

SPAR GROUP INC
Form 10-Q
May 21, 2007

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 first quarterly period ended **March 31, 2007**.

OR

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 for the transition period from _____ to _____

Commission file number: 0-27824

SPAR Group, Inc.

(Exact name of registrant as specified in its charter)

Delaware
State of Incorporation
33-0684451
IRS Employer Identification No.
555 White Plains Road, Suite 250, Tarrytown, New York 10591
(Address of principal executive offices, including zip code)

Registrant's telephone number, including area code: (914) 332-4100

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. (See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act).

Large Accelerated Filer Accelerated Filer Non-Accelerated Filer

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

On March 31, 2007, there were 18,934,182 shares of Common Stock outstanding.

SPAR Group, Inc.

Index

PART I: FINANCIAL INFORMATION

| | | |
|---------|-----------------------------------------------------------------------------------------------------------|----|
| Item 1: | Financial Statements | |
| | <u>Consolidated Balance Sheets</u> <u>as of March 31, 2007 and December 31, 2006</u> | 3 |
| | <u>Consolidated Statements of Operations for the three</u> <u>months ended March 31, 2007 and 2006</u> | 4 |
| | <u>Consolidated Statements of Cash Flows for the</u> <u>three months ended March 31, 2007 and 2006</u> | 5 |
| | <u>Notes to Consolidated Financial Statements</u> | 6 |
| Item 2: | <u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u> | 16 |
| Item 3: | <u>Quantitative and Qualitative Disclosures about Market Risk</u> | 23 |
| Item 4: | <u>Controls and Procedures</u> | 23 |

PART II: OTHER INFORMATION

| | | |
|----------|--------------------------------------------------------------------|----|
| Item 1: | <u>Legal Proceedings</u> | 24 |
| Item 1A: | <u>Risk Factors</u> | 24 |
| Item 2: | <u>Unregistered Sales of Equity Securities and Use of Proceeds</u> | 24 |
| Item 3: | <u>Defaults upon Senior Securities</u> | 25 |
| Item 4: | <u>Submission of Matters to a Vote of Security Holders</u> | 25 |
| Item 5: | <u>Other Information</u> | 25 |
| Item 6: | <u>Exhibits</u> | 25 |
| | <u>SIGNATURES</u> | 26 |

PART I: FINANCIAL INFORMATION**Item 1: Financial Statements****SPAR Group, Inc.**

Consolidated Balance Sheets

(In thousands, except share and per share data)

| | March 31, 2007 | December 31, 2006 |
|------------------------------------------------|---------------------------|------------------------------|
| | (Unaudited) | (Note) |
| Assets | | |
| Current assets: | | |
| Cash and cash equivalents | \$ 2,132 | \$ 1,148 |
| Accounts receivable, net | 11,500 | 12,982 |
| Prepaid expenses and other current assets | 522 | 553 |
| Total current assets | <u>14,154</u> | <u>14,683</u> |
| Property and equipment, net | 1,296 | 901 |
| Goodwill | 798 | 798 |
| Other assets | 1,446 | 1,695 |
| Total assets | <u>\$ 17,694</u> | <u>\$ 18,077</u> |
| Liabilities and stockholders' equity | | |
| Current liabilities: | | |
| Accounts payable | \$ 3,320 | \$ 2,551 |
| Accrued expenses and other current liabilities | 2,973 | 2,864 |
| Accrued expenses due to affiliates | 2,521 | 1,752 |
| Customer deposits | 550 | 560 |
| Lines of credit | 3,609 | 5,318 |
| Total current liabilities | <u>12,973</u> | <u>13,045</u> |
| Other long-term liabilities | 252 | 6 |
| Minority interest | 542 | 498 |
| Total liabilities | <u>13,767</u> | <u>13,549</u> |
| Commitments and contingencies (Note - 9) | | |
| Stockholders' equity: | | |
| Preferred stock, \$.01 par value: | | |
| Authorized shares - 3,000,000 | | |
| Issued and outstanding shares - none | - | - |
| Common stock, \$.01 par value: | | |
| Authorized shares - 47,000,000 | | |
| Issued and outstanding shares - | | |

Edgar Filing: SPAR GROUP INC - Form 10-Q

| | March 31, 2007 | December 31, 2006 |
|--------------------------------------------|---------------------------|------------------------------|
| 18,934,182 - December 31, 2006 | 189 | 189 |
| Treasury stock - March 31, 2007 | (1) | (1) |
| Accumulated other comprehensive loss | (114) | (109) |
| Additional paid-in capital | 11,542 | 11,484 |
| Accumulated deficit | (7,689) | (7,035) |
| Total stockholders' equity | 3,927 | 4,528 |
| Total liabilities and stockholders' equity | \$ 17,694 | \$ 18,077 |

Note: The Balance Sheet at December 31, 2006, is an excerpt from the audited financial statements at that date but does not include any of the information and footnotes required by accounting principles generally accepted in the United States for complete financial statements.

See accompanying notes.

SPAR Group, Inc.
Consolidated Statements of Operations
(unaudited)
(In thousands, except per share data)

| | Three Months Ended March 31, | |
|-----------------------------------------------------------------------|-----------------------------------------|-------------|
| | 2007 | 2006 |
| Net revenues | \$ 15,413 | \$ 15,850 |
| Cost of revenues | 10,294 | 9,854 |
| | | |
| Gross profit | 5,119 | 5,996 |
| Selling, general and administrative expenses | 5,209 | 5,071 |
| Depreciation and amortization | 197 | 213 |
| | | |
| Operating (loss) income | (287) | 712 |
| Interest expense | 89 | 51 |
| Other expense (income) | 21 | (178) |
| | | |
| (Loss) income before provision for income taxes and minority interest | (397) | 839 |
| Provision for income taxes | 67 | 45 |
| | | |
| (Loss) income before minority interest | (464) | 794 |
| Minority interest | 45 | 17 |
| | | |
| Net (loss) income | \$ (509) | \$ 777 |
| | | |
| Basic/diluted net (loss) income per common share: | | |
| Net (loss) income - basic/diluted | \$ (0.03) | \$ 0.04 |
| | | |
| Weighted average common shares - basic | 18,934 | 18,918 |
| | | |
| Weighted average common shares - diluted | 18,934 | 19,071 |
| | | |

See accompanying notes.

SPAR Group, Inc.
Consolidated Statements of Cash Flows
(unaudited) (In thousands)

| | Three Months Ended March 31, | |
|-------------------------------------------------------------------------------------------------------------|-------------------------------------|-----------------|
| | 2007 | 2006 |
| Operating activities | | |
| Net cash provided by (used in) operating activities | \$ 3,044 | \$ (184) |
| Investing activities | | |
| Purchases of property and equipment | (346) | (100) |
| Financing activities | | |
| Net payments on lines of credit | (1,709) | (282) |
| Translation loss | (5) | (36) |
| Net change in cash and cash equivalents | 984 | (602) |
| Cash and cash equivalents at beginning of period | 1,148 | 1,914 |
| Cash and cash equivalents at end of period | \$ 2,132 | \$ 1,312 |
| Supplemental disclosure of cash flow information | | |
| Interest paid | \$ 64 | \$ 44 |
| Taxes paid | \$ 5 | \$ 97 |
| The Company acquired equipment in the amount of \$358,000 by entering into a capital lease in January 2007. | | |

See accompanying notes.

SPAR Group, Inc.
Notes to Consolidated Financial Statements
(unaudited)

1. Basis of Presentation

The accompanying unaudited, consolidated financial statements of SPAR Group, Inc., a Delaware corporation (SGRP), and its subsidiaries (together with SGRP, collectively, the Company or the SPAR Group) have been prepared in accordance with accounting principles generally accepted in the United States for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by accounting principles generally accepted in the United States for complete financial statements. In the opinion of management, all adjustments considered necessary for a fair presentation have been included in these interim financial statements. However, these interim financial statements should be read in conjunction with the annual consolidated financial statements and notes thereto for the Company as contained in the Company s Annual Report for 2006 on Form 10-K for the year ended December 31, 2006, as filed with the Securities and Exchange Commission (the SEC) on April 2, 2007, and amended on Form 10-K/A filed with the SEC on April 13, 2007 (the Company s Annual Report for 2006 on Form 10-K As Amended). The Company s results of operations for the interim periods are not necessarily indicative of its operating results for the entire year.

