SPECTRUM SCIENCES & SOFTWARE HOLDINGS INC
Form 10QSB
August 23, 2004

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-QSB

(Mark One)

[X] QUARTERLY REPORT UNDER SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

FOR THE QUARTERLY PERIOD ENDED: June 30, 2004

OR

[ ] TRANSITION REPORT UNDER SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the transition period from ________ to __________

Commission file number _000-50373__

SPECTRUM SCIENCES & SOFTWARE HOLDINGS CORP.

(Exact name of small business issuer as specified in its charter)

DELAWARE	80-0025175
(State or other jurisdiction of incorporation or organization)	(IRS Employer Identification No.)

91 HILL AVENUE NW,
FORT WALTON BEACH, FLORIDA 32548
(Address of principal executive offices)
(Zip Code)

Issuer's telephone number (850) 796-0909

Check whether the issuer (1) filed all reports required to be filed by Section 13 or 15(d) of the Exchange Act 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 [X] No [ ]

As of June 30, 2004 there were 40,069,300 shares of the registrant's common stock, par value $0.0001, issued and outstanding.

Transitional Small Business Disclosure Format (check one):
Yes [ ] No [X]

SPECTRUM SCIENCES & SOFTWARE HOLDINGS CORP.
JNUE 30, 2004 QUARTERLY REPORT ON FORM 10-QSB

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SPECIAL NOTE REGARDING FORWARD-LOOKING STATEMENTS

To the extent that the information presented in this Quarterly Report on Form 10-QSB for the quarter ended June 30, 2004, discusses financial projections, information or expectations about our products or markets, or otherwise makes statements about future events, such statements are forward-looking. We are making these forward-looking statements in reliance on the safe harbor provisions of the Private Securities Litigation Reform Act of 1995. Although we believe that the expectations reflected in these forward-looking statements are based on reasonable assumptions, there are a number of risks and uncertainties that could cause actual results to differ materially from such forward-looking statements. These risks and uncertainties are described, among other places in this Quarterly Report, in "Management's Discussion and Analysis or Plan of Operations."

In addition, we disclaim any obligations to update any forward-looking statements to reflect events or circumstances after the date of this Quarterly Report. When considering such forward-looking statements, you should keep in mind the risks referenced above and the other cautionary statements in this Quarterly Report.

SPECTRUM SCIENCES & SOFTWARE HOLDINGS CORP.
Consolidated Balance Sheet
As of June 30, 2004
(Unaudited)

ASSETS

Current assets:	
Cash and equivalents	$ 6,049,442
Investments	22,543,386
Receivables	2,898,269
Inventories	372,610
Prepaid expenses	239,256
Total current assets	32,102,963
Property and equipment, net	2,042,653
Deferred tax asset	40,034
Cash surrender value of life insurance	38,665
Other assets and deposits	40,358
TOTAL ASSETS	$ 34,264,673

LIABILITIES AND STOCKHOLDERS' EQUITY

Current liabilities:	
Accounts payable	$ 744,877
Accrued expenses	927,138
Notes payable	1,702,981
Total current liabilities	3,374,996
Total liabilities	3,374,996
Stockholders' equity:	
Preferred stock, $0.0001 par value; 20,000,000 shares authorized, none issued	-
Common stock, $0.0001 par value; 80,000,000 shares authorized, 40,069,300 issued and outstanding	4,007
Additional paid-in capital	72,104,521
Accumulated comprehensive income	13,781

Accumulated deficit	(41,232,632)
Total stockholders' equity	30,889,677
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	$ 34,264,673

See accompanying notes to the consolidated financial statements.

SPECTRUM SCIENCES & SOFTWARE HOLDINGS CORP.
Consolidated Statements of Operations
For the three months ended June 30, 2004 and 2003
(Unaudited)

	2004	2003
Revenues	3,418,747	3,443,361
Cost of Revenues	3,054,924	3,011,137
Gross Profit	363,823	432,224
Operating Expenses	27,053,790	275,170
Impairment Loss	-	145,974
Income (loss) from operations	(26,689,967)	11,080
Other Income (expense)	-	
Interest Income	25,845	52
Building Rent	49,561	45,351
Other Income and Expense	(2,871)	(4,118)
Interest Expense	(64,052)	(80,365)
Penalties	(31)	(2,587)
Total other income (expense)	8,452	(41,667)
Loss before provision for income taxes	(26,681,515)	(30,587)
Income tax benefit	-	-
Net loss	(26,681,515)	(30,587)
Unrealized gain on available for sale securities	13,781	-
Total comprehensive loss	(26,667,734)	(30,587)

Weighted average common shares outstanding:

Basic and diluted	36,795,363	-
Loss per share:		
Basic and diluted	(.72)	-

See accompanying notes to the consolidated financial statements.

