

Fortress International Group, Inc.  
Form 10-Q  
August 14, 2012

**UNITED STATES**

**SECURITIES AND EXCHANGE COMMISSION**

**Washington, D.C. 20549**

**FORM 10-Q**

(Mark One)

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

For the quarterly period ended June 30, 2012

or

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

Commission file number: 000-51426

**FORTRESS INTERNATIONAL GROUP, INC.**

(Exact name of registrant as specified in its charter)

**Delaware**

**20-2027651**

(State or other jurisdiction of  
incorporation or organization)

(I.R.S. Employer Identification No.)

**7226 Lee DeForest Drive, Suite 104**

**21046**

**Columbia, Maryland**

(Address of principal executive offices) (Zip Code)

**(410) 423-7300**

(Registrant's telephone number, including area code)

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

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

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

Large accelerated filer

Accelerated filer

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

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

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

**Common Stock, par value \$0.0001 per share, as of July 31, 2012**      **14,729,520**

**FORTRESS INTERNATIONAL GROUP, INC.**

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

## FORTRESS INTERNATIONAL GROUP, INC.

## CONDENSED CONSOLIDATED BALANCE SHEETS

	(Unaudited)	
	June 30, 2012	December 31, 2011
Assets		
Current Assets		
Cash and cash equivalents	\$5,721,339	\$6,731,487
Contract and other receivables, net	10,375,132	7,147,714
Costs and estimated earnings in excess of billings on uncompleted contracts	809,395	2,729,424
Prepaid expenses and other current assets	668,817	497,712
Total current assets	17,574,683	17,106,337
Property and equipment, net	394,573	305,463
Goodwill	1,768,861	3,839,861
Other intangible assets, net	60,000	60,000
Other assets	22,515	20,975
Total assets	\$19,820,632	\$21,332,636
Liabilities and Stockholders' Equity		
Current Liabilities		
Convertible notes, current portion	\$500,000	\$375,000
Accounts payable and accrued expenses	7,919,649	6,886,094
Billings in excess of costs and estimated earnings on uncompleted contracts	3,738,281	2,819,368
Total current liabilities	12,157,930	10,080,462
Convertible notes, less current portion	2,207,301	2,457,301
Other liabilities	67,397	76,073
Total liabilities	14,432,628	12,613,836
Commitments and Contingencies	-	-
Stockholders' Equity		
Preferred stock- \$.0001 par value; 1,000,000 shares authorized; no shares issued or outstanding	-	-
Common stock- \$.0001 par value, 49,000,000 shares authorized; 14,896,355 and 14,749,356 issued; 14,149,107 and 14,028,407 outstanding at June 30, 2012 and December 31, 2011, respectively	1,488	1,475
Additional paid-in capital	66,011,767	65,805,358
	(1,466,670 )	(1,450,455 )

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Treasury stock 747,248 and 720,949 shares at cost at June 30, 2012 and December 31, 2011, respectively

Accumulated deficit	(59,158,581)	(55,637,578)
Total stockholders' equity	5,388,004	8,718,800
Total liabilities and stockholders' equity	\$ 19,820,632	\$ 21,332,636

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

## FORTRESS INTERNATIONAL GROUP, INC.

## CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

	(Unaudited) For the Three Months Ended		(Unaudited) For the Six Months Ended	
	June 30, 2012	June 30, 2011	June 30, 2012	June 30, 2011
Results of Operations:				
Revenue	\$ 15,540,852	\$ 10,515,498	\$ 29,850,714	\$ 20,130,427
Cost of revenue, excluding depreciation and amortization	13,209,463	6,614,311	25,464,820	12,093,169
Gross profit, excluding depreciation and amortization	2,331,389	3,901,187	4,385,894	8,037,258
Operating expenses:				
Selling, general and administrative	2,399,501	2,795,556	5,307,136	5,830,167
Restructuring and other charges	-	-	279,286	-
Depreciation and amortization	81,356	57,798	158,261	120,498
Impairment loss on goodwill	2,071,000	-	2,071,000	-
Total operating costs	4,551,857	2,853,354	7,815,683	5,950,665
Operating (loss) income	(2,220,468 )	1,047,833	(3,429,789 )	2,086,593
Interest income (expense), net	(48,446 )	(4,422 )	(91,214 )	(21,255 )
Other income (expense), net	-	919,084	-	919,084
(Loss) income before income taxes	(2,268,914 )	1,962,495	(3,521,003 )	2,984,422
Income tax expense	-	-	-	-
Net (loss) income	\$(2,268,914 )	\$ 1,962,495	\$(3,521,003 )	\$ 2,984,422
Basic (Loss) Earnings per Share:				
(Loss) earnings per common share	\$(0.16 )	\$ 0.15	\$(0.25 )	\$ 0.22
Weighted average common shares outstanding	14,147,049	13,456,310	14,124,380	13,427,997
Diluted (Loss) Earnings per Share:				
(Loss) earnings per common share	\$(0.16 )	\$ 0.13	\$(0.25 )	\$ 0.21
Weighted average common shares outstanding	14,147,049	14,899,608	14,124,380	14,828,141

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

## FORTRESS INTERNATIONAL GROUP, INC.

## CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

	(Unaudited)	
	For the Six Months Ended	
	June 30, 2012	June 30, 2011
Cash Flows from Operating Activities:		
Net (loss) income	\$(3,521,003)	\$ 2,984,422
Adjustments to reconcile net income to net cash used in operating activities:		
Depreciation and amortization	158,261	120,498
Provision for doubtful accounts	55,290	90,000
Stock-based compensation	206,422	342,183
Impairment loss on goodwill	2,071,000	-
Other non cash items	-	(78,944 )
Changes in operating assets and liabilities:		
Contracts and other receivables	(3,282,708 )	1,490,248
Costs and estimated earnings in excess of billings on uncompleted contracts	1,920,029	78,289
Prepaid expenses and other current assets	(171,105 )	(199,621 )
Other assets	(1,540 )	7,432
Accounts payable and accrued expenses	1,033,555	(4,820,075 )
Billings in excess of costs and estimated earnings on uncompleted contracts	918,913	(3,472,601 )
Other liabilities	(8,676 )	(30,984 )
Net cash used in operating activities	(621,562 )	(3,489,153 )
Cash Flows from Investing Activities:		
Purchase of property and equipment	(247,371 )	(75,352 )
Proceeds from repayment of note in connection with the sale of substantially all assets and liabilities of Rubicon	-	90,341
Net cash (used in) provided by investing activities	(247,371 )	14,989
Cash Flows from Financing Activities:		
Payment on seller notes	(125,000 )	(180,000 )
Purchase of treasury stock	(16,215 )	(51,861 )
Net cash used in financing activities	(141,215 )	(231,861 )
Net decrease in cash	(1,010,148)	(3,706,025 )
Cash and cash equivalents, beginning of period	6,731,487	10,980,420
Cash and cash equivalents, end of period	\$5,721,339	\$ 7,274,395
Supplemental disclosure of cash flow information:		
Cash paid for interest	\$28,323	\$ 107,910
Cash paid for taxes	\$8,001	\$ -
Supplemental disclosure of non-cash operating activities		
Interest forgiveness in settlement of SMLB seller notes	\$-	\$ 25,310
Supplemental disclosure of non-cash financing activities		
Principal forgiveness in settlement of SMLB seller notes	\$-	\$ 20,572

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

FORTRESS INTERNATIONAL GROUP, INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

**(1) Basis of Presentation**

The unaudited condensed consolidated financial statements are as of June 30, 2012 and December 31, 2011 and for the three and six months ended June 30, 2012 and 2011 for Fortress International Group, Inc. (“Fortress” or the “Company” or “We”).