2. Business and Organization

The Company is a supplier of merchandising and other marketing services throughout the United States and internationally. The Company also provides in-store event staffing, product sampling, radio frequency identification (RFID) services, technology services and marketing research.

Today the Company operates in 12 countries whose population represents approximately 48% of the total world population. The Company s operations are currently divided into two divisions: the Domestic Merchandising Services Division and the International Merchandising Services Division. The Domestic Merchandising Services Division provides merchandising and marketing services, in-store event staffing, product sampling, RFID services, technology services and marketing research to manufacturers and retailers in the United States. The various services are primarily performed in mass merchandisers, electronics store chains, drug store chains and convenience and grocery stores. The International Merchandising Services Division was established in July 2000 and through its subsidiaries, the Company currently provides similar merchandising and marketing services in Japan, Canada, Turkey, South Africa, India, Romania, China, Lithuania, Latvia, Australia and New Zealand. The Company continues to focus on expanding its merchandising and marketing services business throughout the world.

SPAR Group, Inc.
Notes to Consolidated Financial Statements
(unaudited) (continued)

3. Earnings Per Share

The following table sets forth the computations of basic and diluted earnings per share (in thousands, except per share data):

| | Three Months Ended March 31, | |
|----------------------------------------------------------------|-----------------------------------------|-------------|
| | 2007 | 2006 |
| Numerator: | | |
| Net (loss) income | \$ (509) | \$ 777 |
| Denominator: | | |
| Shares used in basic net (loss) income per share calculation | 18,934 | 18,918 |
| Effect of diluted securities: | | |
| Employee stock options | - | 153 |
| Shares used in diluted net (loss) income per share calculation | 18,934 | 19,071 |
| Basic and diluted net (loss) income per common share | \$ (0.03) | \$ 0.04 |

4. Lines of Credit

In January 2003, the Company (other than SGRP's foreign subsidiaries) and Webster Business Credit Corporation, then known as Whitehall Business Credit Corporation (Webster), entered into the Third Amended and Restated Revolving Credit and Security Agreement (as amended, collectively, the Credit Facility). The Credit Facility provides for a \$7.0 million revolving line of credit maturing on January 23, 2009. In March 2007 the credit facility was further amended to among other things, delay the Minimum Fixed Coverage ratio until the fourth quarter 2007, establish an EBITDA covenant and increase the interest rate by .25% beginning March 28, 2007. Borrowings are based upon a borrowing base formula as defined in the agreement (principally 85% of eligible domestic accounts receivable). The Credit Facility is secured by all of the assets of the Company and its domestic subsidiaries. The Credit Facility also limits certain expenditures, including, but not limited to, capital expenditures and other investments.

The basic interest rate under the Credit Facility is Webster's Alternative Base Rate plus 1.0% per annum (a total of 9.25% per annum at March 31, 2007), which automatically changes with each change made by Webster in such Alternative Base Rate. The Company at its option, subject to certain conditions, may elect to have portions of its loans under the Credit Facility bear interest at various LIBOR rates plus 3.50% per annum based on fixed periods of one, two, three or nine months. The actual average interest rate under the Credit Facility was 9.0% per annum for the three months ended March 31, 2007.

SPAR Group, Inc.
Notes to Consolidated Financial Statements
(unaudited) (continued)

The domestic revolving loan balances outstanding under the Credit Facility were \$2.7 million and \$4.2 million at March 31, 2007 and December 31, 2006, respectively. There were letters of credit outstanding under the Credit Facility of approximately \$453,000 at both March 31, 2007, and December 31, 2006. As of March 31, 2007, the SPAR Group had unused availability under the Credit Facility of \$1.1 million out of the remaining maximum \$3.8 million unused revolving line of credit after reducing the borrowing base by outstanding loans and letters of credit.

Because of the requirement to maintain a lock box arrangement with Webster and Webster's ability to invoke a subjective acceleration clause at its discretion, borrowings under the Credit Facility are classified as current at March 31, 2007 and December 31, 2006, in accordance with EITF 95-22, *Balance Sheet Classification of Borrowings Outstanding Under Revolving Credit Agreements That Include Both a Subjective Acceleration Clause and a Lock-Box Agreement*.

The Company was in violation of its Minimum EBITDA covenant at March 31, 2007, and in May 2007 Webster amended the Credit Facility to among other things, waive the violation and established an availability reserve. The Company does not expect to comply with its covenants in future periods and is working with Webster to adjust them. In addition, Webster requested and Messrs. Brown and Bartels agreed to provide personal guarantees totaling \$1.0 million. However, there can be no assurances that Webster will adjust the future covenants or that the Company will be able to comply with the adjusted future covenants and that if the Company violates such adjusted covenants, Webster will continue to issue waivers in the future.

The Japanese subsidiary SPAR FM Japan, Inc. has line of credit agreements totaling 100 million Yen or approximately \$848,000 (based upon the exchange rate at March 31, 2007). The outstanding balances under the line of credit agreements were 70 million Yen or approximately \$594,000 at March 31, 2007 and December 31, 2006 (based upon the exchange rate at those dates). The average interest rate was 1.625% per annum for the three months ended March 31, 2007. In addition, the Japan subsidiary had cash balances totaling 174 million Yen or approximately \$1.5 million (based upon the exchange rate at March 31, 2007).

In 2006, the Australian subsidiary SPARFACTS Australia Pty. Ltd. entered into a revolving line of credit arrangement with Oxford Funding Pty. Ltd. for \$1.1 million (Australian) or approximately \$889,000 (based upon the exchange rate at March 31, 2007). The outstanding balances under the line of credit were \$339,000 (Australian) or approximately \$274,000 and \$429,000 (Australian) or approximately \$339,000 at March 31, 2007 and December 31, 2006, respectively (based upon the exchange rate at these dates). The average interest rate was 10.6% per annum for the three months ended March 31, 2007.

On October 20, 2006, SPAR Canada Company, a wholly owned subsidiary, entered into a credit agreement with Royal Bank of Canada providing for a Demand Operating Loan for a maximum borrowing of \$1.0 million (Canadian) or approximately \$866,000 (based upon the exchange rate at March 31, 2007). The Demand Operating Loan provides for borrowings based upon a borrowing base formula as defined in the agreement (principally 75% of eligible accounts receivable less certain deductions). At March 31, 2007, SPAR Canada did not have any borrowings outstanding under the credit agreement. The outstanding balance on the credit agreement was \$238,000 (Canadian) or approximately \$204,000 at December 31, 2006 (based upon the exchange rate at that date).

5. Capital Lease Obligations

The Company leases certain equipment under capital leases. The economic substance of the leases is such that the Company is financing the acquisition of the assets through the leases. The equipment has cost of \$358,000, accumulated depreciation of \$28,000 and a net book value of \$328,000 at March 31, 2007.

SPAR Group, Inc.
Notes to Consolidated Financial Statements
(unaudited) (continued)

Annual future minimum lease payments required under the leases together with their present value as of March 31, 2007 are as follows:

| Year Ending December 31 | Amount |
|--------------------------------------------------------------|---------------|
| 2007 | \$100,000 |
| 2008 | \$134,000 |
| 2009 | \$134,000 |
| 2010 | \$ 33,000 |
| | <hr/> |
| | \$401,000 |
| Less amount representing interest @ 7.6% | \$ 64,000 |
| | <hr/> |
| Present value of net minimum lease payments | \$337,000 |
| Less current portion included with other current liabilities | \$ 90,000 |
| | <hr/> |
| Long-term portion included with other long-term liabilities | \$247,000 |
| | <hr/> |

6. Related-Party Transactions

Mr. Robert G. Brown, a Director, the Chairman, President and Chief Executive Officer and a major stockholder of SGRP, and Mr. William H. Bartels, a Director, the Vice Chairman and a major stockholder of SGRP, are executive officers and the sole stockholders and directors of SPAR Marketing Services, Inc. (SMS), SPAR Management Services, Inc. (SMSI), and SPAR Infotech, Inc. (SIT).