SPECTRUM SCIENCES & SOFTWARE HOLDINGS CORP.
Consolidated Statements of Operations
For the six months ended June 30, 2004 and 2003
(Unaudited)

	2004	2003
Revenues	$ 7,015,325	$ 6,716,390
Cost of revenues	(6,329,305)	(6,053,574)
Gross profit	686,020	662,816
Operating expenses	41,005,374	439,640
Impairment Loss	-	145,974
Income (loss) from operations	(40,319,354)	77,202
Other income and expense:		
Interest income	26,210	-
Building rent	99,121	90,702
Other income	1,985	(19,164)
Interest expense	(127,903)	(149,145)
Other expenses	(3,912)	-
Total other income (expense)	(4,499)	(77,607)
Net loss before provision for income taxes	(40,323,853)	(405)
Income tax benefit	61,330	-
Net loss	(40,262,523)	(405)
Unrealized gain on available for sale securities	13,781	-
Total comprehensive loss	$(40,248,742)	$ (405)
Weighted average common shares outstanding	27,505,843	-

Basic and diluted loss per share	$ (1.46)	-

See accompanying notes to the consolidated financial statements.

SPECTRUM SCIENCES & SOFTWARE HOLDINGS CORP.
Consolidated Statements of Changes in Stockholders' Equity
For the six months ended June 30, 2004
(Unaudited)

	Common Stock			Accumulated	
	Shares Outstanding	Amount	APIC	Comprehensive Income	Acc D
Balance at January 1, 2004	18,851,000	$ 1,885	$ 79,426		$
Stock options issued for consulting services		-	37,258,300		
Exercise of stock options	21,178,300	2,118	37,095,567		
Stock subscription receivable			(2,520,126)		
Stock options issued under employee stock option plan to a consultant			125,358		
Exercise of stock options	40,000	4	65,996		
Unrealized gain on investments				13,781	
Net loss					(40
Balances at June 30, 2004	40,069,300	$ 4,007	$72,104,521	$ 13,781	$(41

See accompanying notes to the consolidated financial statements.

SPECTRUM SCIENCES & SOFTWARE HOLDINGS CORP.
Consolidated Statements of Cash Flows
For the six months ended June 30, 2004 and 2003
(Unaudited)

	2004	20

Cash flows from operating activities:		
Net income (loss)	$(40,262,523)	$
Adjustments to reconcile net income (loss) to net cash flows from operating activities:		
Impairment Loss		145
Deferred taxes	(28,594)	
Depreciation and amortization	72,083	39
Amortization of investment bond premium	8,496	
Accrued interest payable due to related parties	9,792	
Issuance of common stock options to related party for consulting services	37,258,300	
Issuance of common stock options under employee stock option plan	125,358	
Investor relations expenses paid by a related party	2,057,500	
(Increase) decrease in:		
Receivables	(1,170,385)	272
Inventories	(250,218)	62
Prepaid expenses	(220,533)	(67
Other assets	(26,999)	1
Increase (decrease) in:		
Accounts payable	(525,982)	(338
Accrued expenses	368,557	(180
Contract deposits	(50,000)	(30
Deferred revenues	(36,967)	
Net cash flows used in operating activities	(2,672,115)	(96
Cash flows from investing activities:		
Net purchases of available for sale investments	(22,538,101)	
Purchase of property and equipment	(109,993)	(20
Net cash used in investing activities	(22,648,094)	(20
Cash flows from financing activities:		
Principal payments on notes payable and lines of credit	(753,318)	(272
Net repayment on bank line of credit	-	16
Repayment of short term debt	(307,726)	
Repayments on advances from related parties	(52,500)	
Advances from related parties	672,551	2
Proceeds from the exercise of stock options	31,113,685	
Net cash provided by (used in) financing activities	30,672,692	(252
Net increase (decrease) in cash	5,352,483	(369
Cash at beginning of period	696,959	633
Cash at end of period	$ 6,049,442	$ 264
Supplemental disclosures of cash flow information:		
Cash paid during the quarter for:		
Interest	$ 127,903	$ 149
Supplemental schedule of non-cash financing and investing activities:		
Reduction in due to related party in lieu of cash payment for exercise of stock options.	$ 3,529,873	$

Unrealized gain on available for sale securities	$ 13,781	$

See accompanying notes to the consolidated financial statements.