The accompanying unaudited condensed consolidated financial statements have been prepared pursuant to the rules and regulations of the Securities and Exchange Commission (“SEC”). Certain information and note disclosures normally included in the annual financial statements, prepared in accordance with accounting principles generally accepted in the United States of America (“GAAP”), have been condensed or omitted pursuant to those rules and regulations. We recommend that you read these unaudited condensed consolidated financial statements in conjunction with the audited consolidated financial statements and related notes included in our Annual Report on Form 10-K for the year ended December 31, 2011, previously filed with the SEC. We believe that the unaudited condensed consolidated financial statements in this Quarterly Report on Form 10-Q reflect all adjustments that are necessary to fairly present the financial position, results of operations and cash flows for the interim periods presented. The results of operations for such interim periods are not necessarily indicative of the results that can be expected for the full year.

***Overview***

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

The Company’s focus is centered on growing profitability and corresponding cash flow. On an ongoing basis, the Company works to increase sales, project utilization and align selling, general and administrative expenses with sales through cost cutting measures. We will continue to closely monitor our costs relative to actual and anticipated revenues and may make further reductions to selling, general and administrative expenses including but not limited to personnel and related costs and marketing.

During the first quarter 2012, as a result of the decline in its profitability, the Company failed to comply with certain financial covenants under its revolving line of credit facility (Credit Agreement), which was then terminated June 28, 2012. At the time of termination of the Credit Agreement, Borrowers had no outstanding borrowings under the Credit Agreement. No penalties, fees, charges or assessments were due to the lender in connection with the termination of the Credit Agreement. The Company believes that the termination of the Credit Agreement will not have a material adverse effect on the Company's business, operating results, and financial condition and that the Company's current cash and cash equivalents and expected future cash generated from operations will satisfy over the next twelve months the expected working capital, capital expenditure, and financing obligations of the Company (see Note 9).

The Company had \$5.7 million and \$6.7 million of unrestricted cash and cash equivalents at June 30, 2012 and December 31, 2011, respectively. During the six months ended June 30, 2012, the Company financed its operations through its cash balances and working capital. As a result of efforts to align and monitor operating costs with anticipated revenues, management believes that the Company's current cash and cash equivalents and expected future cash generated from operations will satisfy the expected working capital, capital expenditure and financial service requirements of the Company's current business through the next twelve months.

#### ***Recently Issued Accounting Pronouncements***

In May 2011, the FASB issued a new accounting standard on fair value measurements that clarifies the application of existing guidance and disclosure requirements, changes certain fair value measurement principles and requires additional disclosures about fair value measurements. We were required to adopt this standard in the first quarter of 2012. The adoption of this standard did not have a material impact on the Company's financial statements.

In September 2011, the FASB issued guidance that simplified how entities may test for goodwill impairment. This guidance permits entities to first assess qualitative factors to determine whether it is more likely than not that the fair value of a reporting unit is less than its carrying amount as a basis for determining whether it is necessary to perform a two-step goodwill impairment test. This guidance is effective for annual and interim goodwill impairment tests performed for fiscal years beginning after December 15, 2011, and early adoption is permitted. The adoption of this standard did not have a material effect on the Company's financial statements.

FORTRESS INTERNATIONAL GROUP, INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

**(2) Contract and Other Receivables, net**

The Company had an allowance for doubtful accounts of \$0.1 million at June 30, 2012 and December 31, 2011. Bad debt expense for the three months ended June 30, 2012 and 2011 was \$55,290 and \$30,000, respectively.

Included in accounts receivable was retainage associated with construction projects totaling \$0.8 million and \$0.2 million at June 30, 2012 and December 31, 2011, respectively.

The Company earned approximately 46% and 42% of its revenue from two customers for both the three months ended June 30, 2012 and 2011. The Company earned approximately 41% and 42% of its revenue from one and two customers for the six months ended June 30, 2012 and 2011, respectively. Accounts receivable from these two customers at June 30, 2012 and December 31, 2011 were \$4.6 million and \$0.7 million, respectively.

Additionally, two customers comprising 41% of the Company's total revenue for the three and six months ended June 30, 2011 were purchased in 2010. While we continue to pursue work with these customers, we recorded no revenue for the three and six months ended June 30, 2012 from them.

Under certain construction management contracts, the Company is obligated to obtain performance bonds with various financial institutions, which typically require a security interest in the corresponding receivable. At June 30, 2012 and December 31, 2011, bonds outstanding that are secured by specific project accounts receivable totaled \$17.9 million.

**(3) Accounts Payable and Accrued Expenses**

The Company's accounts payable and accrued expenses were comprised of the following at:

	June 30, 2012	December 31, 2011
Accounts payable	\$ 4,794,698	\$ 3,858,251
Accounts payable retainage	552,689	201,331

Accrued project costs	1,704,383	1,927,439
Restructuring liability	162,631	-
Other accrued expenses	705,248	899,073
Total accounts payable and accrued expenses	\$ 7,919,649	\$ 6,886,094

In an effort to align the Company's resources with anticipated types of services and volume, during the six months ended June 30, 2012 the Company adopted a restructuring plan that included a reduction in employee work force by 18 employees. The restructuring plan resulted in a restructuring charge in the amount of \$0.3 million, which is principally related to estimated employee severance, stock based compensation and post-employment health care costs to be paid by the Company in connection with implementing the restructuring plan. During the three and six months ended June 30, 2012, the Company made cash payments totaling \$62,000 and \$88,000, respectively. No such charges were recorded in the prior year.

#### (4) Goodwill

The Company evaluates goodwill for impairment between annual tests if indicators of impairment exist. During the three months ended June 30, 2012 the overall market capitalization value of the Company declined from the closing price at March 31, 2012. This decline was deemed a circumstance of possible goodwill impairment that required a goodwill impairment evaluation sooner than the required annual evaluation in the fourth quarter of 2012. For this evaluation, the Company as a whole is considered the reporting unit. Based on the requirements of ASC 350, *Intangibles-Goodwill and Other*, the Company determined the carrying value of the reporting unit exceeded the fair value, resulting in an impairment loss on goodwill in the amount of \$2.1 million during the three months ended June 30, 2012. The income and market approach were used in determining the fair value of the reporting unit with a significant weighting placed on the market value due to the changing nature of the Company's business.