SMS and SMSI provided approximately 99% of the Company's domestic merchandising specialists field force (through independent contractors) for both the three months ended March 31, 2007 and 2006, and approximately 78% and 86% of the Company's domestic field management at a total cost to the Company of approximately \$4.7 million and \$5.8 million for the three months ended March 31, 2007 and 2006, respectively. Pursuant to the terms of the Amended and Restated Field Service Agreement dated as of January 1, 2004, SMS provides the services of SMS's merchandising specialist field force of approximately 4,900 independent contractors to the Company. Pursuant to the terms of the Amended and Restated Field Management Agreement dated as of January 1, 2004, SMSI provides approximately 49 full-time national, regional and district managers to the Company. For those services, the Company has agreed to reimburse SMS and SMSI for all of their costs of providing those services and to pay SMS and SMSI each a premium equal to 4% of their respective costs. Total net premiums (4% of SMS and SMSI costs) paid to SMS and SMSI for services rendered were approximately \$189,000 and \$235,000 for the three months ended March 31, 2007, and 2006, respectively. The Company has been advised that Messrs. Brown and Bartels are not paid any salaries as officers of SMS or SMSI so there were no salary reimbursements for them included in such costs or premium. However, since SMS and SMSI are Subchapter S corporations and are owned by Messrs. Brown and Bartels, they benefit from any income of such companies allocated to them.

SIT provided substantially all of the Internet computer programming services purchased by the Company at a total cost of approximately \$166,000 and \$187,000 for the three months ended March 31, 2007 and 2006, respectively. SIT provided approximately 5,400 and 6,400 hours of Internet computer programming services to the Company for the three months ended March 31, 2007 and 2006, respectively. Pursuant to the Amended and Restated Programming and Support Agreement dated as of January 1, 2004, SIT continues to provide programming services to the Company for which the Company has agreed to pay SIT competitive hourly wage rates for time spent on Company matters and to reimburse the related out-of-pocket expenses of SIT and its personnel. The average hourly billing rate was \$30.69 and \$29.07 for the three months ended March 31, 2007 and 2006, respectively. The Company has been advised that no hourly charges or business expenses for Messrs. Brown and Bartels were charged to the Company by SIT for the three months ended March 31, 2007 and 2006, respectively. However, since SIT is a Subchapter S corporation and is owned by Messrs. Brown and Bartels, they benefit from any income of such company allocated to them.

SPAR Group, Inc.
Notes to Consolidated Financial Statements
(unaudited) (continued)

In November 2004 and January 2005, the Company entered into separate operating lease agreements between SMS and the Company's wholly owned subsidiaries, SPAR Marketing Force, Inc. (SMF) and SPAR Canada Company (SPAR Canada). In May 2005, the Company and SMS amended the lease agreements reducing the total monthly payment. Each lease, as amended, has a 36 month term and representations, covenants and defaults customary for the leasing industry. The SMF lease is for handheld computers to be used by field merchandisers in the performance of various merchandising and marketing services in the United States and has a monthly payment of \$17,891. These handheld computers had an original purchase price of \$632,200. The SPAR Canada lease is also for handheld computers to be used by field merchandisers in the performance of various merchandising and marketing services in Canada and has a monthly payment of \$2,972. These handheld computers had an original purchase price of \$105,000. The monthly payments, as amended, are based upon a lease factor of 2.83%.

In March 2005, SMF entered into an additional 36 month lease with SMS for handheld computers. The lease factor is 2.83% and the monthly payment is \$2,341. These handheld computers had an original purchase price of \$82,727.

Through arrangements with the Company, SMS, SMSI and SIT participate in various benefit plans, insurance policies and similar group purchases by the Company, for which the Company charges them their allocable shares of the costs of those group items and the actual costs of all items paid specifically for them. All transactions between the Company and the above affiliates are paid and/or collected by the Company in the normal course of business.

The following transactions occurred between the Company and the above affiliates (in thousands):

| | Three Months Ended March 31, | |
|---------------------------------------------------------|-----------------------------------------|-------------|
| | 2007 | 2006 |
| Services provided by affiliates: | | |
| Independent contractor services (SMS) | \$ 3,871 | \$ 4,820 |
| Field management services (SMSI) | \$ 793 | \$ 951 |
| Handheld computer leases (SMS) | \$ 70 | \$ 70 |
| Internet and software program consulting services (SIT) | \$ 166 | \$ 187 |

| | March 31, 2007 | December 31, 2006 |
|-----------------------------------------------------------|---------------------------|------------------------------|
| Accrued expenses due to affiliates (in thousands): | | |
| SPAR Marketing Services, Inc. (SMS) | \$ 1,911 | \$ 1,238 |
| SPAR Management Services, Inc. (SMSI) | \$ 438 | \$ 346 |
| SPAR Infotech, Inc. (SIT) | \$ 172 | \$ 168 |

In addition to the above, through the services of Affinity Insurance, Ltd. (Affinity), the Company purchases insurance coverage for its casualty and property insurance risk. The Company's Chairman/CEO and Vice Chairman own, through SMSI, a minority (less than 5%) equity

interest in Affinity.

SPAR Group, Inc.
Notes to Consolidated Financial Statements
(unaudited) (continued)

7. Stock-Based Compensation

As of January 1, 2006, SFAS No. 123(R) became effective and applicable to the Company's accounting for its employee stock options. Under SFAS No. 123(R), compensation expense is now recognized in the Company's financial statements when employee stock options are granted. Share-based compensation cost is measured on the grant date, based on the fair value of the award calculated at that date, and is recognized over the employee's requisite service period, which generally is the options' vesting period. Fair value is calculated using the Black-Scholes option pricing model. The Black-Scholes calculation was performed for the three months ended March 31, 2007, utilizing the methodology and assumptions consistent with those used in prior periods, which were disclosed in the Company's previously filed Annual Report on Form 10-K, As Amended.

Share-based compensation expense related to employee stock option grants totaled approximately \$80,000 and \$84,000 for the three months ended March 31, 2007 and 2006 respectively. Basic and diluted earnings per share were impacted by approximately \$0.004 for both the three month periods ended March 31, 2007 and 2006.

In addition, the Company awards stock options to the employees of the Company's affiliates. Under the provision of SFAS No. 123 dealing with non-employee stock options awarded to the employees of the Company's affiliates, the Company recorded an expense for the three months ended March 31, 2007 and 2006, of approximately \$37,000 and \$57,000 respectively.

The Company determines the fair value of the options granted to employees and non-employees using the Black-Scholes valuation model and expenses amounts or recovers amounts previously expensed over the employee's requisite service period, which generally is the options' vesting period. Until an option is vested, the fair value of the option continues to be updated through the vesting date. The options granted have a ten (10) year life and vest over four-year periods at a rate of 25% per year, beginning on the first anniversary of the date of grant.

8. Customer Deposits

Customer deposits at March 31, 2007, were approximately \$550,000 (approximately \$194,000 from domestic operations and approximately \$356,000 from international operations) compared to approximately \$560,000 at December 31, 2006 (approximately \$214,000 from domestic operations and approximately \$346,000 from international operations).

9. Commitments and Contingencies

International Commitments

The Company's international business model is to partner with local merchandising companies and combine the Company's proprietary software and expertise in the merchandising and marketing services business with their partner's knowledge of the local market. In 2001, the Company established its Japanese subsidiary to provide the latest in-store merchandising and marketing services to the Japanese market. Since 2003, the Company has expanded its international presence to Canada, Turkey, South Africa, India, Romania, China, Lithuania, Latvia, Australia, and New Zealand. Today the Company operates in 12 countries whose population represents approximately 48% of the total world population.

Certain of these subsidiaries are profitable, while others are operating at a loss. None of these entities have excess cash reserves. In the event of continued losses, the Company may be required to provide additional cash infusions into these subsidiaries.

