0.5 years	0.5 years	0.5 years
Weighted average fair value per share at grant date	$ 3.80	$ 14.46	$ 13.05	$ 1.82	$ 2.82	$ 1.80

The Company continues to apply the provisions of APB 25 and provide the pro forma disclosures in accordance with the provisions of FAS Nos. 123 and 148. Under APB 25, the Company has not recorded in net income any stock-based employee compensation cost associated with the Company's stock option plan, as all options granted under the plan had an exercise price equal to the market value of the underlying common stock on the date of grant.

The following table illustrates the effect on net income and earnings per share if the Company had applied the fair value recognition provisions of SFAS No. 123 to its stock option plan:

	Years Ended December 31,		
	2001	2002	2003
Net income, as reported	$13,067,111	$22,253,565	$17,240,777
Pro forma compensation expense, net of tax	(1,031,607)	(2,970,848)	(4,732,105)
Pro forma net income	$12,035,504	$19,282,717	$12,508,672
Net income per share:			
Basic—as reported	$ 0.54	$ 0.84	$ 0.64
Basic—pro forma	$ 0.50	$ 0.73	$ 0.46
Diluted—as reported	$ 0.47	$ 0.75	$ 0.58
Diluted—pro forma	$ 0.43	$ 0.65	$ 0.42

Income Taxes

The Company accounts for deferred income taxes using the asset and liability method, under which the expected future tax consequences of differences between the book and tax bases of assets and liabilities are recognized as deferred tax assets and liabilities.

Use of Estimates

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect certain reported amounts and disclosures. Such estimates include reserves for doubtful accounts, valuation allowance for deferred taxes, estimates to complete for contracts, and certain accrued expenses. Accordingly, actual results could differ from those estimates.

Segment Reporting

The Company operates as a single segment and will evaluate additional disclosure requirements as it expands its operations.

Reclassifications

Certain reclassifications have been made to the prior-period financial statements in order to conform to the 2003 presentation.

2. Acquisitions

On November 20, 2001, the Company acquired all of the outstanding common shares of Troy Systems, Inc. (Troy). The results of Troy's operations have been included in the consolidated financial statements since that date. Effective January 1, 2002, Troy was fully integrated into the Company and ceased to exist as a wholly owned subsidiary. Troy derives revenue from system development, networking, engineering, integration services, and information systems security and its primary customer is the federal government. The aggregate purchase price was $18.6 million, including acquisition costs of $0.3 million, consisting of $15.3 million of cash and common stock valued at $3.0 million (103,065 shares). The number of shares was determined using the average closing price of the stock for the five trading days immediately prior to the acquisition.

The following table summarizes the estimated fair values of the assets acquired and liabilities assumed at the date of acquisition. Third party valuations were obtained in determining the allocation of the purchase price for certain intangible assets.

	At November 20, 2001
Current assets, including cash of $1,446,775	$ 9,602,232
Property and equipment	333,538
Intangible assets	3,025,000
Goodwill	9,921,799
Other assets	1,096,513
Total assets acquired	23,979,082
Current liabilities	(4,297,364)
Long-term liabilities, including capital leases	(1,087,965)
Total liabilities assumed	(5,385,329)
Net assets acquired	$18,593,753

The $3.0 million of acquired intangible assets was assigned to customer contracts and related relationships with a weighted-average useful life of 4.5 years. The transaction resulted in $9.9 million of goodwill, all of which is deductible for tax purposes.

Unaudited pro forma results of operations as if the acquisition has occurred at the beginning of each period presented are as follows:

	Year ended December 31, 2001 (in thousands except per share)
Total revenue	$138,524
Net income	$ 13,000
Basic earnings per share	$ 0.54
Diluted earnings per share	$ 0.46

The pro forma consolidated results of operations include adjustments to give effect to amortization of goodwill and other adjustments, together with related income tax effects. The unaudited pro forma information is not necessarily indicative of the results of operations that would have occurred had the purchase been made at the beginning of the periods presented or the future results of the combined operations.