At June 30, 2012 and December 31, 2011, the adjusted carrying value of goodwill was as follows:

	June 30, 2012	December 31, 2011
Gross carrying amount of goodwill	\$20,016,727	\$20,016,727
Accumulated impairment loss on goodwill	(18,247,866)	(16,176,866)
Net goodwill	\$1,768,861	\$3,839,861

FORTRESS INTERNATIONAL GROUP, INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

**(5) Basic and Diluted (Loss) Earnings per Share**

Basic and diluted net (loss) earnings per common share are computed as follows:

	<b>Three Months Ended June 30,</b>			2011		
	2012					
	Loss	Shares	\$ per Share	Income	Shares	\$ per Share
<b>BASIC (LOSS) EARNINGS PER SHARE</b>						
Net (loss) income	\$(2,268,914)	14,147,049	\$(0.16)	\$1,962,495	13,456,310	\$0.15
<b>EFFECT OF DILUTIVE SECURITIES</b>						
Unvested restricted stock	-	-	-	-	1,065,658	(0.01)
Unsecured convertible note	-	-	-	28,323	377,640	(0.01)
<b>DILUTED (LOSS) EARNINGS PER SHARE</b>	\$(2,268,914)	14,147,049	\$(0.16)	\$1,990,818	14,899,608	\$0.13

	<b>Six months ended June 30,</b>			2011		
	2012					
	Loss	Shares	\$ per Share	Income	Shares	\$ per Share
<b>BASIC (LOSS) EARNINGS PER SHARE</b>						
Net (loss) income	\$(3,521,003)	14,124,380	\$(0.25 )	\$2,984,422	13,427,997	\$0.22
<b>EFFECT OF DILUTIVE SECURITIES</b>						
Unvested restricted stock	-	-	-	-	1,022,504	(0.01 )
Unsecured convertible note	-	-	-	56,372	377,640	-
<b>DILUTED (LOSS) EARNINGS PER SHARE</b>	\$(3,521,003)	14,124,380	\$(0.25 )	\$3,040,794	14,828,141	\$0.21

473,003 shares of unvested restricted stock, 1,532,500 of options to purchase our common stock, and unsecured promissory notes convertible into 366,666 shares of common stock that were outstanding at June 30, 2012 were not included in the computation of diluted net loss per common share for the three and six months ended June 30, 2012, as their inclusion would be anti-dilutive.

**(6) Employee Benefit Plans**

On June 6, 2012, shareholders approved a 2,000,000 increase to shares available for award under the Company's 2006 Omnibus Incentive Compensation Plan (the "2006 Plan").

*Stock Compensation*

For the three months ended June 30, 2012 and June 30, 2011, the Company granted 1,532,500 options to purchase common shares and 250,000 shares of restricted stock, respectively, under the 2006 Plan. For the three months ended June 30, 2012 and 2011, the Company recorded non-cash compensation expense included in selling, general and administrative expenses associated with vesting awards of \$0.1 million and \$0.2 million, respectively. At June 30, 2012, there was approximately \$1.0 million of unrecognized stock compensation with a weighted average remaining life of 2.8 years.

For the six months ended June 30, 2012 and June 30, 2011, the Company granted 250,000 and 231,250 shares of restricted stock, respectively, and 1,532,500 and zero options to purchase common shares, respectively, under the 2006 Plan. For the six months ended June 30, 2012 and 2011, the Company recorded non-cash compensation expense included in selling, general and administrative expenses associated with vesting awards of \$0.1 million and \$0.2 million, respectively.

FORTRESS INTERNATIONAL GROUP, INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

*Stock Options*

Under the 2006 Plan the Company has historically issued restricted stock; however, to further enable us to attract, retain and motivate key employees the Company for the first time issued 1,532,500 options to purchase common stock during the three months ended June 30, 2012. The grants have various vesting features including ratably over three years on each anniversary from the grant date or they become exercisable on the condition that the Company's fair market value exceed a set price for 20 consecutive trading days.

***Fair Value Determination***-The Company utilized a Black-Scholes-Merton model to value stock options vesting over time, while market exercisable awards were valued using a Monte Carlo simulation. The Company will reconsider the use of the Black-Scholes-Merton model and Monte-Carlo simulation if additional information becomes available in the future that indicates another model would be more appropriate or if grants issued in future periods have characteristics that cannot be reasonably estimated under these models.

***Volatility***-The expected volatility of the options granted was estimated based upon historical volatility of the Company's share price through weekly observations of the Company's trading history corresponding to the expected term for Black-Scholes-Merton model and longest available history, or 6.69 years, for the Monte Carlo simulation.

***Expected Term***-Given the lack of historical experience, the expected term of options granted to employees was determined utilizing a plain vanilla approach whereby minimum or median time to vest and the contractual term of 10 years are averaged.

***Risk-free Interest Rate***-The yield was determined based on U.S. Treasury rates corresponding to the expected term of the underlying grants.

***Dividend Yield***-The Black-Scholes-Merton valuation model requires an expected dividend yield as an input. The Company does not anticipate paying dividends; therefore the yield was estimated at zero.

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The following table summarizes weighted-average assumptions used in our calculations of fair value for the six months ended June 30, 2012:

	Black-Scholes-Merton		Monte Carlo Simulation	
Volatility	100	%	94	%
Expected life of options (in years)	6		6	
Risk-free interest rate	0.92	%	1.64	%
Dividend yield	0	%	0	%
Forfeiture rate	0	%	0	%

**(7) Common Stock Repurchases**

For the three months ended June 30, 2012, the Company repurchased 4,652 shares with an aggregate value of \$0.01 million associated with the vesting of restricted stock held by an employee. For the six months ended June 30, 2011, the Company repurchased 26,298 shares with an aggregate value of \$0.3 million associated with the vesting of restricted stock held by an employee. Per terms of the restricted stock agreements, the Company paid the employee's related taxes associated with the employee's vested stock and decreased the shares held by the employee by a corresponding value, resulting in a share issuance net of taxes to the employee. The value of the shares netted for employee taxes represents treasury stock repurchased.

FORTRESS INTERNATIONAL GROUP, INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

**(8) Income Taxes**

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

The Company is in a net operating loss carryover position. The net operating losses not utilized can be carried forward for 20 years to offset future taxable income. As of June 30, 2012 and December 31, 2011, a full valuation allowance has been recorded against the Company's deferred tax assets, as the Company has concluded that, under relevant accounting standards, it is more likely than not that the deferred tax assets will not be realizable.

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

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

The Company's prior federal and state income tax filings since 2008 remain open under statutes of limitation. Innovative Power System Inc.'s statutes of limitation are open from the 2008 tax year forward for both federal and Commonwealth of Virginia purposes. Quality Power Systems Inc.'s statutes of limitation are open from the 2008 tax year forward for both federal and Commonwealth of Virginia purposes. SMLB, Ltd. statutes of limitation are open from the 2008 tax year forward for both federal and State of Illinois purposes.

**(9) Convertible Notes**

	June 30, 2012	December 31, 2011
Convertible, unsecured promissory note, due 2012 (4.0%)	\$ 2,707,301	\$ 2,832,301
Less current portion	500,000	375,000
Total debt, less current portion	\$ 2,207,301	\$ 2,457,301

For the six months ended June 30, 2012, the Company had and made scheduled principal repayments totaling \$0.1 million. For the six months ended June 30, 2011, the Company made its final payment totaling \$180,000 on seller notes associated with the acquisition of Innovative Power Systems, Inc. and SMLB, Inc.

*Line of Credit*

On November 8, 2011, the Company and its subsidiaries Innovative Power Systems, Inc., VTC, L.L.C., Total Site Solutions Arizona, LLC, and Alletag Builders, Inc. (together with the Company, collectively, "Borrowers") obtained a credit facility (the "Credit Facility") from Wells Fargo Bank, National Association ("Lender") pursuant to a Credit Agreement by and among Borrowers and Lender (the "Credit Agreement"). Borrowers' obligations under the Credit Facility were joint and several. The maximum amount of the Credit Facility was \$2,000,000. The Credit Facility was subject to a borrowing base of 80% of eligible accounts receivable. Borrowings under the Credit Facility incurred interest at the London interbank offered rate plus 2.25% per annum. At December 31, 2011, there was no balance outstanding on the Credit Facility.