SPAR Group, Inc.
Notes to Consolidated Financial Statements
(unaudited) (continued)

Legal Matters

Safeway Inc. (Safeway) filed a Complaint against PIA Merchandising Co., Inc. (PIA Co.), a wholly owned subsidiary of SPAR Group, Inc. (SGRP), Pivotal Sales Company (Pivotal), a wholly owned subsidiary of PIA Co., and SGRP in Alameda Superior Court, case no. 2001028498 on October 24, 2001. Safeway claims, as subsequently amended, alleged causes of action for breach of contract and breach of implied contract. PIA Co. and Pivotal filed cross-claims against Safeway on or about March 11, 2002, and amended them on or about October 15, 2002, alleging causes of action by PIA Co. and Pivotal against Safeway for breach of contract, interference with economic relationship, unfair trade practices and unjust enrichment. Trial commenced in March 2006.

On May 26, 2006, the jury in this case returned a verdict resulting in a net award of \$1,307,700 to Pivotal, a SGRP subsidiary. This net award is to be paid by Safeway and resulted from separate jury findings that awarded damages to those SGRP subsidiaries on certain claims and damages to Safeway on other claims. In particular, the jury awarded damages to Pivotal of \$5,760,879 for Safeway's interference with Pivotal's contractual relationships with third party manufacturers and also awarded \$782,400 to Pivotal and PIA for Safeway's breach of contract with those SGRP subsidiaries. The jury awarded damages to Safeway of \$5,235,579 for breach of contract by SGRP and those SGRP subsidiaries. Judgment was entered in favor of Pivotal in September 2006 for \$1,307,700. Both parties filed post trial motions but all post trial motions were denied. Notices of Appeal were thereafter filed by both Safeway and Pivotal. Pivotal/SGRP is seeking to have Safeway's judgment overturned, thereby increasing the award to Pivotal by over \$5 million. Safeway has asked for a new trial on the judgment found against it. The appellate process is expected to take fourteen to twenty four months to complete. In the interim, the court has ordered a mediation of the dispute that is to take place during May 2007. The Company has recorded the net \$1.3 million settlement award in other assets.

In addition to the above, the Company is a party to various other legal actions and administrative proceedings arising in the normal course of business. In the opinion of Company's management, disposition of these other matters are not anticipated to have a material adverse effect on the financial position, results of operations or cash flows of the Company.

10. Geographic Data

A summary of the Company's net revenues, operating (loss) income and long lived assets by geographic area for the three months ended March 31, 2007 and 2006, respectively, and at March 31, 2007 and December 31, 2006, are as follows (in thousands):

| | Three Months Ended March 31, | |
|---------------------------|-----------------------------------------|------------------|
| | 2007 | 2006 |
| <u>Net revenues:</u> | | |
| United States | \$ 8,433 | \$ 10,818 |
| International | 6,980 | 5,032 |
| Total net revenues | \$ 15,413 | \$ 15,850 |

SPAR Group, Inc.
Notes to Consolidated Financial Statements
(unaudited) (continued)

| | Three Months Ended March 31, | |
|--------------------------------------|-----------------------------------------|---------------|
| <u>Operating (loss) income:</u> | 2007 | 2006 |
| United States | \$ (273) | \$ 716 |
| International | (14) | (4) |
| Total operating (loss) income | \$ (287) | \$ 712 |

| | March 31, 2007 | December 31, 2006 |
|--------------------------------|---------------------------|----------------------------------|
| <u>Long lived assets:</u> | 2007 | 2006 |
| United States | \$ 3,293 | \$ 3,141 |
| International | 247 | 253 |
| Total long lived assets | \$ 3,540 | \$ 3,394 |

International revenues disclosed above were based upon revenues reported by the Company's nine international subsidiaries. The Japan subsidiary contributed 18% and 17% of the consolidated net revenue of the Company for the three months ended March 31, 2007 and 2006, respectively. Included in the international revenue for the three months ended March 31, 2006, was an additional quarter of revenue, totaling approximately \$1.3 million or 8% of the consolidated net revenue of the Company, associated with the change in reporting year of the Company's subsidiary in Japan. The Canadian subsidiary contributed 8% and 7% of the consolidated net revenue of the Company for the three months ended March 31, 2007 and 2006, respectively. The Australian subsidiary contributed 9% to the consolidated net revenue of the Company for the three months ended March 31, 2007. Each of the remaining foreign subsidiaries contributed less than 4% to the consolidated net revenue for the three months ended March 31, 2007 and 2006, respectively.

11. Supplemental Balance Sheet Information

| | March 31, 2007 | December 31, 2006 |
|---------------------------------------------------------------------|---------------------------|----------------------------------|
| Accounts receivable, net, consists of the following (in thousands): | | |
| Trade | \$ 8,102 | \$ 10,112 |
| Unbilled | 3,246 | 2,774 |
| Non-trade | 482 | 496 |
| | 11,830 | 13,382 |
| Less allowance for doubtful accounts | (330) | (400) |
| Accounts receivable, net | \$ 11,500 | \$ 12,982 |

SPAR Group, Inc.
Notes to Consolidated Financial Statements
(unaudited) (continued)

| | March 31, 2007 | December 31, 2006 |
|------------------------------------------------------------------------|---------------------------|----------------------------------|
| | <u> </u> | <u> </u> |
| Property and equipment, net, consists of the following (in thousands): | | |
| Equipment | \$ 5,514 | \$ 5,380 |
| Furniture and fixtures | 597 | 606 |
| Leasehold improvements | 943 | 568 |
| Capitalized software development costs | 1,557 | 1,508 |
| | <u>8,611</u> | <u>8,062</u> |
| Less accumulated depreciation and amortization | 7,315 | 7,161 |
| Property and equipment, net | <u>\$ 1,296</u> | <u>\$ 901</u> |

| | March 31, 2007 | December 31, 2006 |
|-----------------------------------------------------------------------------------------|---------------------------|----------------------------------|
| | <u> </u> | <u> </u> |
| Accrued expenses and other current liabilities consist of the following (in thousands): | | |
| Taxes payable | \$ 766 | \$ 489 |
| Accrued accounting and legal expense | 183 | 219 |
| Accrued salaries payable | 622 | 946 |
| Other | 1,402 | 1,210 |
| Accrued expenses and other current liabilities | <u>\$ 2,973</u> | <u>\$ 2,864</u> |

12. Foreign Currency Rate Fluctuations

The Company has foreign currency exposure associated with its international subsidiaries. In both 2007 and 2006, these exposures are primarily concentrated in the Canadian Dollar, South African Rand, Australian Dollar and Japanese Yen. At March 31, 2007, international assets totaled \$7.1 million and international liabilities totaled \$10.5 million. For 2007, international revenues totaled \$7.0 million and the Company's share of the net loss was approximately \$118,000.

13. Interest Rate Fluctuations

The Company is exposed to market risk related to the variable interest rate on its lines of credit. At March 31, 2007, the Company's outstanding debt totaled approximately \$3.6 million, as noted in the table below (in thousands):

| Location | Variable Interest Rate (1) | Local Currency Amount | US Dollars Equivalent (2) |
|-----------------|-----------------------------------|------------------------------|--------------------------------------|
| | <u> </u> | <u> </u> | <u> </u> |
| United States | 9.25% | 2,741 USD | \$ 2,741 |
| Japan | 1.63% | 70,000 YEN | 594 |
| Australia | 10.60% | 339 AUD | 274 |

Edgar Filing: SPAR GROUP INC - Form 10-Q

| <u>Location</u> | <u>Variable Interest Rate (1)</u> | <u>Local Currency Amount</u> | <u>US Dollars Equivalent (2)</u> |
|-----------------|-----------------------------------|------------------------------|----------------------------------|
| | | | \$ 3,609 |

(1) Based on interest rate at March 31, 2007.

(2) Based on exchange rate at March 31, 2007.

Based on the average outstanding borrowings under variable-rate debt, a one-percentage point increase in interest rates would negatively impact annual pre-tax earnings and cash flows for the three months ended March 31, 2007 by approximately \$11,100.