Notes to the Consolidated Financial Statements
Three and Six Months ended June 30, 2004 (Unaudited)

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES:

(A) Organization and Nature of Business
Silva Bay International, Inc., a Delaware corporation, was formed in 1998 for the purpose of locating and recovering rare and valuable aircraft. Silva Bay International, Inc. had no operations and no revenue from inception in 1998 to the time of the acquisition of Spectrum Sciences & Software, Inc. in April, 2003.

Spectrum Sciences & Software, Inc. was incorporated in the State of Florida on October 8, 1982. Headquartered in Fort Walton Beach, Florida, the Company has three reportable segments - management services, manufacturing, and engineering and information technology services. Management services include providing engineering, technical, and operational services in the area of defense range management specializing in bombing and gunnery training range operation and maintenance. Manufacturing operations include the design and construction of munitions ground support equipment and containers for the shipping and storage of munitions and equipment. The Company's engineering and information technology services segment consists of the sale of computer software developed to assist in hazard management and weapons impact analysis.

On April 2, 2003, Silva Bay International, Inc. acquired Spectrum Sciences & Software, Inc., a Florida corporation, in exchange for the issuance of 2,500,000 shares of common stock (taking into account the forward two for one stock split of April 9, 2003) (see Note 3). Spectrum Sciences & Software, Inc. is now the wholly owned subsidiary of Silva Bay International, Inc. (now collectively referred to as the "Company").

On April 8, 2003, Silva Bay International, Inc. changed its name to Spectrum Sciences & Software Holdings Corp. On April 9, 2003, the Company effectuated a two for one forward split of its common stock. On November 4, 2003, the Company's registration statement as a reporting company under the Exchange Act became effective.

The Company's contracts are primarily fixed price contracts with the United States Department of Defense (DOD). During the three months and six months ended June 30, 2004, 99% of the Company's revenues were derived from such contracts.

(B) Income Taxes
The Company accounts for income taxes utilizing the asset and liability method. This approach requires the recognition of deferred tax assets and liabilities for the expected future tax consequences attributable to temporary differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases and operating loss and tax credit carryforwards. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enacted date. Valuation allowances are

established when necessary to reduce deferred tax assets to the amount expected to be realized.

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES, CONTINUED:

(B) Income Taxes, Continued

The Company currently has a net operating loss carryforward of $40,300,000, which would equate to a deferred tax asset of approximately $16,000,000 at June 30, 2004. The Company has not recorded that federal tax benefit in the accompanying financial statements, as management does not have sufficient information to estimate when or to the extent to which the Company will realize the tax benefit.

(C) Earnings (Loss) Per Share

The Company reports its earnings (loss) per share in accordance with Financial Accounting Standards Board (FASB) Statement No. 128, "Earnings Per Share." Statement No. 128 requires the presentation of basic and diluted loss per share on the face of the statement of operations. Net income (loss) per common share is computed by dividing the net income (loss) by the weighted average number of common shares outstanding for the period. Diluted net income (loss) per common share reflects the potential dilution that could occur if stock options were exercised.

The weighted average number of common shares outstanding for computing basic and diluted net income (loss) per common share for the six months ended June 30, 2004 was 27,505,843.

(D) Financial Instruments

The Company considers all highly liquid interest-earning investments with a maturity of three months or less at the date of purchase to be cash equivalents. All cash and investments are classified as available for sale and are recorded at market value using the specific identification method; unrealized gains and losses are reflected in Other Comprehensive Income ("OCI").

Investments consist of debt instruments. Debt securities are classified as available for sale and are recorded at market using the specific identification method. Unrealized gains and losses (excluding other-than-temporary impairments) are reflected in OCI.

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES, CONTINUED:

2. BASIS OF PRESENTATION

The accompanying unaudited consolidated financial statements for the three and six month periods ended June 30, 2004 and 2003 have been prepared in accordance with accounting principles generally accepted in the United States of America for interim financial information and pursuant to the rules and regulations of the Securities and Exchange Commission for Form 10-QSB. Accordingly, they do not include all the information and footnotes required by accounting principles generally accepted in the United States of America for complete financial statements. In the opinion of management, the accompanying unaudited consolidated financial statements contain all adjustments, consisting only of normal recurring accruals, considered necessary for a fair presentation of the Company's financial position, results of operations, and cash flows for the periods presented.