On June 14, 2002, the Company acquired the contracts and employees of Vector Research Inc., ("Vector") for $5.7 million cash plus the assumption of $0.1 million in accrued liabilities. The excess of purchase price over fair value of the nest assets was approximately $4.3 million. Vector was fully integrated into the Company and its results are incorporated in the Company's financial statements. Vector was a provider of technology development and engineering services to the federal government. The aggregate purchase price was $5.8 million. Pro forma results of operations of the Company would not have been materially different assuming the acquisition of Vector occurred on January 1, 2001.

3. Goodwill and Intangibles

Prior to January 1, 2002, the Company amortized goodwill related to the Viking purchase on a straight-line basis over its estimated useful life of 5 years. Goodwill at December 31, 2001 was net of accumulated amortization of $961,296. The Company also recognized goodwill pursuant to its acquisitions of Troy in November 2001 and Vector in June 2002. These acquisitions have been accounted for as purchases pursuant to the guidance Statement of Financial Accounting Standards No. 141 (FAS 141), *Business Combinations*. Therefore, goodwill of $9.9 million and $4.3 million, respectively, are not being amortized.

The changes in the carrying amount of goodwill for the year ended December 31, 2002 is as follows (in millions):

Balance as of December 31, 2001	$12.6
Goodwill acquired during the year	4.3
Balance as of December 31, 2002 and 2003	$16.9

Upon the adoption of FAS 142, the Company discontinued the amortization of goodwill. The following table presents a reconciliation of net income and earnings per share adjusted for the exclusion of goodwill:

	Years Ended December 31, 2001 (dollars in thousands, except per share)
Reported net income	$13,067
Add: Goodwill amortization, net of tax	440
Adjusted net income	$13,507
Reported basic earnings per share	$ 0.54
Add: Goodwill amortization, net of tax	0.02
Adjusted basic earnings per share	$ 0.56
Reported diluted earnings per share	$ 0.47
Add: Goodwill amortization, net of tax	0.02
Adjusted diluted earnings per share	$ 0.49

The Company only has one reporting unit. Non-amortizable intangible assets at December 31, 2003, consist only of goodwill of $16,932,205. The Company's amortizable intangible assets include customer contracts and related relationships purchased in the acquisition of Troy on November 20, 2001 and Vector on June 14, 2002. The intangibles related to the Troy acquisition totaled $3,025,000 and are amortized on a straight-line basis over a 4.5-year period. The intangibles on the Vector purchase totaled $1,500,000 and are being amortized on a straight-line basis over an 8.4 year period. Total accumulated amortization as of December 31, 2002 and 2003 was $824,967 and $1,675,761, respectively.

Amortization expense related to intangibles was $56,019, $768,948 and $850,794 for the years ended December 31, 2001, 2002 and 2003, respectively. Intangibles are amortized on a straight-line basis.

Estimated amortization expense for each of the five succeeding calendar years based on the intangible assets as of December 31, 2003 is as follows in thousands:

Year ending December 31,	Amount
2004	$851
2005	851
2006	458
2007	179
2008	179

4. Accounts Receivable

Accounts receivable consisted of the following as of:

	December 31, 2002	December 31, 2003
Billed accounts receivable	$45,411,428	$32,099,688
Unbilled accounts receivable:		
Amounts currently billable	5,855,777	12,033,614
Revenues recorded in excess of contract value or funding	3,098,543	4,775,812
Progress payments	(1,070,117)	(438,992)
	53,295,631	48,470,122
Allowance for doubtful accounts	(322,042)	(114,433)
Accounts receivable, net	$52,973,589	$48,355,689

Unbilled accounts receivable currently billable consist of recognized recoverable costs and accrued profits on contracts for which billings had not been presented to clients as of the balance sheet date. Revenues recorded in excess of contract value or funding are billable upon receipt of contractual amendments. Management anticipates the collection of these amounts within 90 days of the balance sheet date. Payments to the Company on contracts with agencies and departments of the Federal government are subject to adjustment upon audit by the Federal government. All years subsequent to 2000 are subject to audit. Management believes that audit adjustments, if any, on periods not yet audited, will not have a material effect on the financial statements.