The Credit Facility would have matured on November 1, 2012, however during the three months ended March 31, 2012, the Company failed to comply with the financial covenants requiring (a) a maximum ratio of total liabilities to tangible net worth as set forth in the Credit Agreement; and (b) a minimum debt service coverage ratio as set forth in the Credit Agreement. The Credit Facility was terminated effective June 28, 2012.

FORTRESS INTERNATIONAL GROUP, INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

**(10) Related Party Transactions**

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

**S3 Integration, L.L.C.** (S3 Integration) is 15% owned by Thomas P. Rosato, the Company's former Chief Executive Officer and former member of the Board of Directors. On December 31, 2011, Gerard J. Gallagher, our Chief Operating Officer and member of the Board of Directors, sold his 15% interest in S3 Integration, reducing his ownership to zero, in exchange for a \$60,000 promissory note with a two year repayment schedule. S3 Integration provides commercial security systems design and installation services as a subcontractor to the Company.

**Chesapeake Mission Critical, L.L.C.** (Chesapeake MC) is 10.32% owned by Mr. Rosato. Additionally, Chesapeake MC owes approximately \$0.5 million to Mr. Rosato. Additionally, Mr. Rosato is entitled to certain contingent payments not to exceed \$0.5 million in the event of a liquidation or sale of the business. On November 4, 2011, Mr. Gallagher sold his 9% interest in Chesapeake MC, reducing his ownership to zero. Chesapeake MC is a manufacturers' representative reselling and servicing mechanical and electrical equipment from original equipment manufacturers.

**CTS Services, LLC** (CTS) is 9% owned by Mr. Rosato. CTS is a mechanical contractor that acts as a subcontractor to the Company for certain projects. In addition, CTS utilizes the Company as a subcontractor on projects as needed. Mr. Rosato also holds a note payable over ten years that has a balance of \$2.8 million at June 30, 2012. CTS is a mechanical and electrical contractor that specializes in commercial buildings and mission critical facilities.

**Telco P&C, LLC** (Telco P&C) is 12% owned by Mr. Rosato, who receives approximately \$78,000 per year from Telco P&C through 2012. Telco P&C is a specialty electrical installation company that acts as a subcontractor to the Company. The Company has also acted as a subcontractor to Telco P&C as needed.

**TPR Group Re Three, LLC** (TPR Group Re Three) is 50% owned by Mr. Rosato and Mr. Gallagher. TPR Group Re Three leases office space to the Company under the terms of a real property lease to TSS/Vortech. The original lease term expired at December 31, 2011. Prior to expiration, the lease was renegotiated to a full service lease, excluding

utilities, at \$24 per square foot or an aggregate annual rate of \$0.3 million, representing an annual reduction of approximately \$0.2 million. The lease is cancellable by either the Company or TPR Group Re Three with six months written notice. The Company obtained an independent appraisal of the original lease, which determined the lease to be at fair value.

**Chesapeake Tower Systems, Inc.** was owned 100% by Mr. Rosato and assigned its rights and obligations under our lease for certain office and warehouse space to RF Realty Investments, LLC (“RF Realty”) on October 1, 2011. RF Realty is owned by Mr. Rosato and his family. The Company obtained an independent appraisal of the lease, which determined the lease to be at fair value.

**eSite Systems, LLC** (eSite) is a limited liability company formed June 1, 2011 into which Mr. Rosato invested \$0.4 million. eSite is a manufacturers’ representative reselling and servicing mechanical and electrical equipment from original equipment manufacturers. The Company has not entered into any contracts with the related entity greater than \$25,000 to date. The Company received a contract for approximately \$745,000 from a customer that has contracted to purchase equipment from eSite. In addition, Mr. Rosato provided this customer with a loan in an amount up to \$650,000 to purchase that equipment.

The following table sets forth transactions the Company has entered into with the above related parties for the three and six months ended June 30, 2012 and 2011. It should be noted that revenue represents amounts earned on contracts with related parties under which we provide services; and cost of revenue represents costs incurred in connection with related parties which provide services to us on contracts for our customers. As such a direct relationship to the revenue and cost of revenue information below by company should not be expected.

## FORTRESS INTERNATIONAL GROUP, INC.

## NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

	Three Months Ended June 30, 2012	Three Months Ended June 30, 2011	Six Months Ended June 30, 2012	Six Months Ended June 30, 2011
Revenue				
Telco P&C, LLC	21,361	64,095	23,739	285,071
Chesapeake Mission Critical, LLC	-	132,203	-	281,966
Total	\$ 21,361	\$ 196,298	\$ 23,739	\$ 567,037
Cost of Revenue				
CTS Services, LLC	\$ -	\$ 8,128	\$ -	\$ 17,413
Chesapeake Systems, LLC	-	6,000	-	6,000
Chesapeake Mission Critical, LLC	116,017	5,639	116,017	71,191
S3 Integration, LLC	8,632	12,426	8,632	50,697
Total	\$ 124,649	\$ 32,193	\$ 124,649	\$ 145,301
Selling, general and administrative				
Office rent paid on Chesapeake Tower Systems	\$ 37,998	\$ 37,998	\$ 75,996	\$ 95,921
Office rent paid to TPR Group Re Three, LLC	69,156	71,366	163,397	214,099
Total	\$ 107,154	\$ 109,364	\$ 239,393	\$ 310,020

	June 30, 2012	December 31, 2011
Accounts receivable/(payable):		
CTS Services, LLC	\$8,555	\$ -
CTS Services, LLC	-	(1,400 )
Chesapeake Mission Critical, LLC	-	154
Telco P&C, LLC	18,870	36,133
Total Accounts receivable	\$27,425	\$ 36,287
Total Accounts (payable)	\$-	\$ (1,400 )

**(11) Commitments, Contingencies and Other**

On March 28, 2012, Mr. Rosato resigned as non-executive Chairman of the Board, which resulted in the termination of his consulting agreement. Based on a unanimous vote, the Board elected Mr. Woodward to serve as the non-executive Chairman of the Board effective March 28, 2012.

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

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

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

### **Business Formation and Overview**

We were incorporated in Delaware on December 20, 2004 as a special purpose acquisition company formed under the name "Fortress America Acquisition Corporation" for the purpose of acquiring an operating business that performs services in the homeland security industry. On January 19, 2007, we acquired all of the outstanding membership interests of each of VTC, L.L.C., doing business as "Total Site Solutions" ("TSS"), and Vortech, L.L.C. ("Vortech" and, together with TSS, "TSS/Vortech") and simultaneously changed our name to "Fortress International Group, Inc." The acquisition fundamentally transformed the Company from a special purpose acquisition company to an operating business.

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

### ***Competition in Current Economic Environment***

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

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

***Contract Backlog***

We believe an indicator of our future performance is our backlog of uncompleted projects in process or recently awarded. Our backlog represents our estimate of anticipated revenue from executed and awarded contracts that have not been completed and that we expect will be recognized as revenues over the life of the contracts. The use of our backlog as an indicator of our future performance is limited because backlog does not include certain sources of revenue including any future renewals of facilities maintenance contracts and the contracts underlying our backlog may be cancelled or modified on short notice which would affect the amount of backlog actually recognized as revenue. We have broken our backlog into the following three categories: (i) technology consulting, consisting of services related to consulting and/or engineering design contracts, (ii) construction management, and (iii) facility management.