The results of operations for the interim periods ended June 30, 2004 and 2003 are not necessarily indicative of the results to be expected for the full year. These interim consolidated financial statements should be read in conjunction with the December 31, 2003 consolidated financial statements.

3. ACQUISITION OF SPECTRUM SCIENCES & SOFTWARE, INC.:

On April 3, 2003, Spectrum Sciences & Software Holdings Corp. (formerly Silva Bay International, Inc.) entered into an amended and restated agreement and plan of merger with Spectrum Sciences & Software, Inc., pursuant to which Spectrum Sciences & Software, Inc. became Spectrum Sciences & Software Holdings Corp.'s wholly owned subsidiary. As part of this agreement, 2,500,000 shares of the Company's common stock were issued to Donal Myrick, the sole stockholder of Spectrum Sciences & Software, Inc.

The acquisition was accounted for under the purchase method of accounting; accordingly, the purchase price has been allocated to reflect the fair value of assets and liabilities acquired at the date of acquisition. Due to the composition of the majority of the governing body and senior management of the Company being the same as Spectrum Sciences & Software, Inc. prior to the April 3, 2003 acquisition, Spectrum Sciences & Software, Inc. has been deemed to be the accounting acquirer (a reverse acquisition).

The financial statements of the Company prior to April 3, 2003 are those of Spectrum Sciences & Software, Inc. The results of operation of the acquired business have been included in the accompanying consolidated financial statements from the date of acquisition.

4. CASH AND INVESTMENTS:

Cash and investments consist of the following at June 30, 2004:

	Cost Basis	Unrealized Gains	Unrealized Losses	Recorded Basis
June 30, 2004				
Cash and equivalents:				
Cash	$ 1,572,445	$ -	$ -	$ 1,572,445
Money market mutual funds	4,476,997	-	-	4,476,997
Cash and equivalents	6,049,442	-	-	6,049,442
Investments:				
Certificate of deposit	500,000			500,000
U.S. government and agency securities	21,927,654	13,781	-	21,941,435
Bond premium, net of amortization	101,951	-	-	101,951
Total, investments	$22,529,605	$ 13,781	$ -	$22,543,386

5. RECEIVABLES:

Receivables, which are primarily comprised of amounts due to the Company for work performed on contracts directly related to the U.S. Department of Defense and through U.S. Department of Defense contractors, consisted of the following at June 30, 2004:

Contracts - billed	$ 2,591,838
Contracts - unbilled	298,355
Other receivables	8,076
	$ 2,898,269

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6. INVENTORIES:

Inventories are valued at the lower of cost or market. Cost is determined using the first-in, first-out method. The major components of inventories at June 30, 2004 are summarized as follows:

Raw materials, net of reserve	$ 113,888
Work in process	258,722
Total inventories	372,610

7. PROPERTY AND EQUIPMENT:

Property and equipment at June 30, 2004 is summarized as follows:

Land	$ 175,000
Buildings and improvements	1,633,520
Furniture and fixtures	28,721
Equipment	990,787
Vehicles	55,390
Investment property	220,900
	3,104,318
Less accumulated depreciation	(1,061,665)
Property and equipment, net	$ 2,042,653

8. ACCRUED EXPENSES:

The major components of accrued expenses at June 30, 2004 are summarized as follows:

Accrued salaries and related benefits	$ 764,409
Payroll related taxes	17,457
Accrued vacation and sick leave	116,976
Accrued interest payable	11,965
Accrued property taxes	16,331
Total accrued expenses	$ 927,138

9. LONG TERM DEBT:

Long term debt at June 30, 2004 consists of the following:

Note payable to a bank, due in monthly installments of $14,870, including interest at 8.50%. Final balloon payment of $1,476,298 due April 1, 2005, collateralized by real estate and a personal guarantee of the former Company President.	$ 1,514,49
Note payable to a bank, due in monthly installments of $1,588, including interest at 8.75%. Final Balloon payment due April 1, 2005, collateralized by a condominium and a personal guarantee of the former Company President.	188,49
	1,702,98
Less current portion	(1,702,98
Total long-term debt	$

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10\. RELATED PARTY TRANSACTIONS:

Transactions related to BG Capital Group Limited, Endeavor Group, LLC and Related Stockholder

The Company was provided management consulting services by Endeavor Capital Group, LLC, which is owned by one of the stockholders of the Company. The terms of the original consulting agreement between Endeavor Capital Group, LLC and the Company was from March 1, 2003, to March 1, 2004. Consulting fees of $4,000 a month for January and February, 2004 and expenses of $15,106 are reported as consulting fees in the accompanying financial statements.