During 2002 the Company had two customers that each accounted for more than 10% of revenue. For the year, EDS (Navy Marine Corps Intranet) accounted for 16%, or $29.3 million, and our biometric identification system through a subcontract with NCS Pearson, Inc. (Pearson) accounted for 13%, or $23.7 million. At December 31, 2002, there was $3.5 million due from EDS and $15.6 million due from Pearson. Subsequent to December 31, 2002 we received a payment of approximately $10 million of the $15.6 million Pearson accounts receivable. The Company filed a lawsuit in Federal Court against Pearson in September 2003 to recover full payment on this receivable and expects to receive full payment.

During 2003 the Company had one customer who accounted for more than 10% of revenue. For the year ended December 31, 2003, revenue from the Special Projects Division of the Drug Enforcement Agency was $17.6 million, and as of December 31, 2003, accounts receivable were $4.0 million.

The allowance for doubtful accounts reflects management's best estimate of probable losses based on historical experience, known troubled accounts and other currently available information. Allowances are established for specific receivables when deemed appropriate.

5. Property and Equipment

Property and equipment consisted of the following as of:

	December 31, 2002	December 31, 2003
Leasehold improvements	$ 937,273	$ 1,164,225
Property and equipment	6,922,691	6,713,033
Software	933,971	894,678
Building	23,001,600	23,001,600
	31,795,535	31,773,536
Less: accumulated depreciation	(3,828,922)	(5,099,439)
	$27,966,613	$26,674,097

Depreciation expense was $865,158, $1,288,042 and $2,469,768 for the years ended December 31, 2001, 2002 and 2003, respectively.

6. Investments

The Company has an ownership interest in an unconsolidated and affiliated company that owns an office building that the Company leases. The Company's net investments in and advances to this entity totaled $4.4 million and $4.6 million at December 31, 2002 and 2003, respectively, which is included in Investments on the Consolidated Balance Sheet. Summarized financial information for this entity as of December 31, was as follows (in thousands):

	2002	2003
Current assets	$ 1,244	$ 472
Non-current assets	29,431	29,111
Current liabilities	717	218
Non-current liabilities	20,500	20,287
Gross revenue	275	3,320
Net gain (loss)	(178)	1,959

The Company has applied equity accounting to its interest in the LLC. The accounting records of the LLC are consistent with the accounting of the Company. The Company recorded equity losses of approximately $85,000 for the year ended December 31, 2002, and equity gains of approximately $853,000 for the year ended December 31, 2003, which are included in investment and other income.

The Company also invests in marketable securities classified as available for sale. As of December 31, 2003, the aggregate fair market value of those securities was $78.9 million. As of December 31, 2003, unrealized gains and losses included in other comprehensive loss were $13,662 and $77,084, respectively. Proceeds from sales of securities during 2003 were $81.1 million with realized gains of $15,032. The Company recognizes gains and losses on the sale of securities using the specific identity method of accounting.

7. Line of Credit

The Company has a loan agreement with Bank of America which provides for a line of credit with a limit of $10,000,000 at the one-month LIBOR rate plus 250 basis points per annum (3.9% and 3.6% as of December 31, 2002 and 2003, respectively). The line is collateralized by the assets of the Company. As of December 31, 2002 and 2003, there were no balances outstanding. The bank has issued Letters of Credit in the amount of $2,782,009 against the line of credit in lieu of rent deposits as of December 31, 2003. The agreement expires June 30, 2005.

8. Other current liabilities

Other liabilities consisted of the following:

	December 31,	
	2002	**2003**
Employee stock purchase plan	$ 8,430	$ 9,883
Amounts due related to Vector acquisition	164,070	—
Employee benefits payable	133,378	64,424
Payroll taxes payable	628,434	520,462
Income taxes payable	—	568,636
	$934,312	$1,163,405

9. Stock Option Plans

On February 1, 1987, the Company established an incentive stock option agreement (the "Agreement"), to attract, retain and reward employees and on January 1, 1995 the Company established a nonqualified stock option plan (the "Plan", collectively, the "Plans") to attract, retain and reward key employees. The Plans are administered by the Board of Directors, which has the authority to determine which officers and key employees are awarded options pursuant to the Plans and the related terms and option prices. The number of options available for grant under the Plans is limited to the number of Company common shares authorized and available.

Each stock option granted pursuant to the Plans has an exercise price equal to the fair market value of the underlying common stock at the date of grant. Each stock option granted under the Agreement has a five-year term and a two-year vesting period. Each stock option granted pursuant to the Plan has a ten-year term and no vesting period.