SPAR Group, Inc.
Notes to Consolidated Financial Statements
(unaudited) (continued)

14. Recently Issued Accounting Standards

In February 2007, the FASB issued SFAS No. 159 *The Fair Value Option for Financial Assets and Financial Liabilities – including an Amendment of SFAS No. 115* (SFAS No. 159), which permits an entity to measure many financial assets and financial liabilities at fair value that are not currently required to be measured at fair value. Entities that elect the fair value option will report unrealized gains and losses in earnings at each subsequent reporting date. The fair value option may be elected on an instrument-by-instrument basis, with few exceptions. SFAS No. 159 amends previous guidance to extend the use of the fair value option to available-for-sale and held-to-maturity securities. The Statement also establishes presentation and disclosure requirements to help financial statement users understand the effect of the election. SFAS No. 159 is effective as of the beginning of the first fiscal year beginning after November 15, 2007. Management is currently assessing the potential impact of this standard on SPAR's financial condition and results of operations.

15. Taxes

In July 2006, the FASB issued FASB interpretation No. 48 (FIN 48), *Accounting for Uncertainty in Income Taxes*. FIN 48 prescribes detailed guidance for the financial statement recognition, measurement and disclosure of uncertain tax positions recognized in an enterprise's financial statements in accordance with FASB Statement No. 109, *Accounting for Income Taxes*. Tax positions must meet a more-likely-than-not recognition threshold at the effective date to be recognized upon the adoption of FIN 48 and in subsequent periods. FIN 48 is effective for fiscal years beginning after December 15, 2006 and the provisions of FIN 48 will be applied to all tax positions upon initial adoption of the Interpretation. The Company has adopted FIN 48 as of January 1, 2007 and has reported on its financial statements the effects in this 10-Q report for the period ended March 31, 2007.

FIN 48 requires that interest and penalties that the tax law requires to be paid on the underpayment of taxes should be accrued on the difference between the amount claimed or expected to be claimed on the return and the tax benefit recognized in the financial statements. Management has made the policy to record this interest and penalties as additional tax expense.

SPAR and its subsidiaries file numerous consolidated, combined and separate company income tax returns in the U.S. Federal jurisdiction and in many U.S. state and foreign jurisdictions. With few exceptions, SPAR is subject to U.S. Federal, state and local income tax examinations for the years 2004 through the present. However, tax authorities have the ability to review years prior to the position taken by the Company to the extent that SPAR utilized tax attributes carried forward from those prior years.

The Company's tax reserves at December 31, 2006, \$140,000 for potential domestic state tax liabilities were sufficient to meet the requirements of FIN 48. However, the \$146,000 reserve for potential international tax liabilities were not sufficient to meet the adoption of FIN 48 and therefore, the Company recorded an adjustment to the accumulated deficit of \$145,000.

Details of the Company's FIN 48 reserves at March 31, 2007 are outlined in the table below (in thousands):

| | <u>Taxes</u> | <u>Interest</u> | <u>Penalty</u> | <u>Total Tax Liability</u> |
|----------------------|--------------|-----------------|----------------|----------------------------|
| Domestic | | | | |
| State | \$ 105 | \$ 17 | \$ 18 | \$ 140 |
| Federal | - | - | - | - |
| International | 251 | 14 | 26 | 291 |
| | <u>356</u> | <u>31</u> | <u>44</u> | <u>431</u> |
| Total FIN 48 Reserve | \$ 356 | \$ 31 | \$ 44 | \$ 431 |

SPAR Group, Inc.

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

Forward-Looking Statements

Statements contained in this Quarterly Report on Form 10-Q for the three months ended March 31, 2007 (this Quarterly Report), of SPAR Group, Inc. (SGRP, and together with its subsidiaries, the SPAR Group or the Company), include forward-looking statements (within the meaning of Section 27A of the Securities Act and Section 21E of the Exchange Act) that are based on the Company's best estimates. In particular and without limitation, this Management's Discussion and Analysis of Financial Condition and Results of Operations contains such forward-looking statements, which are included in (among other places) the discussions respecting net revenues from significant clients, significant chain work and international joint ventures, federal taxes and net operating loss carryforwards, commencement of operations and future funding of international joint ventures, credit facilities and covenant compliance, cost savings initiatives, liquidity and sources of cash availability. Forward-looking statements involve known and unknown risks, uncertainties and other factors that could cause the Company's actual results, performance and achievements, whether expressed or implied by such forward-looking statements, to not occur or be realized or to be less than expected. Such forward-looking statements generally are based upon the Company's best estimates of future results, performance or achievement, current conditions and the most recent results of operations. Forward-looking statements may be identified by the use of forward-looking terminology such as may, will, likely, expect, intend, believe, estimate, anticipate, continue or similar terms, variations of those terms or the negative of those terms. You should carefully consider such risks, uncertainties and other information, disclosures and discussions containing cautionary statements or identifying important factors that could cause actual results to differ materially from those provided in the forward-looking statements.

You should carefully review this management discussion and analysis together with the risk factors and other cautionary statements contained in the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2006, as filed with the Securities and Exchange Commission (the SEC) on April 2, 2007 and as amended on Form 10-K/A filed with the SEC on April 13, 2007 (the Company's Annual Report for 2006 on Form 10-K As Amended), including the risk factors described in Item 1 of that annual report under the caption Certain Risk Factors and the changes (if any) in such risk factors described in Item 1A of Part II of this Quarterly Report (collectively, Risk Factors), as well as the cautionary statements contained in this Quarterly Report. All forward-looking statements attributable to the Company or persons acting on its behalf are expressly qualified by the Risk Factors and other cautionary statements in this Quarterly Report and in the Company's Annual Report for 2006 on Form 10-K As Amended, which are incorporated by reference into this Quarterly Report. Although the Company believes that its plans, intentions and expectations reflected in or suggested by such forward-looking statements are reasonable, it cannot assure that such plans, intentions or expectations will be achieved in whole or in part. The Company undertakes no obligation to publicly update or revise any forward-looking statements, or any Risk Factors or other cautionary statements, whether as a result of new information, future events or otherwise, except as required by law.

Overview

Today the Company operates in 12 countries whose population represents approximately 48% of the total world population. The Company's operations are currently divided into two divisions: the Domestic Merchandising Services Division and the International Merchandising Services Division. The Domestic Merchandising Services Division provides merchandising and marketing services, in-store event staffing, product sampling, RFID services, technology services and marketing research to manufacturers and retailers in the United States. The various services are primarily performed in mass merchandisers, electronics store chains, drug store chains and convenience and grocery stores. The International Merchandising Services Division was established in July 2000 and through its

SPAR Group, Inc.

subsidiaries, the Company currently provides similar merchandising and marketing services in Japan, Canada, Turkey, South Africa, India, Romania, China, Lithuania, Latvia, Australia and New Zealand.

Domestic Merchandising Services Division

The Company's Domestic Merchandising Services Division provides nationwide merchandising and other marketing services primarily on behalf of consumer product manufacturers and retailers at mass merchandisers, electronic store chains, drug store chains and grocery stores. Included in its clients are home entertainment, general merchandise, health and beauty care, consumer goods and food product companies in the United States.

Merchandising and marketing services primarily consist of regularly scheduled dedicated routed services and special projects provided at the store level for a specific retailer or single or multiple manufacturers or distributors. Services also include stand-alone large-scale implementations. These services may include sales enhancing activities such as ensuring that client products authorized for distribution are in stock and on the shelf, adding new products that are approved for distribution but not presently on the shelf, setting category shelves in accordance with approved store schematics, ensuring that shelf tags are in place, checking for the overall salability of client products and setting new and promotional items and placing and/or removing point of purchase and other related media advertising. Specific in-store services can be initiated by retailers or manufacturers or distributors, and include new store openings and existing store resets, re-merchandising, remodels and category implementations, new product launches, special seasonal or promotional merchandising, focused product support and product recalls. The Company also provides in-store product demonstrations, in-store product sampling and other in-store event staffing services, RFID services, technology services and marketing research services.