Backlog is not a measure defined in generally accepted accounting principles, and our methodology for determining backlog may not be comparable to the methodology of other companies in determining their backlog. Our backlog is generally recognized under two categories: (1) contracts for which work authorizations have been or are expected to be received (2) contracts awarded to us where some, but not all, of the work have not yet been authorized. At June 30, 2012, we had authorizations to proceed with work for approximately \$11.2 million, or 59% of our total backlog of \$19.1 million. At December 31, 2011, we had authorizations to proceed with work for approximately \$27.2 million, or 77% of our total backlog of \$35.3 million.

Approximately \$7.9 million, or 42%, and \$24.4 million, or 69%, of our backlog, relates to two customers at June 30, 2012 and December 31, 2011, respectively.

We believe that approximately 62% of the backlog at June 30, 2012 will be recognized during the next twelve months. The following table reflects the value of our backlog in the above three categories as of June 30, 2012 and December 31, 2011, respectively.

(in millions)

	June 30, 2012	December 31, 2011
Technology consulting	\$ 8.1	\$ 8.5
Construction management	4.3	19.3

Facilities management	6.7	7.5
Total	\$ 19.1	\$ 35.3

## **Critical Accounting Policies and Estimates**

Our financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America, or GAAP. The preparation of the financial statements included elsewhere in this Quarterly Report on Form 10-Q requires that management make estimates and assumptions that affect the amounts reported in the financial statements and the accompanying notes. Actual results could differ significantly from those estimates.

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

### *Revenue Recognition*

We recognize revenue when pervasive evidence of an arrangement exists, the contract price is fixed or determinable, services have been rendered or goods delivered, and collectability is reasonably assured. Our revenue is derived from the following types of contractual arrangements: fixed-price contracts, time-and-materials contracts and cost-plus-fee contracts (including guaranteed maximum price contracts). Revenue from fixed-price contracts is accounted for under the application of ASC 605-35 Construction-Type and Certain Production-Type Contracts, recognizing revenue on the percentage-of-completion method using costs incurred in relation to total estimated project costs. The cost to total cost method is used because management considers cost incurred and costs to complete to be the best available measure of progress in the contracts. Contract costs include all direct materials, subcontract and labor costs and those indirect costs related to contract performance, such as indirect labor, payroll taxes, employee benefits and supplies.

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

Certain of our contracts involve the delivery of multiple elements including design management, system installation and facilities maintenance. Revenues from contracts with multiple element arrangements are recognized as each element is earned based on the relative selling price of each element provided the delivered elements have value to customers on a standalone basis. Amounts allocated to each element are based on its objectively determined fair value, such as the sales price for the service when it is sold separately or competitor prices for similar services.

Revenue and related costs for master and other service agreements billed on a time and materials basis are recognized as the services are rendered based on actual labor hours performed at contracted billable rates, and costs incurred on behalf of the Company's customer. Services are also performed under master and other service agreements billed on a fixed fee basis. Under fixed fee master service and similar type service agreements for facilities and equipment, the Company furnishes various unspecified units of service for a fixed price. These services agreements are recognized on the proportional performance method or ratably over the course of the service period and costs are recorded as incurred in performance.

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

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

#### *Allowance for Doubtful Accounts*

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

### *Non-cash Compensation*

The Company applies the fair value method that requires all share-based payments to employees be expensed over their requisite service period based on their fair value at the grant date. The recognition of the value of the instruments results in compensation or professional expenses in our financial statements. The expense differs from other compensation and professional expenses in that these charges are typically settled through the issuance of common stock, which would have a dilutive effect upon earnings per share, if and when such restricted stock vests. The determination of the estimated fair value used to record the compensation or professional expenses associated with the equity or liability instruments issued requires management to make a number of assumptions and estimates that can change or fluctuate over time.

### *Goodwill and Other Purchased Intangible Assets*

Goodwill represents the excess of costs over fair value of net assets of businesses acquired. Other purchased intangible assets include the fair value of items such as customer contracts, backlog and customer relationships. SFAS No. 142, "Goodwill and Other Intangible Assets (SFAS No. 142)," establishes financial accounting and reporting for acquired goodwill and other intangible assets. Goodwill and intangible assets acquired in a purchase business combination and determined to have an indefinite useful life are not amortized, but rather tested for impairment on an annual basis or triggering event. Purchased intangible assets with a definite useful life are amortized on a straight-line basis over their estimated useful lives.

The estimated fair market value of identified intangible assets is amortized over the estimated useful life of the related intangible asset. We have a process pursuant to which we typically retain third-party valuation experts to assist us in determining the fair market values and useful lives of identified intangible assets. In interim periods, we evaluate these assets for impairment when events occur that suggest a possible impairment. Through the second quarter 2012, we experienced an other than temporary decline in the market value of our common shares. As a result of the decline during the interim period we evaluated the carrying value of goodwill and other long-lived intangible assets for impairment. Utilizing a third party firm we determined the carrying value of goodwill was in excess of the estimated fair value, resulting in an aggregate impairment on goodwill of approximately \$2.1 million during the three and six months ended June 30, 2012. At June 30, 2012, the net carrying value of goodwill was \$1.8 million.

### *Long-Lived Assets (Excluding Goodwill)*

In accordance with the accounting guidance related to accounting for long-lived assets such as property, equipment and intangible assets subject to amortization, we review the assets for impairment. If circumstances indicate the carrying value of the asset may not be fully recoverable, a loss is recognized at the time impairment exists and a

permanent reduction in the carrying value of the asset is recorded. We believe that the carrying values of our long-lived assets as of June 30, 2012 are fully realizable.

### *Income Taxes*

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

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

ASC 740 Income Taxes prescribes a more-likely-than-not threshold of financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return, and also provides guidance on de-recognition of income tax assets and liabilities, classification of current and deferred tax assets and liabilities, accounting for interest and penalties associated with tax positions, accounting for income taxes in interim periods and income tax disclosures. As of June 30, 2012, we do not have any material gross unrecognized tax benefit liabilities.

### *Recently Issued Accounting Pronouncements*

In May 2011, the FASB issued a new accounting standard on fair value measurements that clarifies the application of existing guidance and disclosure requirements, changes certain fair value measurement principles and requires additional disclosures about fair value measurements. We were required to adopt this standard in the first quarter of 2012. The adoption of this standard did not have a material impact on our financial statements.

In September 2011, the FASB issued guidance that simplified how entities may test for goodwill impairment. This guidance permits entities to first assess qualitative factors to determine whether it is more likely than not that the fair value of a reporting unit is less than its carrying amount as a basis for determining whether it is necessary to perform a two-step goodwill impairment test. This guidance is effective for annual and interim goodwill impairment tests performed for fiscal years beginning after December 15, 2011, and early adoption is permitted. The adoption of this

standard did not have a material effect on the Company's financial statements.

**Results of operations for the three months ended June 30, 2012 compared with the three months ended June 30, 2011.**

*Revenue.* Revenue increased \$5.0 million to \$15.5 million for the three months ended June 30, 2012 from \$10.5 million for the three months ended June 30, 2011. The increase primarily relates to an increase in construction management services as we had a large project in process as compared to the prior year when a large project was concluding.