In January 2000, the Company established a stock plan (the "2000 Plan"), which includes both incentive and non-qualified stock options. Under the 2000 Plan, options to purchase 1,500,000 shares of common stock were initially available. Beginning in 2001, the number of options eligible for grant in each year are equal to the sum of 6.25% of the number of outstanding shares on January 1 of that year, plus the number of shares eligible for grant in the prior year that were not granted. No more than 15,000,000 options may be granted during the 10-year term of the 2000 Plan. Each stock option granted pursuant to the 2000 Plan has a ten-year term and a two-year vesting period for incentive options and various vesting periods for non-qualified options ranging from immediate vesting to vesting in four years.

In January 2000, the Company established an employee stock purchase plan (the "Purchase Plan"). Under the Purchase Plan, employees, through payroll deductions, are granted options to purchase shares of common stock at a price no less than 85% of the fair market value of the common stock on the first or last trading day of each six month option period or the date the shares of common stock are purchased. There initially were 2,000,000 shares of common stock available for purchase under the Purchase Plan. There currently are 1,590,130 shares of common stock available for purchase under the Purchase Plan. On June 30, 2003, a total of 77,771 shares were issued under the plan at a prices ranging from $10.22 to $13.69 per share. On December 31, 2003, a total of 62,943 shares were issued under the plan at prices ranging from $12.64 to $13.67 per share.

The following table summarizes the Company's activity for all of its stock option awards granted under the Plans and the 2000 Plan:

	Number of Options	Range of Exercise Price	Weighted Average Exercise Price
Balance, December 31, 2000	4,575,855	$0.63-12.00	$ 2.87
Granted	359,653	7.50-22.10	8.23
Exercised	(551,089)	0.78- 7.50	2.34
Canceled	(38,838)	1.10-12.00	8.22
Balance, December 31, 2001	4,345,581	0.63-22.10	3.34
Granted	1,126,729	18.01-37.61	20.92
Exercised	(566,163)	1.68-37.61	4.93
Canceled	(60,836)	1.68-37.61	23.36
Balance, December 31, 2002	4,845,311	0.63-37.61	6.99
Granted	512,859	14.46-29.90	20.58
Exercised	(379,248)	2.04-29.90	5.23
Canceled	(193,785)	8.13-37.61	21.61
Balance, December 31, 2003	4,785,137	$0.63-37.61	$ 7.99

The following table summarizes additional information about stock options outstanding as of December 31, 2003:

	Options Outstanding			Options Exercisable	
Range of Exercise Prices	Number of Options	Weighted-Average Remaining Contractual Life (years)	Weighted-Average Exercise Price	Number Exercisable	Weighted-Average Exercise Price
$0.63 to $0.86	450,246	1.88	$ 0.83	450,246	$0.83
$1.21	951,564	3.00	1.21	951,564	1.21
$1.85 to $3.12	1,484,262	4.47	2.56	1,484,262	2.56
$6.94 to $12.00	481,701	6.62	8.59	456,701	8.68
$14.46 to $20.05	1,127,479	8.80	17.29	10,000	20.05
$21.97 to $37.61	289,885	8.62	32.00	43,306	31.14
	4,785,137	5.42	$ 7.99	3,396,079	$3.19

10. Basic Earnings Per Share and Diluted Earnings Per Share

Basic net income per common share is computed on the basis of the weighted-average number of common shares outstanding for the periods. Diluted net income per common share includes the weighted-average effect of dilutive options outstanding during the periods. The weighted average number of shares issuable upon the exercise of outstanding stock options assumes that the applicable proceeds from such exercises are used to acquire treasury shares at the average price of common stock during the periods.