International Merchandising Services Division

In July 2000, the Company established its International Merchandising Services Division, operating through a wholly owned subsidiary, SPAR Group International, Inc. (SGI), to focus on expanding its merchandising and marketing services business worldwide. The Company has expanded its international business as follows:

| Location | Ownership Percentage | Date Established |
|----------------------|----------------------|------------------|
| Osaka, Japan | 50% | May 2001 |
| Toronto, Canada | 100% | June 2003 |
| Istanbul, Turkey | 51% | July 2003 |
| Durban, South Africa | 51% | April 2004 |
| New Delhi, India | 51% | April 2004 |
| Bucharest, Romania | 51% | December 2004 |
| Hong Kong, China | 50% | February 2005 |
| Siauliai, Lithuania | 51% | September 2005 |
| Melbourne, Australia | 51% | April 2006 |

Critical Accounting Policies

There were no material changes to the Company's critical accounting policies as reported in the Company's Annual Report for 2006 on Form 10-K As Amended.

SPAR Group, Inc.

Results of Operations

Three months ended March 31, 2007, compared to three months ended March 31, 2006

The following table sets forth selected financial data and data as a percentage of net revenues for the periods indicated (in thousands, except percent data).

| | Three Months Ended March 31, | | | | |
|-----------------------------------------------------------------|------------------------------|--------|-----------|--------|-----------------------------|
| | 2007 | | 2006 | | Increase (decrease) % |
| | \$ | % | \$ | % | |
| Net revenues | \$ 15,413 | 100.0% | \$ 15,850 | 100.0% | (2.8)% |
| Cost of revenues | 10,294 | 66.8 | 9,854 | 62.2 | 4.5 |
| Selling, general & administrative expense | 5,209 | 33.8 | 5,071 | 32.0 | 2.7 |
| Depreciation and amortization | 197 | 1.3 | 213 | 1.3 | (7.4) |
| Interest expense | 89 | 0.6 | 51 | 0.3 | 73.0 |
| Other expense (income) | 21 | 0.1 | (178) | (1.1) | (111.9) |
| (Loss) income before income tax provision and minority interest | (397) | (2.6) | 839 | 5.3 | (147.3) |
| Provision for income taxes | 67 | 0.4 | 45 | 0.3 | 50.1 |
| (Loss) income before minority interest | (464) | (3.0) | 794 | 5.0 | (158.4) |
| Minority interest | 45 | 0.3 | 17 | 0.1 | 165.3 |
| Net (loss) income | \$ (509) | (3.3)% | \$ 777 | 4.9% | (165.5)% |

Net Revenues

Net revenues for the three months ended March 31, 2007, were \$15.4 million, compared to \$15.8 million for the three months ended March 31, 2006, a decrease of \$437,000.

International net revenues totaled \$7.0 million for 2007 compared to \$5.0 million in 2006. Included in international revenues for 2006 was an additional quarter of revenue totaling \$1.3 million resulting from the change in the reporting year for the Japanese subsidiary. Excluding the \$1.3 million, international 2007 net revenues increased \$3.3 million or 110% from 2006. The increase in international net revenues was due to additional revenues from international subsidiaries that began operations in the second half of 2006 totaling \$1.6 million (Australia \$1.4 million, Lithuania \$207,000) and increased net revenues from subsidiaries with operations continuing from 2006 totaling \$2.0 million (Japan \$1.5 million, India \$172,000, Turkey \$100,000, Canada \$173,000 and China \$52,000), partially offset by net revenue decreases in South African and Romania of \$266,000 and \$15,000, respectively.

Domestic net revenues totaled \$8.4 million in 2007 compared to \$10.8 million in 2006. Included in domestic revenue for 2006 was \$770,000 from the termination of a customer service agreement. Excluding the \$770,000, domestic net revenues decreased \$1.6 million primarily as a result of reduced business from a client that is in the process of selling its US operation, partially offset by revenue from new clients that started doing business with the Company in the fourth quarter of 2006.

Approximately 12% and 10% of the Company's net revenues for the three months ended March 31, 2007 and 2006, respectively, resulted from merchandising services performed for clients at a leading domestic electronics chain. Services performed for these clients in that electronics chain also accounted for approximately 5% and 7% of the Company's accounts receivable at March 31, 2007 and December 31, 2006, respectively. The Company's contractual relationships or agreements are with various clients and not that retail electronics chain.

SPAR Group, Inc.

One domestic client accounted for 8% and 13% of the Company's net revenue for the three months ended March 31, 2007, and 2006, respectively. This client also accounted for approximately 4% and 6% of accounts receivable at March 31, 2007, and December 31, 2006, respectively.

A second domestic client accounted for 6% and 12% of the Company's net revenue for the three months ended March 31, 2007, and 2006, respectively. This client also accounted for approximately 6% and 10% of accounts receivable at March 31, 2007, and December 31, 2006, respectively.

The loss of the ability to provide merchandising and marketing services in this chain and other chains or the loss of other clients could significantly decrease the Company's revenues and such decreased revenues could have a material adverse effect on the Company's business, results of operations and financial condition.

Cost of Revenues

Cost of revenues consists of in-store labor and field management wages, related benefits, travel and other direct labor-related expenses. Cost of revenues was 66.8% of net revenues for the three months ended March 31, 2007, compared to 62.2% for the three months ended March 31, 2006.

Domestic cost of revenues was 67.3% and 61.9% of net revenues for the three months ended March 31, 2007, and 2006, respectively. The \$770,000 of 2006 revenue attributed to the termination of a client service agreement favorably impacted 2006 cost of revenue by 4.8%.

Internationally, the cost of revenues as a percentage of net revenues was 66.1% and 62.7% for the three months ended March 31, 2007, and 2006, respectively. The international cost of revenues percentage increase was primarily attributable to higher cost revenues in Japan.

Approximately 82% and 86% of the Company's domestic cost of revenues in the three months ended March 31, 2007 and 2006, respectively, resulted from in-store independent contractor and field management services purchased from certain of the Company's affiliates, SPAR Marketing Services, Inc. (SMS), and SPAR Management Services, Inc. (SMSI), respectively (see Note 6 Related-Party Transactions).

Selling, General and Administrative Expenses

Selling, general and administrative expenses include corporate overhead, project management, information technology, executive compensation, human resource, legal and accounting expenses. Selling, general and administrative expenses increased by approximately \$138,000, or 2.7%, for the three months ended March 31, 2007 to \$5.2 million compared to \$5.1 million for the three months ended March 31, 2006.

International selling, general and administrative expenses totaled \$2.3 million for 2007 compared to \$1.9 million in 2006. Included in 2006 was an additional quarter of selling, general, and administrative expenses totaling \$544,000 resulting from the change in the reporting year for the Japanese subsidiary. Excluding the \$544,000, international 2007 selling, general, and administrative expenses increased \$1.0 million or 80.4% from 2006. The increase in international selling, general and administrative expenses was due to additional selling, general and administrative expenses from international subsidiaries that began operations in the second half of 2006 totaling \$482,000 (Australia \$420,000 and Lithuania \$62,000) and increased selling, general and administrative expenses from subsidiaries with operations continuing from 2006 totaling \$566,000 (Japan \$308,000, Canada 4,000, Turkey \$17,000, China \$43,000, India \$27,000 and \$52,000 in corporate international business development expenses), partially offset by decreases in selling, general and administrative expenses, South African \$36,000 and Romania \$9,000.

SPAR Group, Inc.

Domestic selling, general and administrative expenses totaled \$2.9 million in 2007 compared to \$3.2 million in 2006. The decrease in domestic selling, general and administrative expenses of \$300,000 is primarily the result of cost reductions initiated in 2006.

Depreciation and Amortization

Depreciation and amortization charges for the three months ended March 31, 2007 totaling \$197,000 were comparable with \$213,000 for the three months ended March 31, 2006.

Interest Expense

Interest expense totaled \$89,000 and \$51,000 for the three months ended March 31, 2007 and 2006, respectively. The increase in interest expense was a result of higher debt levels and interest rates in the first three months in 2007.