On March 11, 2004, the Company entered into a new consulting agreement with the stockholder. The term of the agreement was for a one year period, and the stockholder is tasked with bringing to the Company's attention potential or actual opportunities which meet its business objectives or logical extensions thereof, alert the Company to new or emerging high potential forms of production and distribution, comment on corporate development, identify respective suitable merger or acquisition candidates and related due diligence and other such planning and development services as shall be requested by the Company.

On March 11, 2004, as a result of execution of the new consulting agreement, the stockholder received options to purchase 9,000,000 shares of the Company's common stock at a per share exercise price equal to the lesser of $1.65 or the fair market value at the time of exercise. In accordance with FASB Statement No. 123, Accounting for Stock-based Compensation, the Company recorded consulting expense of $11,418,038 in the first quarter of 2004, based on the fair value of the stock options at the date of grant using the Black-Scholes pricing model.

On April 16, 2004, the Company and the stockholder amended and restated the March 11, 2004, consulting agreement. The amended agreement extended the term of the contract to April 19, 2006, and contains an exclusivity provision. As part of that agreement, the stockholder was issued options to acquire an additional 9,000,000 shares of common stock at a per share exercise price equal to the lesser of $1.95 or 60% of the closing price on the day preceding notice to exercise. In addition, the stockholder was issued options to acquire 5,000,000 shares of common stock at an exercise price equal to the lesser of a $1.65 or the fair market value at the time of exercise as a result of his role in the Inland Fabricators LLC (IFAB) transaction which is further described in Part II, Item 1 of this filing. In accordance with FASB Statement No. 123, the Company recorded consulting expense of $25,840,262 in the second quarter of 2004, based on the fair value of the stock options at the date of grant using the Black-Scholes pricing model. The total options granted to the stockholder during the six months ended June 30, 2004, were 23,000,000.

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10. RELATED PARTY TRANSACTIONS, Continued

Transactions related to BG Capital Group Limited, Endeavor Group, LLC and Related Stockholder, Continued

The stockholder exercised 21,178,300 options during the first six months of 2004 with an aggregate exercise price of $37,097,685. The Company received $31,047,685 of cash from the stockholder and converted outstanding debt of $3,529,873 owed to the stockholder and related companies in lieu of cash for exercise of these options. The Company owed the stockholder $792,030 at December 31, 2003. The stockholder had advanced the Company $672,551 during the first four months of 2004 to pay operating expenses, and the Company had accrued interest of $7,792 on two interest-bearing notes in the first quarter of 2004. In addition, the stockholder paid for certain investor relations expenses totaling $2,065,000 during the first quarter of 2004 on behalf of the Company. During the second quarter of 2004 the Company reversed $7,500 of those expenses bringing the total investor relations expense paid by the stockholder on behalf of the Company to $2,057,500. As a result of these transactions the Company is owed $2,520,126 by the stockholder at June 30, 2004 which amount has been netted against stockholder equity.

These transactions are summarized in the following table:

Amount owed to stockholder & related entities at December 31, 2003	$ 792,0
Advances by stockholder during January through April, 2004, to pay operating expenses	672,5
Interest accrued on outstanding notes payable	7,7
Investor relations expenses paid by stockholder	2,057,5
Stock exercise - executed for debt on March 12, 2004	(1,485,0
Stock exercise - executed for debt on March 19, 2004	(1,650,0
Stock exercise - executed April 15, 2004, for which no payment was received	(1,815,0
Stock exercise - partially executed for debt on April 16, 2004	(1,100,0
Total	$(2,520,1

On April 28, 2004, the Company was informed the SEC was conducting an informal inquiry into the Company as further described in Part II, Item 5 of this filing. As a result of this inquiry, on May 4, 2004, the Company suspended the consulting agreement with this stockholder.

Transactions related to the spouse of the President of the Company

The Company in the second quarter of 2004 repaid $52,500 to the spouse of the President of the Company. $50,000 was funds advanced to cover operating expenses in 2003 and $2,500 represented interest.

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11. STOCK OPTION PLAN:

On March 11, 2004, the board of directors approved and adopted a 2004 Non-Statutory Stock Option Plan for 10,000,000 shares of common stock to be granted to employees, non-employee Directors, consultants and advisors. The vesting and terms of all of the options are determined by the Board of Directors and may vary by optionee; however, the term may be no longer than 10 years from the date of grant. On April 16, 2004, the Board of Directors amended and restated the stock option plan by increasing the number of shares from 10,000,000 to 30,000,000.