Basic and diluted earnings per share for 2001, 2002, and 2003, were determined as follows:

	Year Ended December 31, 2001		
	Net Income	Shares	Per Share
Basic EPS	$13,067,111	24,257,564	$0.54
Effect of dilutive options	—	3,724,486	(0.07)
Diluted EPS	$13,067,111	27,982,050	$0.47

	Year Ended December 31, 2002		
	Net Income	Shares	Per Share
Basic EPS	$22,253,565	26,381,131	$0.84
Effect of dilutive options	—	3,113,089	(0.09)
Diluted EPS	$22,253,565	29,494,220	$0.75

	Year Ended December 31, 2003		
	Net Income	Shares	Per Share
Basic EPS	$17,240,777	27,085,532	$0.64
Effect of dilutive options	—	2,677,683	(0.06)
Diluted EPS	$17,240,777	29,763,215	$0.58

For the years ended December 31, 2002 and 2003, 138,316 and 1,160,043 shares, respectively, attributable to outstanding stock options were excluded from the calculation of diluted earnings per share because the effect was antidilutive. For 2001, shares were not antidilutive.

11. Employee Benefit Plan

During 1985, the Company established a qualified profit sharing plan in accordance with Section 401(k) of the Internal Revenue Service Code. Under the plan, the Company makes contributions out of profits of the Company based on an amount determined at the discretion of the Board of Directors. All employees, except interns and leased employees, are eligible to participate in the plan. Eligibility is restricted for new employees, who are not permitted to participate until the first day of the first calendar quarter following date of hire. The Company contributed $2.7 million, $4.1 million and $2.6 million for 2001, 2002 and 2003, respectively.

12. Supplemental Retirement Program

In December 1998, the Company adopted a funded Executive Supplemental Retirement Program for a select group of management or highly compensated employees. The program allows these employees to defer a portion of their salary and bonus. The Company has the option of adding additional amounts of deferred compensation at its sole discretion. The Company contributions are vested after five years. Employee deferrals were $87,045, $109,029 and $241,586 in 2001, 2002 and 2003, respectively. The Company contributed $146,639, $164,083 to the program in 2001and 2002. There were no Company contributions to the program in 2003.

13. Income Taxes

The provision for income taxes consisted of the following:

	Years Ended December 31, 2001	2002	2003
Current:			
Federal	$7,109,964	$11,167,206	$ 8,739,792
State	1,300,217	2,231,229	1,803,124
Total current	8,410,181	13,398,435	10,542,916
Deferred:			
Federal	(55,314)	344,882	(167,707)
State	(6,395)	40,599	(19,742)
Total deferred	(61,709)	385,481	(187,449)
Provision for income taxes	$8,348,472	$13,783,916	$10,355,467

Deferred tax assets were comprised of the following:

	Years Ended December 31, 2001	2002	2003
Deferred tax assets (liabilities):			
Accrued vacation	$ 566,659	$ 640,924	$ 738,074
Allowance for doubtful accounts	69,456	2,593	44,809
Property and equipment	(369,547)	(766,167)	(627,104)
Capital loss carryforward	8,021	7,948	—
Deferred rent	360,547	524,532	700,771
Net operating loss carryforward from acquired company (expiring beginning in 2012)	857,607	755,112	655,175
Deferred compensation	253,414	370,085	547,274
Investment in building partnership	—	(186,794)	(513,842)
Other	—	12,441	2,965
Total deferred tax assets, net	$1,746,157	$1,360,674	$1,548,122

A reconciliation between the Company's statutory tax rate and the effective tax rate is as follows:

	Years Ended December 31, 2001	2002	2003
Statutory federal rate	35%	35%	35%
State income taxes, net of federal benefits	4%	4%	4%
Federal tax-exempt interest income	—	(1%)	(1%)
Effective tax rate	39%	38%	38%

14. Commitments and Contingencies

During 2001, the Company negotiated an equity position in a limited liability company (the "LLC") that constructed a build-to-suit office building. The Company has contributed cash of $4,500,000 to the LLC and has a 48% ownership interest in the LLC. The Company also entered into a sixteen-year lease agreement for the building that began on December 1, 2002 and is the primary occupant.

Due to the equity involvement in LLC, the Company was considered to be the owner (for accounting purposes) of the property during the construction period in accordance with Emerging Issues Task Force (EITF) Issue No. 97-10, *The Effect of Lessee Involvement in Asset Construction*. This is the case even though the Company is not obligated to guarantee the non-recourse mortgage obligation, nor was it involved in the management of the LLC. Accordingly, through December 1, 2002, the Company recorded total construction costs of $23.0 million with an offsetting long-term lease obligation. Due to the fact that the Company was considered the owner of the building during the construction period, then effectively a sale and leaseback of the building occurs when construction was complete and the lease term began. As a result of the Company's continued involvement in the LLC, the Company is unable to use sale-leaseback accounting under FAS 98, *Accounting for Leases,* and the building, and offsetting long-term lease obligation, must remain on the Company's financial records.