Other Expense

Other expense was \$21,000 for the three months ended March 31, 2007 compared to other income of \$178,000 for the three months ended March 31, 2006. Other income in 2006 was primarily a result of a favorable settlement of a vendor lawsuit of approximately \$175,000.

Income Taxes

Income taxes were approximately \$67,000 and \$45,000 for the three months ended March 31, 2007 and 2006, respectively. The tax provisions were primarily for minimum state taxes due. There were no tax provisions for federal tax as the Company reported a loss for the three months ended March 31, 2007, and in 2006 the Company was projecting to use net operating loss carryforwards to offset projected federal income taxes.

Minority Interest

The combined operating results of the 51% and the 50% owned subsidiaries generated net losses for both the three months ended March 31, 2007 and 2006. These losses resulted in a charge to minority interest of approximately \$45,000 and \$17,000, respectively.

Net Loss

The Company had a net loss of \$509,000 for the three months ended March 31, 2007, or \$0.03 per diluted share, compared to a net income of \$777,000, or \$0.04 per diluted share, for the corresponding period last year.

Liquidity and Capital Resources

In the three months ended March 31, 2007 the Company had a net loss of \$509,000.

Net cash provided by operating activities for the three months ended March 31, 2007 was \$3.0 million compared to net cash used in operating activities of \$184,000 for the prior year. The increase in net cash provided by operating activities was primarily due to decreases in accounts receivable and other assets, and increases in accounts payable and accrued expenses due to affiliates.

Net cash used in investing activities for the three months ended March 31, 2007 and March 31, 2006, was approximately \$346,000 and \$100,000, respectively. The increase in net cash used in investing activities was a result of increased purchases of property and equipment in 2007.

SPAR Group, Inc.

Net cash used in financing activities for the three months ended March 31, 2007 and March 31, 2006, was approximately \$1.7 million and \$282,000, respectively. The increase of net cash used in financing activities was primarily a result of increased payments on lines of credit.

The above activity resulted in an increase in cash and cash equivalents for the three months ended March 31, 2007, of approximately \$984,000.

At March 31, 2007, the Company had positive working capital of \$1.3 million, as compared to a positive working capital of \$1.6 million at December 31, 2006. The Company's current ratio was 1.10 at March 31, 2007, and 1.13 at December 31, 2006.

In January 2003, the Company (other than SGRP's foreign subsidiaries) and Webster Business Credit Corporation, then known as Whitehall Business Credit Corporation (Webster), entered into the Third Amended and Restated Revolving Credit and Security Agreement (as amended, collectively, the Credit Facility). The Credit Facility provides for a \$7.0 million revolving line of credit maturing on January 23, 2009. In March 2007 the credit facility was further amended to among other things, delay the Minimum Fixed Coverage ratio until the fourth quarter 2007, establish an EBITDA covenant and increase the interest rate by .25% beginning April 2007. Borrowings are based upon a borrowing base formula as defined in the agreement (principally 85% of eligible domestic accounts receivable). The Credit Facility is secured by all of the assets of the Company and its domestic subsidiaries. The Credit Facility also limits certain expenditures, including, but not limited to, capital expenditures and other investments.

The basic interest rate under the Credit Facility is Webster's Alternative Base Rate plus 0.75% per annum (a total of 9.0% per annum at March 31, 2007), which automatically changes with each change made by Webster in such Alternative Base Rate. The Company at its option, subject to certain conditions, may elect to have portions of its loans under the Credit Facility bear interest at various LIBOR rates plus 3.50% per annum based on fixed periods of one, two, three or nine months. The actual average interest rate under the Credit Facility was 9.0% per annum for the three months ended March 31, 2007.

The domestic revolving loan balances outstanding under the Credit Facility were \$2.7 million and \$4.2 million at March 31, 2007 and December 31, 2006, respectively. There were letters of credit outstanding under the Credit Facility of approximately \$453,000 at both March 31, 2007, and December 31, 2006. As of March 31, 2007, the SPAR Group had unused availability under the Credit Facility of \$1.1 million out of the remaining maximum \$3.8 million unused revolving line of credit after reducing the borrowing base by outstanding loans and letters of credit.

Because of the requirement to maintain a lock box arrangement with Webster and Webster's ability to invoke a subjective acceleration clause at its discretion, borrowings under the Credit Facility are classified as current at March 31, 2007 and December 31, 2006, in accordance with EITF 95-22, *Balance Sheet Classification of Borrowings Outstanding Under Revolving Credit Agreements That Include Both a Subjective Acceleration Clause and a Lock-Box Agreement*.

The Company was in violation of its Minimum EBITDA covenant at March 31, 2007, and in May 2007 Webster amended the Credit Facility to among other things, waive the violation and establish an availability reserve. The Company does not expect to comply with its covenants in future periods and is working with Webster to adjust them. In addition, Webster requested and Messrs. Brown and Bartels agreed to provide personal guarantees totaling \$1.0 million. However, there can be no assurances that Webster will adjust the future covenants or that the Company will be able to comply with the adjusted future covenants and that if the Company violates such adjusted covenants, Webster will continue to issue waivers in the future.

The Japanese subsidiary SPAR FM Japan, Inc. has line of credit agreements totaling 100 million Yen or approximately \$848,000 (based upon the exchange rate at March 31, 2007). The outstanding balances under the line

SPAR Group, Inc.

of credit agreements were 70 million Yen or approximately \$594,000 at March 31, 2007 and December 31, 2006 (based upon the exchange rate at those dates). The average interest rate was 1.625% per annum for the three months ended March 31, 2007. In addition, the Japan subsidiary had cash balances totaling 174 million Yen or approximately \$1.5 million (based upon the exchange rate at March 31, 2007).

In 2006, the Australian subsidiary SPARFACTS Australia Pty. Ltd. entered into a revolving line of credit arrangement with Oxford Funding Pty. Ltd. for \$1.1 million (Australian) or approximately \$889,000 (based upon the exchange rate at March 31, 2007). The outstanding balances under the line of credit were \$339,000 (Australian) or approximately \$274,000 and \$429,000 (Australian) or approximately \$339,000 at March 31, 2007 and December 31, 2006, respectively (based upon the exchange rate at these dates). The average interest rate was 10.6% per annum for the three months ended March 31, 2007.

On October 20, 2006, SPAR Canada Company, a wholly owned subsidiary, entered into a credit agreement with Royal Bank of Canada providing for a Demand Operating Loan for a maximum borrowing of \$1.0 million (Canadian) or approximately \$866,000 (based upon the exchange rate at March 31, 2007). The Demand Operating Loan provides for borrowings based upon a borrowing base formula as defined in the agreement (principally 75% of eligible accounts receivable less certain deductions). At March 31, 2007, SPAR Canada did not have any borrowings outstanding under the credit agreement. The outstanding balance on the credit agreement was \$238,000 (Canadian) or approximately \$204,000 at December 31, 2006 (based upon the exchange rate at that date).

The Company's international business model is to partner with local merchandising companies and combine the Company's proprietary software and expertise in the merchandising and marketing services business with their partner's knowledge of the local market. In 2001, the Company established its first subsidiary in Japan and has continued this strategy. As of this filing, the Company is currently operating in 12 countries and has 9 international subsidiaries. Certain of these subsidiaries are profitable, while others are operating at a loss. None of these entities have excess cash reserves. In the event of continued losses, the Company may be required to provide additional cash infusions into these subsidiaries.

Management believes that based upon the results of Company's operations and the existing credit facilities, sources of cash availability will be sufficient to support ongoing operations over the next twelve months. However, continued losses, delays in collection of receivables due from any of the Company's major clients, or a significant reduction in business from such clients could have a material adverse effect on the Company's cash resources and its ongoing ability to fund operations.