As of June 30, 2004, 23,000,000 options were granted to a non-employee stockholder who provided consulting services to the Company as described in Note 10. FASB Statement No. 123, Accounting for Stock-based Compensation, requires these options be valued at fair value at the date of grant. The fair value of the first 9,000,000 options issued was estimated at the date of grant using the Black-Scholes option pricing model with the following weighted-average assumptions: risk-free interest rate of 1%; no dividend yields; volatility factors of the expected market price of our common stock of 0.62; and an expected life of the options of 2 years. This generates a price of $1.27 per option at the date of grant, which was March 11, 2004. As a result, $11,418,038 of consulting expense and additional paid-in capital was recorded at the date of grant. The fair value of the remaining 14,000,000 options issued was estimated at the date of grant using the Black-Scholes option pricing model with the following weighted-average assumptions: risk-free interest rate of 1%; no dividend yields; volatility factors of the expected market price of our common stock of 0.67; and an expected life of the options of 2 years. This generates a price of $1.85 per option at the date of grant, which was April 20, 2004. As a result, $25,840,261 of consulting expense and additional paid-in capital was recorded at the date of grant.

On April 20, 2004, the Company awarded 677,500 stock options to certain employees, consultants, officers and directors for services rendered. The Company applied the intrinsic value method of recognition and measurement under Accounting Principles Board Opinion No. 25 (APB No. 25), "Accounting for Stock Issued to Employees," to 602,500 stock options. As such no compensation expense related to 602,500 employee stock options at the date of grant is reflected in net income.

The remaining 75,000 options were issued to an individual who is a consultant to the company. On April 28, 2004, that consultant exercised 40,000 options and the company received $66,000 of cash at exercise. These options were valued at the fair market value at the date of grant in accordance with FASB statement 123, Accounting for Stock Compensation. The fair value of these options issued was estimated at the date of grant using the Black-Scholes option pricing model with the following weighted average assumptions: risk free interest rate 1%; no dividend yields; volatility factors of the expected market price of our common stock of .67; and an expected life of the option of one year. This generates a price of $1.67 per option at the date of grant. As a result, $125,358 of consulting expense and additional paid in capital were recorded at the date of grant.

12. SEGMENT INFORMATION:

Segment information has been presented on a basis consistent with how business activities are reported internally to management. Management evaluates operating profit by segment taking into account direct costs of each segment's products and services as well as an allocation of indirect corporate overhead costs. The Company has three operating segments - management services, manufacturing, and engineering and information technology. Management services include providing engineering, technical, and operational services in the area of defense range management specializing in bombing and gunnery training range operation and maintenance. Manufacturing operations include the design and

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construction of munitions ground support equipment and containers for the shipping and storage of munitions and equipment. The Company's engineering and information technology segment consists of the sale of computer software developed to assist in hazard management and weapons impact analysis.

The following is a summary of certain financial information related to the three segments during the six months ended June 30, 2004, and 2003:

	Six months June 30 2004	2003
Total revenues by segment		
Management Services	$ 5,006,801	$4,637,617
Engineering and Information Technology	767,903	763,981
Manufacturing	1,240,621	1,314,792
Total Revenues	$ 7,015,325	$6,716,390
Operating profit (loss) by segment		
Management Services	$ 45,008	$ 172,388
Engineering and Information Technology	429,728	315,180
Manufacturing	211,284	175,248
Operating Expenses not allocable to segments	(41,005,374)	(439,640)
Impairment Loss		(145,974)
Interest income (expense) net	(101,693)	(149,145)
Other income (expense), net	97,194	71,538
Net loss before provision for income taxes	(40,323,853)	(405)

During the six months ended June 30, 2004 and 2003, all of the Company's revenue was generated in the United States of America (USA). As of June 30, 2004, all of the Company's long-lived assets are located in the USA.

13. Commitments and Contingencies:

On March 31, 2004, the Company signed a letter of intent to acquire all of the issued and outstanding membership interests of Inland Fabricators, LLC (IFAB) as further described in Part II, Item 1 of this filing. The letter of intent was not binding and the transaction was subject to the execution of a definitive acquisition agreement by both parties.

On May 6, 2004, the Company provided guarantees in the amount of $500,000 to secure an Irrevocable Letter of Credit(LOC) in favor of a major international construction firm. The LOC provided the necessary performance guarantee for IFAB under a previously negotiated Purchase Order with that major international construction firm. No draws on the LOC have been made as of June 30, 2004. The LOC expires May, 2005.