EITF 97-10 specifically excludes land acquisition costs from total project costs; therefore, the value of the land was not recorded on the Company's accounting records during the construction phase. Therefore, for consistency, the land is also excluded from the failed sales-leaseback and will require that the lease payments be bifurcated between the land and the building. The land portion of the rent is treated as an operating lease. The lease payments were allocated between the land and building based upon their relative fair values. The fair value of the land was determined through a third party appraisal and the fair value of the building was determined based upon total construction costs. The building portion of the lease payment is recast as interest and principal payments on the lease obligation. The building and lease obligation are being amortized to fair value at the end of the lease term, such that if the lease is not extended there will be no gain or loss upon lease termination.

The future minimum lease payments under operating leases includes the land portion of the rent associated with the building, while the remaining balance of the lease payments, and the associated interest, have been included in the capital lease payment table. For purposes of the capital lease payments, payments through December 31, 2018 have been included, at which time the depreciated value of the building and the remaining long-term lease obligation will be equivalent.

The Company leases office facilities and equipment under non-cancelable capital lease agreements, which expire in various years through 2018. The economic substance of such transactions is that the Company is acquiring assets using lease financing. The future minimum lease payments under capital leases as of December 31, 2003, are as follows:

Years Ended December 31,	
2004	$ 2,470,751
2005	2,557,227
2006	2,646,730
2007	2,739,365
2008	2,835,244
Thereafter through December 31, 2018	34,425,501
Total minimum lease payments	47,674,818
Less: amount representing interest	(35,887,235)
Present value of net minimum lease payments	11,787,583
Less: current portion	—
Residual value	11,274,657
Long-term portion	$ 23,062,240

At December 31, 2003, building, leasehold improvements and equipment under capital leases of $23,001,600, net of accumulated depreciation of $1,101,931, is included with property and equipment.

The Company leases office facilities and equipment under non-cancelable operating agreements, which expire in various years through 2018. Future minimum lease payments under operating leases that have non-cancelable lease terms in excess of one year as of December 31, 2003 are as follows:

Years Ended December 31,	
2004	$ 7,127,779
2005	6,980,362
2006	6,933,025
2007	6,015,938
2008	5,950,463
Thereafter	42,075,833
	$75,083,400

The total rental expense under operating leases was $5,615,636, $7,389,678 and $7,482,054 for the years ended December 31, 2001, 2002 and 2003, respectively.

During 2001 and 2002, the Company subleased space in one of its facilities. Sublease rental income was $315,658 and $324,736 for the years ended December 31, 2001 and 2002, respectively. The Company had no sublease income for 2003.

In the ordinary course of business, the Company may be party to various legal proceedings. In the opinion of management, the Company's liability, if any, in all pending litigation or other legal proceedings will not have a material effect upon the financial condition, results of operations or liquidity of the Company.

On and after March 18, 2003, several purported class action complaints were filed against the Company and certain of its officers in the United States District Court for the Eastern District of Virginia. The complaints allege that between October 22, 2002 and March 14, 2003, the defendants made, or were aware of, false and misleading statements which had the effect of inflating the market price of our stock, in violation of Sections 10(b) and 20(a) of the Securities Exchange Act of 1934. The complaints were consolidated into a single action on June 13, 2003. The complaint was dismissed by the Court on January 28, 2004. Plaintiffs have filed notice of appeal. In addition, a stockholder's legal counsel sent a letter of demand that the Board of Directors investigate the same charges addressed in the class action suit. The Board concluded after its investigation and based on its business judgement to reject the demand letter.

On September 11, 2003, the Company instituted a lawsuit in the United States District Court of Minnesota against NCS Pearson, Inc. for improperly withholding the payment of funds owed to the Company under a subcontract. The Company is seeking recovery of $6.3 million in unpaid receivables plus interest and costs. The proceedings are moving according to schedule.