Certain Contractual Obligations

The following table contains a summary of certain of the Company's contractual obligations by category as of March 31, 2007 (in thousands).

| Contractual Obligations | Payments due by Period | | | | |
|-----------------------------|------------------------|------------------|-----------|-----------|-------------------|
| | Total | Less than 1 year | 1-3 years | 3-5 years | More than 5 years |
| Credit Facility | \$3,609 | \$3,609 | - | \$ - | \$ - |
| Capital Lease Obligations | 401 | 100 | 301 | - | - |
| Operating Lease Obligations | 2,189 | 810 | 1,128 | 251 | - |
| Total | \$6,199 | \$4,519 | \$1,429 | \$251 | \$ - |

The Company also had approximately \$453,000 in outstanding Letters of Credit at March 31, 2007.

SPAR Group, Inc.
Item 3. Quantitative and Qualitative Disclosures about Market Risk

The Company's accounting policies for financial instruments and disclosures relating to financial instruments require that the Company's consolidated balance sheets include the following financial instruments: cash and cash equivalents, accounts receivable, accounts payable and lines of credit. The Company carries current assets and liabilities at their stated or face amounts in its consolidated financial statements, as the Company believes those amounts approximate the fair value for these items because of the relatively short period of time between origination of the asset or liability and their expected realization or payment. The Company monitors the risks associated with asset and liability positions, as well as interest rates. The Company's investment policy objectives require the preservation and safety of the principal, and the maximization of the return on investment based upon the safety and liquidity objectives.

The Company is exposed to market risk related to the variable interest rate on its lines of credit. At March 31, 2007, the Company's outstanding debt totaled \$3.6 million, as noted in the table below (in thousands):

| <u>Location</u> | <u>Variable Interest Rate</u> | | <u>US Dollars Equivalent</u> |
|-----------------|-------------------------------|----------------------------------|------------------------------|
| | | <u>(1) Local Currency Amount</u> | <u>(2)</u> |
| United States | 9.25% | 2,741 USD | \$2,741 |
| Japan | 1.63% | 70,000 YEN | 594 |
| Australia | 10.60% | 339 AUD | 274 |
| | | | \$3,609 |

(1) Based on interest rate at March 31, 2007.

(2) Based on exchange rate at March 31, 2007.

Based on the 2007 average outstanding borrowings under the Company's variable interest on its lines of credit, a one-percentage point increase in interest rates would negatively impact annual pre-tax earnings and cash flows for the three months ended March 31, 2007, by approximately \$11,100.

The Company has foreign currency exposure associated with its international subsidiaries. In both 2007 and 2006, these exposures are primarily concentrated in the Canadian Dollar, South African Rand, Australian Dollar and Japanese Yen. At March 31, 2007, international assets totaled \$7.1 million and international liabilities totaled \$10.5 million. For 2007, international revenues totaled \$7.0 million and the Company's share of the net loss was approximately \$118,000.

Item 4. Controls and Procedures

The Company's Chief Executive Officer and Chief Financial Officer evaluated the effectiveness of the Company's disclosure controls and procedures (as defined in Exchange Act Rules 13a-14 and 15d-14) as of the end of the period covering this report. Based on this evaluation, the Chief Executive Officer and Chief Financial Officer concluded that the Company's disclosure controls and procedures are effective to provide reasonable assurance that information required to be disclosed by the Company in the reports that it files or submits under the Exchange Act is recorded, processed, summarized and reported within the time periods specified by the Securities and Exchange Commission's rules and forms.

There were no significant changes in the Company's internal controls or in other factors that could significantly affect these controls during the three months covered by this report or from the end of the reporting period to the date of this Form 10-Q.

The Company has established a plan and has begun to document and test its domestic internal controls over financial reporting and is currently developing a detailed plan to document and test internal controls for its international operations as required by Section 404 of the Sarbanes-Oxley Act of 2002.

SPAR Group, Inc.

PART II: OTHER INFORMATION

Item 1. Legal Proceedings

Safeway Inc. (Safeway) filed a Complaint against PIA Merchandising Co., Inc. (PIA Co.), a wholly owned subsidiary of SPAR Group, Inc. (SGRP), Pivotal Sales Company (Pivotal), a wholly owned subsidiary of PIA Co., and SGRP in Alameda Superior Court, case no. 2001028498 on October 24, 2001. Safeway claims, as subsequently amended, alleged causes of action for breach of contract and breach of implied contract. PIA Co. and Pivotal filed cross-claims against Safeway on or about March 11, 2002, and amended them on or about October 15, 2002, alleging causes of action by PIA Co. and Pivotal against Safeway for breach of contract, interference with economic relationship, unfair trade practices and unjust enrichment. Trial commenced in March 2006.

On May 26, 2006, the jury in this case returned a verdict resulting in a net award of \$1,307,700 to Pivotal, a SGRP subsidiary. This net award is to be paid by Safeway and resulted from separate jury findings that awarded damages to those SGRP subsidiaries on certain claims and damages to Safeway on other claims. In particular, the jury awarded damages to Pivotal of \$5,760,879 for Safeway's interference with Pivotal's contractual relationships with third party manufacturers and also awarded \$782,400 to Pivotal and PIA for Safeway's breach of contract with those SGRP subsidiaries. The jury awarded damages to Safeway of \$5,235,579 for breach of contract by SGRP and those SGRP subsidiaries. Judgment was entered in favor of Pivotal in September 2006 for \$1,307,700. Both parties filed post trial motions but all post trial motions were denied. Notices of Appeal were thereafter filed by both Safeway and Pivotal. Pivotal/SGRP is seeking to have Safeway's judgment overturned, thereby increasing the award to Pivotal by over \$5 million. Safeway has asked for a new trial on the judgment found against it. The appellate process is expected to take fourteen to twenty four months to complete. In the interim, the court has ordered a mediation of the dispute that is to take place during May 2007.

In addition to the above, the Company is a party to various other legal actions and administrative proceedings arising in the normal course of business. In the opinion of Company's management, disposition of these other matters are not anticipated to have a material adverse effect on the financial position, results of operations or cash flows of the Company.

There have been no other new reportable proceedings or material developments in previously reported proceedings since the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2006, as filed with the Securities and Exchange Commission (the SEC) on April 2, 2007, as amended on Form 10-K/A by Amendment No. 1 filed with the SEC on April 13, 2007, (the Company's Annual Report for 2006 on Form 10-K As Amended).

Item 1A. Risk Factors

The Company's Annual Report for 2006 on Form 10-K As Amended describes various risk factors applicable to the Company and its businesses in Item 1 under the caption "Certain Risk Factors", which risk factors are incorporated by reference into this Quarterly Report. There have been no material changes in the Company's risk factors since the Company's Annual Report for 2006 on Form 10-K As Amended.

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

Item 2(a): Not applicable

Item 2(b): Not applicable

Item 2(c): Not applicable

SPAR Group, Inc.

Item 3: Defaults upon Senior Securities

Item 3(a): Defaults under Indebtedness: None.

Item 3(b): Defaults under Preferred Stock: Not applicable.

Item 4: Submission of Matters to a Vote of Security Holders

Not applicable.

Item 5: Other Information

Not applicable.

Item 6: Exhibits

- 10.1 Waiver and Amendment No. 9 To Third Amended and Restated Revolving Credit and Security Agreement entered into as of May 18, 2007.
- 10.2 Limited Guaranty of Robert G. Brown in favor of Webster Business Credit Corporation, dated as of May 18, 2007.
- 10.3 Limited Guaranty of William H. Bartels in favor of Webster Business Credit Corporation, dated as of May 18, 2007.
- 31.1 Certification of the CEO pursuant to 18 U.S.C. Section 1350 adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002, as filed herewith.
- 31.2 Certification of the CFO pursuant to 18 U.S.C. Section 1350 adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002, as filed herewith.
- 32.1 Certification of the CEO pursuant to 18 U.S.C. Section 1350 adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, as filed herewith.
- 32.2 Certification of the CFO pursuant to 18 U.S.C. Section 1350 adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, as filed herewith.

SPAR Group, Inc.

SIGNATURES

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

Date: May 21, 2007

SPAR Group, Inc., Registrant

By: /s/ Charles Cimitile
Charles Cimitile
Chief Financial Officer, Treasurer, Secretary
and duly authorized signatory

26