*Cost of Revenue.* Cost of revenue increased \$6.6 million to \$13.2 million for the three months ended June 30, 2012 from \$6.6 million for the three months ended June 30, 2011. The increase in revenue described above was the primary driver for the increase in cost of revenues.

*Gross Margin Percentage.* Gross margin percentage decreased to 15.0% for the three months ended June 30, 2012 compared to 37.1% for the three months ended June 30, 2011. The decrease in gross margin is attributable primarily to the effect in the prior year of a large construction management project entering its final stages of completion, whereby claims and estimates relating to disputed change orders were concluded and we experienced an improving mix in our services. The current gross margin percentage is consistent with anticipated gross margin levels given the composition of work, and we anticipate it to continue in the 15% to 20% range for the remainder of the year.

*Selling, general and administrative expenses.* Selling, general and administrative expenses decreased \$0.4 million to \$2.4 million for the three months ended June 30, 2012 from \$2.8 million for the three months ended June 30, 2011. The decrease was primarily driven by \$0.2 million in personnel savings from restructuring efforts in the first quarter of 2012 and \$0.2 million decrease in commissions resulting from the decline in gross profit.

*Depreciation.* Depreciation remained consistent at \$0.1 million for the three months ended June 30, 2012 compared to \$0.1 million for the three months ended June 30, 2011.

*Impairment loss on goodwill.* Impairment loss on goodwill and other intangibles increased \$2.1 million to \$2.1 million for the three months ended June 30, 2012 from zero for the three months ended June 30, 2011. The increase in this expense is attributable to the impairment of the carrying values of the associated goodwill. During the three months ended June 30, 2012 we experienced a decline in the overall market capitalization value of the Company, which was deemed a circumstance of possible goodwill impairment that required a goodwill impairment evaluation sooner than the required annual evaluation in the fourth quarter of 2012.

We conducted analyses of the operations in order to identify any impairment in the carrying value of the goodwill and other intangibles related to our business. Analyzing our business using both an income approach and a market approach determined that the carrying value exceeded the current fair value of our business, resulting in goodwill impairment of \$2.1 million for the three months ended June 30, 2012. At June 30, 2012, the adjusted carrying value of goodwill was \$1.8 million.

*Interest income (expense), net.* Our interest income (expense), net increased to (\$48,446) for the three months ended June 30, 2012 compared to (\$4,422) for the three months ended June 30, 2011. The increase in this expense was primarily attributable to increased interest from amortizing and writing off the costs of establishing our line of credit as the facility was terminated during the second quarter 2012.

*Other income (expense), net.* Other income (expense), net decreased \$0.9 million to zero million for the three months ended June 30, 2012 compared to \$0.9 million for the three months ended June 30, 2011. During the three months ended June 30, 2011, the Company settled a dispute relating to a potential project. The parties reached a mutual settlement that included a general release through the date of the agreement. As the settlement was unrelated to an existing customer contract or ongoing customer relationship, it has been included as other income. There was no similar income for the three months ended June 30, 2012.

**Results of operations for the six months ended June 30, 2012 compared with the six months ended June 30, 2011.**

*Revenue.* Revenue increased \$9.8 million to \$29.9 million for the six months ended June 30, 2012 from \$20.1 million for the six months ended June 30, 2011. The increase primarily relates to an increase in construction management services as we had a large project in process as compared to the prior year when a large project was concluding.

*Cost of Revenue.* Cost of revenue increased \$13.4 million to \$25.5 million for the six months ended June 30, 2012 from \$12.1 million for the six months ended June 30, 2011. The increase in revenue described above was the primary driver for the increase in cost of revenues.

*Gross Margin Percentage.* Gross margin percentage decreased to 14.7% for the six months ended June 30, 2012 compared to 39.9% for the six months ended June 30, 2011. The decrease in gross margin is attributable primarily to the effect in the prior year of a large construction management project entering its final stages of completion, whereby claims and estimates relating to disputed change orders were concluded and we experienced an improving mix in our services. The current gross margin percentage is consistent with anticipated gross margin levels given the composition of work, and we anticipate it to continue in the 15% to 20% range for the remainder of the year.

*Selling, general and administrative expenses.* Selling, general and administrative expenses decreased \$0.5 million to \$5.3 million for the six months ended June 30, 2012 from \$5.8 million for the six months ended June 30, 2011. The decrease was primarily driven by \$0.4 million decrease in commissions resulting from the decline in gross profit.

*Restructuring charges.* Restructuring charges, consisting primarily of severance payments and equity based expense, increased \$0.3 million to \$0.3 million for the six months ended June 30, 2012 from zero for the six months ended June 30, 2011. In an effort to align our resources with anticipated types of services and volume, we implemented a restructuring plan with estimated annual savings of \$2.8 million of which \$1.4 million relates to selling, general and administrative expenses based on pay reductions, reductions in force of approximately 18 employees, and related reductions in employee benefits and other costs. We will continue to closely monitor our bookings and anticipated revenues, and we may take future actions to reduce operating costs associated with personnel and related costs to align with our sales in an effort to remain profitable.

*Depreciation.* Depreciation increased \$0.1 million to \$0.2 million for the six months ended June 30, 2012 compared to \$0.1 million for the six months ended June 30, 2011. The increase in depreciation is due to an increase in the average depreciable asset base associated with plant property and equipment additions.

*Impairment loss on goodwill.* Impairment loss on goodwill and other intangibles increased \$2.1 million to \$2.1 million for the six months ended June 30, 2012 from zero for the six months ended June 30, 2011. The increase in this expense is attributable to the impairment of the carrying value of the associated goodwill. During the three months ended June 30, 2012 we experienced a decline in the overall market capitalization value of the Company, which was deemed a circumstance of possible goodwill impairment that required a goodwill impairment evaluation sooner than the required annual evaluation in the fourth quarter of 2012.

We conducted analyses of the operations in order to identify any impairment in the carrying value of the goodwill and other intangibles related to our business. Analyzing our business using both an income approach and a market approach determined that the carrying value exceeded the current fair value of our business, resulting in goodwill impairment of \$2.1 million for the six months ended June 30, 2012. At June 30, 2012, the adjusted carrying value of goodwill was \$1.8 million.

*Interest income (expense), net.* Our interest income (expense), net increased to (\$91,214) for the six months ended June 30, 2012 compared to (\$21,255) for the six months ended June 30, 2011. The increase in this expense was primarily attributable to increased interest expenses resulting from the acceleration of unamortized loan costs resulting from the termination of our credit facility during the second quarter 2012.

*Other income (expense), net.* Other income (expense), net decreased \$0.9 million to zero million for the six months ended June 30, 2012 compared to \$0.9 million for the six months ended June 30, 2011. During the six months ended June 30, 2011, the Company settled a dispute relating to a potential project. The parties reached a mutual settlement that included a general release through the date of the agreement. As the settlement was unrelated to an existing customer contract or ongoing customer relationship, it has been included as other income. There was no similar income for the six months ended June 30, 2012.