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On May 6, 2004, a creditor group filed a suit against IFAB for certain sums owed to the creditor group by IFAB as a successor to Thomas Inland Marine, LLC, Pipeworks, Inc., Pipeworks Reserve, Inc. and Pipeworks Venezuela.

The Company also has a $25,000 deposit with IFAB at June 30, 2004, in relation to the letter of intent. The letter of intent expired on June 30, 2004. The Board of Directors and company management are considering the expiration of the letter of intent, the structure of the offer and the impact of the outcome of Inland's pending litigation. The status of negotiations with IFAB is further described in Part II, Item 1 of this filing.

Robert Genovese, the stockholder described in Note 10 to the accompanying financial statements, has submitted an additional $903,711 of expenses related to investor relations services paid by him or related companies on behalf of the Company. However, the Company has not been provided adequate support documentation such as invoices, contracts, examples of work performed, and cancelled checks to support these expenses. In addition, legal concerns exist with regard to these expenses based on language in the revised consulting agreement and the SEC informal inquiry. This matter is further discussed in Part II, Item 1.

ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OR PLAN OF OPERATIONS

You should read the following discussion and analysis in conjunction with the unaudited financial statements (and notes thereto) and other financial information of our company appearing elsewhere in this report.

COMPARISON OF THREE MONTHS ENDED JUNE 30, 2004 AND JUNE 30, 2003

Consolidated Overview:

	For the three months ended June 30			
	2004		2003	
Revenue	$ 3,418,747	100.0%	$ 3,443,361	100.0%
Cost of Revenue	3,054,924	89.4%	3,011,137	87.4%
Gross Profit	$ 363,823	10.6%	$ 432,224	12.6%

Overall, sales for the three-months ended June 30, 2004 decreased by less than 1% compared to the same period in 2003, primarily as a result of decreased sales in the manufacturing segment, offset by slight increases in sales in the management services and engineering and information technology services segments. Gross profit as a percentage of sales was 10.6% for the 3 month period ended June 30, 2004, compared to 12.6% for the prior year period, primarily as a result of decrease in gross profit in the management services and manufacturing segment, offset by an increase in gross profit margin of the engineering and information technology services segment.

With the closeout of our Management Services contract at Gila Bend and the Barry M. Goldwater Bombing Range (BMGR), scheduled for September 30, 2004 the Company will experience a drop in revenue (and associated costs) that will not be immediately replaced. The Gila Bend contract represents 69% of the company's revenues and 6.5% of its gross profit. Overall company profit margins are expected to increase based on the other two profitable segments. The company will continue to look for business opportunities for our Management Services group; however, the thrust will be for contracts with sufficient profitability to support the effort of securing and managing the higher revenue projects.

Spectrum management has spent the last quarter positioning the company for the future. The company has secured additional manufacturing space via a lease/purchase agreement for a building adjacent to our corporate headquarters. This increased capacity has added a metal treatment capability that the manufacturing division did not previously possess. The company is actively performing treatment on its own products (reducing overall costs of production) and using the excess capacity to support local manufacturing concerns including several large defense contractors in the area. Our ultimate goal is to have the metal treatment capability revenues supporting the costs of the additional building. With this new facility, we have increased our manufacturing space by 33,000 square feet. With this increased capacity we are positioning ourselves for performance on several large multi-year manufacturing contracts we are pursuing.

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Our Engineering and Information Technology Division is receiving the first increment of new development efforts which are a direct result of the Safe Range Users Conference that Spectrum hosted for the Department of Defense earlier this year. We expect further incremental contract awards as a result of that conference. These awards will assure the next generation of the Safe Range program's use in the Department of Defense over the coming years. The division continues to market it's Safe Borders concept to appropriate government agencies. Please see extended discussion of the status of Safe Borders in the six months ending analysis section.

Management Services

	For the three months ended June 30			
	2004		2003	
Revenue	$ 2,365,770	100.0%	2,344,517	100.0%
Cost of Revenue	2,338,308	98.8%	2,254,082	96.1%
Gross Profit	$ 27,462	1.2%	$ 90,435	3.9%

Sales in the Management Services division increased approximately 1% for the three-month period ended June 30, 2004 compared to 2003. However, gross profit declined by approximately 69% due to increased expenses. The increases in revenue and expense are primarily due to scheduled increases in reimbursable labor cost under the Service Contract Act and collective bargaining agreement for Spectrum's largest subcontractor, Washington Group International. In addition, revenues and gross profit margins were adversely affected due to the way the Company's largest range management contract was originally bid in 1999, in that the fifth and final option year of the contract was bid at overall lower rates in order to be successful in the contract award process. This bid strategy is no longer employed by the company.