15. Recent Accounting Pronouncements

In November 2002, the FASB's Emerging Issues Task Force, or EITF, finalized EITF Issue 00-21, *Revenue Arrangements with Multiple Deliverables*. EITF 00-21 addresses how to determine whether an arrangement involving multiple deliverables contains more than one unit of accounting. It also addresses how arrangement consideration should be measured and allocated to the separate units of accounting in an arrangement. EITF 00-21 does not apply to deliverables in arrangements to the extent the accounting for such deliverables are within the scope of other existing higher-level authoritative accounting literature. The Company adopted the provisions of EITF 00-21 for new contracts entered into on or after July 1, 2003 with no material impact on its financial position, results of operations or cash flows, nor would there have been a material impact on prior years. On December 17, 2003, the Securities and Exchange Commission issued Staff Accounting Bulletin No. 104 ("SAB 104"), *Revenue*

Recognition, which supercedes SAB 101, *Revenue Recognition in Financial Statements*. SAB 104's primary purpose is to rescind accounting guidance contained in SAB 101 related to multiple revenue arrangements, superceded as a result of the issuance of EITF 00-21, *Accounting for Revenue Arrangements with Multiple Deliverables*. As the Company had already adopted EITF 00-21, the change has no effect on the Company's financial position.

In November 2002, FASB Interpretation No. 45, *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others, an Interpretation of FASB Statements No. 5, 57, and 107 and Rescission of FASB Interpretation No. 34*, (FIN 45) was issued. FIN 45 clarifies the requirements of SFAS No. 5, *Accounting for Contingencies*, relating to guarantors' accounting for, and disclosure of, the issuance of certain types of guarantees. The disclosure provisions of FIN 45 are applicable to interim or annual periods that ended after December 15, 2002, and did not have an impact on the September 30, 2003 financial statements. The provisions for initial recognition and measurement under FIN 45 are effective on a prospective basis for guarantees that are issued or modified after December 31, 2002. The initial recognition and measurement provisions under FIN 45 did not have any impact on the Company's financial statements.

On January 17, 2003, the Financial Accounting Standards Board ("FASB") issued FASB Interpretation No. 46, (FIN 46), *Consolidation of Variable Interest Entities*. The provisions will be the guidance that determines (1) whether consolidation is required under the "controlling financial interest" model of Accounting Research Bulletin No. 51 (ARB 51), *Consolidated Financial Statements* (or other existing authoritative guidance) or, alternatively, (2) whether the variable interest model under FIN 46 should be used to account for existing and new entities. At this time, the Company does not have any entities that would be covered under FIN 46.

16. Unaudited Selected Quarterly Financial Information

2002	**First Quarter**	**Second Quarter**	**Third Quarter**	**Fourth Quarter**
	(in thousands, except per share data)			
Revenues	$38,231	$42,761	$52,844	$48,349
Operating income	$ 6,135	$ 7,485	$11,941	$ 9,232
Net income	$ 4,046	$ 4,845	$ 7,402	$ 5,961
Earnings per share:				
Basic	$ 0.15	$ 0.18	$ 0.28	$ 0.22
Diluted	$ 0.14	$ 0.16	$ 0.25	$ 0.20
Weighted average shares used in computing earnings per share:				
Basic	26,166	26,261	26,463	26,629
Diluted	29,879	29,787	29,566	30,251
2003				
Revenues	$43,466	$44,265	$43,295	$41,017
Operating income	$ 5,676	$ 7,633	$ 7,253	$ 7,361
Net income	$ 3,491	$ 4,638	$ 4,442	$ 4,671
Earnings per share:				
Basic	$ 0.13	$ 0.17	$ 0.16	$ 0.17
Diluted	$ 0.12	$ 0.16	$ 0.15	$ 0.16
Weighted average shares used in computing earnings per share:				
Basic	26,935	27,047	27,151	27,204
Diluted	29,925	29,491	29,978	29,852

Report of Independent Auditors on Financial Statement Schedule

To the Board of Directors and Stockholders of
PEC Solutions, Inc.

Our audits of the consolidated financial statements referred to in our report dated February 10, 2004, appearing in this Annual Report on Form 10-K, also included an audit of the financial statement schedule appearing on page S-2. In our opinion, this financial statement schedule presents fairly, in all material respects, the information set forth therein when read in conjunction with the related consolidated financial statements.