**Financial Condition, Liquidity and Capital Resources**

	For the Six Months Ended June 30,		
	2012	2011	Change
Net income (loss)	\$ (3,521,003 )	\$ 2,984,422	\$(6,505,425)
Adjustments to reconcile net income to net cash used in provided by operations:			
Depreciation and amortization	158,261	120,498	37,763
Stock and warrant-based compensation	206,422	342,183	(135,761 )
Impairment loss on goodwill	2,071,000	-	2,071,000
Provision for doubtful accounts	55,290	90,000	(34,710 )
Other non-cash items	-	(78,944 )	78,944
Net adjustments to reconcile net income for non-cash items	2,490,973	473,737	2,017,236
Net change in working capital	408,468	(6,947,312 )	7,355,780
Cash used in operations	(621,562 )	(3,489,153 )	2,867,591
Cash (used in) provided by investing	(247,371 )	14,989	(262,360 )
Cash used in financing	(141,215 )	(231,861 )	90,646
Net decrease in cash	\$ (1,010,148 )	\$ (3,706,025 )	\$ 2,695,877

Cash and cash equivalents decreased \$1.0 million to \$5.7 million at June 30, 2012 from \$6.7 million at December 31, 2011. The decrease was primarily attributable \$0.6 million used in operating activities, \$0.3 million of purchased property and equipment, and \$0.1 million used in financing activities. The \$0.6 million decrease in operating activities was primarily attributable to net loss of \$3.5 million, offset in part by non-cash adjustments and working capital totaling \$2.9 million.

*Operating Activity*

Net cash used in operating activities totaled \$0.6 million for the six months ended June 30, 2012 compared to \$3.5 million used in operating activities for the six months ended June 30, 2011. The \$2.9 million decrease in operating cash outflows was attributable to a \$7.4 million increase in cash provided from the decrease in working capital, offset in part by a decrease in net income of \$6.5 million. The decrease in working capital was attributable primarily to projects at various stages of production in the second quarter 2012 compared to a significant project that was substantially completed in the second quarter 2011.

*Investing Activity*

Net cash used in investing activities increased \$0.3 million to \$0.2 million for the six months ended June 30, 2012 from approximately zero used in for the six months ended June 30, 2011. The increase was associated with purchases of property and equipment including an upgraded sales software management tool and leasehold improvements associated with consolidation of our office space.

*Financing Activity*

Net cash used in financing decreased \$0.1 million to approximately \$0.1 million for the six months ended June 30, 2012 from \$0.2 million for the six months ended June 30, 2011. For both the six months ended June 30, 2012 and 2011, financing activities consisted primarily of the scheduled seller note repayments.

## Adjusted EBITDA

A reconciliation of Adjusted EBITDA to net (loss) income:

	(Unaudited) For the Three Months Ended		(Unaudited) For the Six Months Ended	
	June 30, 2012	June 30, 2011	June 30, 2012	June 30, 2011
Net income (loss)	\$ (2,268,914 )	\$ 1,962,495	\$ (3,521,003 )	\$ 2,984,422
Interest (income) expense, net	48,446	4,422	91,214	21,255
Income tax expense (benefit)	-	-	-	-
Depreciation and amortization	81,356	57,798	158,261	120,498
EBITDA	\$ (2,139,112 )	\$ 2,024,715	\$ (3,271,528 )	\$ 3,126,175
Stock based compensation	67,388	175,257	164,754	342,183
Other income (expense), net	-	(919,084 )	-	(919,084 )
Impairment loss on goodwill	2,071,000	-	2,071,000	-
Lease exit costs	-	(33,062 )	-	(33,062 )
Provision for bad debts	55,290	60,000	55,290	90,000
Adjusted EBITDA	\$ 54,566	\$ 1,307,826	\$ (980,484 )	\$ 2,606,212

Adjusted EBITDA decreased \$1.2 million to \$0.1 million in the three months ended June 30, 2012 from \$1.3 million for the three months ended June 30, 2011. The decrease was primarily driven by decreased gross profit for the three months ended June 30, 2012. Please refer to the preceding discussion within this “Results of Operations” section.

Adjusted EBITDA decreased \$3.6 million to (\$1.0 million) in the six months ended June 30, 2012 from \$2.6 million for the six months ended June 30, 2011. The decrease was primarily driven by decreased gross profit for the six months ended June 30, 2012. Please refer to the preceding discussion within this “Results of Operations” section.

Adjusted EBITDA is a supplemental financial measure not defined in GAAP. We define Adjusted EBITDA as net income before interest expense, income taxes, depreciation and amortization, impairment loss on goodwill and other intangibles, net, stock-based compensation, lease exit costs, and provision for bad debts. We present Adjusted EBITDA because we believe this supplemental measure of operating performance is helpful in comparing our operating results across reporting periods on a consistent basis by excluding items that may, or could, have a disproportionate positive or negative impact on our results of operations in any particular period. We also use Adjusted EBITDA as a factor in evaluating the performance of certain management personnel when determining incentive compensation. We believe that the line item on the consolidated statement of operations entitled “net income (loss)” is the most directly comparable GAAP financial measure to Adjusted EBITDA. Since Adjusted EBITDA is not a measure of performance calculated in accordance with GAAP, it should not be considered in isolation of, or as a substitute for, net income as an indicator of operating performance or any other GAAP financial measure. Adjusted

EBITDA, as calculated by us, may not be comparable to similarly titled measures employed by other companies. In addition, this measure does not necessarily represent funds available for discretionary use and is not necessarily a measure of our ability to fund our cash needs. As Adjusted EBITDA excludes certain financial information that is included in net income attributable to the Company, users of this financial information should consider the type of events and transactions that are excluded. Our non-GAAP performance measure, Adjusted EBITDA, has certain material limitations as follows:

It does not include impairment loss on goodwill and other intangibles, net. Because we utilize goodwill and other intangibles to generate revenues in our operations, this is a periodic and ongoing cost of our operations.

It does not include stock-based compensation. Stock based compensation is a necessary and ongoing part of our costs and has assisted us in reducing our cash compensation to attract and retain our workforce who support and generate revenues. Stock-based compensation will remain a key element of our overall compensation program.

It does not include provision for bad debts. Provision for bad debts is necessary as we take credit risk with customers and is an ongoing part of our operations.

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

It does not include taxes. The payment of taxes is a necessary and ongoing part of our operations.

It does not include depreciation and amortization. We must utilize property, plant and equipment and intangible assets in order to generate revenues in our operations, depreciation and amortization are necessary and ongoing costs of our operations.

Other Companies in our industry may calculate Adjusted EBITDA differently than we do, limiting its usefulness as a comparative measure.

*Liquidity and Capital Resources*

We had \$5.7 million and \$6.7 million of unrestricted cash and cash equivalents at June 30, 2012 and December 31, 2011, respectively. During the six months ended June 30, 2012, we have financed our operations primarily with cash on hand and working capital.

Our current corporate focus is centered on growing sales and profitability. We have worked to increase project utilization and realign selling, general and administrative expenses through cost cutting measures. In our efforts to maintain and grow profitability, we will closely monitor our costs relative to actual and anticipated revenues and may make further reductions to selling, general and administrative expenses including but not limited to personnel and related costs and marketing.

During the six months ended June 30, 2012, our cash and working capital declined \$1.0 million and \$1.6 million, respectively, due primarily to our operating losses in the corresponding period. We work to monitor project utilization and align selling, general and administrative expenses through anticipated revenues. While we experienced an increase in revenue during 2012 from the prior year, they were at a lower overall gross margin. As a result of our continued focus on profitability, during the first quarter we implemented restructuring plans with estimated total annual savings of \$2.8 million, of which \$1.4 million is an estimated reduction in selling, general and administrative expenses.