/s/ Pricewaterhouse Coopers LLP

McLean, Virginia
February 10, 2004

PEC Solutions, Inc.
SCHEDULE II—VALUATION AND QUALIFYING ACCOUNTS

DESCRIPTION	BALANCE AT START OF PERIOD	CHARGED TO COSTS AND EXPENSES	CHARGED/ CREDITED TO OTHER ACCOUNTS	DEDUCTIONS	BALANCE AT END OF PERIOD
YEAR ENDED DECEMBER 31, 2001					
Allowance for doubtful accounts . . .	$177,879	$—	$ 146,867(1)	$ —	$324,746
YEAR ENDED DECEMBER 31, 2002					
Allowance for doubtful accounts . . .	$324,746	$—	$ —	$ 2,704(2)	$322,042
YEAR ENDED DECEMBER 31, 2003					
Allowance for doubtful accounts . . .	$322,042	$—	$ —	$ 207,609(2)	$114,433

(1) Addition related to the acquisition of Troy Systems, Inc. on November 20, 2001

(2) Reflects amounts written off against the allowance and related accounts receivable accounts and settlement of doubtful accounts.

Exhibit 23.1

CONSENT OF INDEPENDENT ACCOUNTANTS

We hereby consent to the incorporation by reference in the Registration Statement on Forms S-8 (Nos. 333-35538 and 333-105263) of PEC Solutions, Inc. of our report dated February 10, 2004, relating to the consolidated financial statements of PEC Solutions, Inc. which appears in this Form 10-K. We also consent to the incorporation by reference of our report dated February 10, 2004 relating to the financial statement schedule, which appears in this Form 10-K.

/s/ PricewaterhouseCoopers LLP

McLean, Virginia
March 15, 2004

Exhibit 31.1

Section 302 Certification

I, David C. Karlgaard, certify that:

1. I have reviewed this annual report on Form 10-K report of PEC Solutions, Inc.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial 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 and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) for the registrant and have:
   a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
   b) Evaluated the effectiveness of the registrant's disclosure controls and procedures 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
   c) 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 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 officers 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.

By: /s/ DAVID C. KARLGAARD

Name: David C. Karlgaard
Title: President, Chief Executive Officer and Chairman (Principal Executive Officer)

March 15, 2004

Exhibit 31.2

Section 302 Certification

I, Stuart R. Lloyd, certify that:

1. I have reviewed this annual report on Form 10-K report of PEC Solutions, Inc.;

2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;

3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial 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 and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) for the registrant and have:

   a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;

   b) Evaluated the effectiveness of the registrant's disclosure controls and procedures 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

   c) 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 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 officers 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.

By: /s/ STUART R. LLOYD

Name: Stuart R. Lloyd Title: Chief Financial Officer, Senior Vice President and Director (Principal Financial and Accounting Officer)

March 15, 2004

Exhibit 32.1

Certification of Principal Executive Officer
Pursuant to 18 U.S.C. 1350
(Section 906 of the Sarbanes-Oxley Act of 2002)

I, David C. Karlgaard, President and Chief Executive Officer (principal executive officer) of PEC Solutions, Inc. (the "Registrant"), certify that to the best of my knowledge, based upon review of the Annual Report on Form 10-K for the period ended December 31, 2003 of the Registrant (the "Report"):

(1) The Report fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934, as amended; and

(2) The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Registrant.

/s/ DAVID C. KARLGAARD

Name: David C. Karlgaard
Date: March 15, 2004

Exhibit 32.2

Certification of Principal Financial Officer
Pursuant to 18 U.S.C. 1350
(Section 906 of the Sarbanes-Oxley Act of 2002)

I, Stuart R. Lloyd, Chief Financial Officer (principal financial officer) of PEC Solutions, Inc. (the "Registrant"), certify that to the best of my knowledge, based upon review of the Annual Report on Form 10-K for the period ended December 31, 2003 of the Registrant (the "Report"):

(1) The Report fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934, as amended; and

(2) The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Registrant.

/s/ STUART R. LLOYD

Name: Stuart R. Lloyd
Date: March 15, 2004

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