During the six months ended June 30, 2012, we completed implementation of an enhanced sales reporting tool, as we aim to increase sales productivity by realigning our sale focus and supporting productivity measures. Our efforts to maintain and grow profitability include closely monitoring our costs relative to actual and anticipated revenue, which may require us to make further reductions to operating costs.

During the first quarter 2012, as a result of the decline in profitability we failed to comply with certain financial covenants under our revolving line of credit facility. During the three months ended June 30, 2012, the Company discussed with its bank modifying the terms of the Credit Facility; however, we were unable to come to agreement which culminated in the termination of the Credit Facility and all future availability of funds under the Credit Agreement effective June 28, 2012. At the time of covenant violation and subsequent termination of the Credit Agreement, we had no outstanding borrowings under the Credit Agreement and incurred no fees or penalties. While we do not believe the termination of the Credit Agreement will have a material impact on our business, we have not determined the impact of not having a credit facility relative to our total bonding capacity. We believe that our current cash and cash equivalents and expected future cash generated from operations will satisfy over the next twelve months the expected working capital, capital expenditure and financing obligations of our current business, including \$0.5 million in repayment of unsecured convertible promissory notes.

We may elect to secure additional capital in the future, at acceptable terms, to improve our liquidity or fund acquisitions. The amounts involved in any such transaction, individually or in the aggregate, may be material. To the extent that we raise additional capital through the sale of equity securities, the issuance of such securities could result in dilution to our existing stockholders. If we raise additional funds through the issuance of debt securities, the terms of such debt could impose additional restrictions on our operations.

#### *Off Balance Sheet Arrangements*

As of June 30, 2012, we do not have any off balance sheet arrangements.

#### **Item 3. Quantitative and Qualitative Disclosures about Market Risk.**

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

#### **Item 4. Controls and Procedures.**

Our management performed an evaluation under the supervision and with the participation of our Chief Executive Officer (principal executive officer) and our Chief Financial Officer (principal financial officer) of the effectiveness of our disclosure controls and procedures (as defined in Rule 13a-15(e) or 15d-15(e) of the Securities Exchange Act of 1934, as amended) as of June 30, 2012. Based upon that evaluation, our Chief Executive Officer and Chief Financial Officer have concluded that as of June 30, 2012, our disclosure controls and procedures were effective.

#### **Changes in Internal Control over Financial Reporting**

There were no changes in the Company's internal control over financial reporting for the first quarter of 2012 that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting as such term is defined in Rule 13a-15 and 15d-15 of the Exchange Act of 1934, as amended.

## **PART II - OTHER INFORMATION**

### **Item 1. Legal Proceedings.**

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

### **Item 1A. Risk Factors.**

In addition to the other information set forth in this Form 10-Q, you should carefully consider the factors discussed in Part I, “Item 1A: Risk Factors” in our Annual Report on Form 10-K for the year ended December 31, 2011, which could materially affect our business, financial condition or future results. The risks described in our Annual Report on Form 10-K are not the only risks that we face. Additional risks and uncertainties not currently known to us or that we currently deem to be immaterial also may materially adversely affect our business, financial condition and/or operating results.

### ***SPECIAL NOTE REGARDING FORWARD-LOOKING STATEMENTS***

This Quarterly Report on Form 10-Q and, in particular, our Management’s Discussion and Analysis of Financial Condition and Results of Operations set forth in Part I—Item 2 contain or incorporate a number of forward-looking statements. These forward-looking statements can be identified by the use of forward-looking terminology, including the words “believes,” “anticipates,” “plans,” “expects” and similar expressions that are intended to identify forward-looking statements. You should read such statements carefully because they discuss our future expectations, contain projections of our future results of operations or of our financial position, or state other forward-looking information. There are a number of factors that could cause actual events or results to differ materially from those indicated by such forward-looking statements, many of which are beyond our control, including the factors set forth under “Item 1A. Risk Factors” of our 2011 Annual Report on Form 10-K

Any or all of our forward-looking statements in this Quarterly Report on Form 10-Q may turn out to be wrong. They can be affected by inaccurate assumptions we might make or by known or unknown risks and uncertainties. Many factors mentioned in our discussion in this Quarterly Report on Form 10-Q will be important in determining future

results. Consequently, no forward-looking statement can be guaranteed. Actual future results may vary materially. In addition, the forward-looking statements contained herein represent our estimate only as of the date of this filing and should not be relied upon as representing our estimate as of any subsequent date. While we may elect to update these forward-looking statements at some point in the future, we specifically disclaim any obligation to do so to reflect actual results, changes in assumptions or changes in other factors affecting such forward-looking statements.

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

Monthly Period During the Quarter Ended June 30, 2012	Total Shares Purchased	Average Price Paid per Share	Total Shares Purchased as Part of Publically Announced Plans	Approximate Dollar Amount of Shares Yet To Be Purchase Under Plans
April 1, 2012-April 30, 2012	7,132	\$ 0.98	-	-
May 1, 2012-May 31, 2012	-	\$ -	-	-
June 1, 2012-June 30, 2012	14,515	\$ 0.50	-	-
Total	21,647	\$ 0.98	-	-

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

**Item 3. Defaults upon Senior Securities.**

Not applicable.

**Item 4. Mine Safety Disclosures**

Not applicable.

**Item 5. Other Information.**

Not applicable.

**Item 6. Exhibits.**

- 10.1 Fortress International Group, Inc. 2006 Omnibus Incentive Compensation Plan, as amended (previously filed with the Commission as Annex A to the Company's Definitive Proxy Statement on Schedule 14A filed on April 30, 2012, and incorporated herein by reference).
- 10.2 Stock Option Agreement, dated as of April 30, 2012, between the Company and Anthony Angelini with respect to options to purchase 250,000 shares of the Company's common stock (previously filed with the Commission as Exhibit 99.2 to the Company's Current Report on Form 8-K filed on June 8, 2012, and incorporated herein by reference).
- 10.3 Stock Option Agreement, dated as of April 30, 2012, between the Company and Timothy C. Dee (previously filed with the Commission as Exhibit 99.3 to the Company's Current Report on Form 8-K filed on June 8, 2012, and incorporated herein by reference).
- 10.4 Stock Option Agreement, dated as of April 30, 2012, between the Company and Anthony Angelini with respect to options to purchase 500,000 shares of the Company's common stock (previously filed with the Commission as Exhibit 99.4 to the Company's Current Report on Form 8-K filed on June 8, 2012, and incorporated herein by reference).
- 10.5 Letter Agreement, dated July 25, 2012, between the Company and Harvey L. Weiss (previously filed with the Commission as Exhibit 99.1 to the Company's Current Report on Form 8-K filed on July 26, 2012, and incorporated herein by reference).
- 31.1\* Certification of Fortress International Group, Inc. Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 31.2\* Certification of Fortress International Group, Inc. Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 32.1‡ Certification of Fortress International Group, Inc. Chief Executive Officer and Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

\*

Filed herewith.

‡

Furnished herewith.

**SIGNATURES**

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

**FORTRESS INTERNATIONAL GROUP,  
INC.**

Date: August 14, 2012 By: /s/ Anthony Angelini  
Anthony Angelini  
*Chief Executive Officer (Authorized Officer  
and Principal Executive Officer)*

Date: August 14, 2012 By: /s/ Timothy C. Dec  
Timothy C. Dec  
*Chief Financial Officer (Authorized  
Officer  
and Principal Financial Officer)*