The Gila Bend contract represents 69% of the company's revenue and approximately 6.5% of the company's profit. The loss of this contract will have a significant impact on the company's revenue that may not be immediately be replaced. However, the impact of the loss of profits to the company will be minimal. The company has determined to pursue more Operations & Maintenance contracts that are of the Cost Plus Fixed Fee type in the future, versus a Firm Fixed Price contract such as the Gila Bend contract.

Engineering and Information Technology Services

	For the three months ended June 30			
	2004	2003		
Revenue	$447,813	100.0%	$ 434,628	100.0%
Cost of Revenue	169,877	37.9%	210,656	48.5%
Gross Profit	$277,936	62.1%	$ 223,972	51.5%

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Sales in the Engineering and Information Technology Services segment increased 3.0 % for the three month period ended June 30, 2004 as compared to the same period in 2003.

Gross profit as a percent of sales was 62.1%, an increase of 24%. This increase in gross profit was due to reductions of excess management salary costs associated with the departure of Donald Garrison, Vice President, and the restructuring of workflow and software production in the division. Please see the six month ending M D & A section for greater discussion of Safe Borders and other marketing activities of the division.

Manufacturing Segment

	For the three months ended June 30,			
	2004		2003	
Revenue	$605,164	100.0%	$664,216	100.0%
Cost of Revenue	546,739	90.3%	546,399	82.3%
Gross Profit	$ 58,425	9.7%	$117,817	17.7%

Sales in the Manufacturing segment decreased 8.8 % for the three-month period ended June 30, 2004 as compared to the same period in 2003. The minor decrease in sales is a direct result of programmed pursuit and acquisition of more profitable engineering and prototype work. This focus effectively offset the sales decrease while using the excess production capacity to perform long-term developmental work, much of which is proprietary to Spectrum. During the same period several Air Force and Navy multi-year, high margin contracts were awarded to the company which will contribute to revenue in future periods.

Gross profit fell $59,392 for the three-month period ended June 30, 2004 as compared to the same period in 2003. The superior performance by the division in the second quarter of 2003 was based on specific repetitive contract work that the division expects to secure more of in the near future.

The division has made a business development shift from job-type work to more long term (multi-year) and advanced prototyping efforts. Our rapid response capabilities permit us to accept and complete engineering design and prototype manufacture of components required to complete on-going U.S. Air Force armament systems test and development programs. In addition, improvements to manufacturing processes and procedures were implemented which have enhanced and streamlined our production efforts. These improvements have produced cost efficiencies in overhead labor, purchasing, inventory management and overall manufactured deliverables which will be reflected in the results of future periods. Excess production capacity has been used to perform long-term developmental work, much of which is proprietary to Spectrum.

Operating Expenses

	June 30, 2004	June 30, 2003	Increase
Selling, general and administrative expenses	$ 27,053,790	$ 275,170	9,731%

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Selling, general and administrative expenses Selling, general and administrative ("SG&A") expenses increased 9,731% for the three-month period ended June 30, 2004, as compared to the same period in 2003.

During the quarter ended June 30, 2004, there was $25,965,620 recorded for stock-based consulting compensation. The impact caused an expense to the Company; however, the grant of the options also increased additional paid-in capital by $25,965,620. In addition, the Company recorded $101,348 of investor relations expenses and $531,108 of legal and professional fees during the second quarter of 2004. The significant increase in legal fees is associated with the company's legal consultations and actions taken to respond to the SEC informal inquiry.

These types of expenses were not present in the quarter ended June 30, 2003.

Other Income and Expenses

Interest income and expense, net - Net interest expense was $38,207 and $80,313 for the three-month period ended June 30, 2004 and 2003, respectively. The reduction of $42,106 is due to the decrease of all principal balances due on debt with SouthTrust Bank and other vendors, except that debt associated with the real estate, and the significant interest income of $25,845 that was not present in the quarter ended June 30, 2003.

Other income and expense, net - Net other income was $46,659 and $38,646 for the three-month period ended June 30, 2004 and 2003, respectively. The increase of $8,013 is attributed primarily to an increase in rental income from L-3 Communications in 2004.

COMPARISON OF SIX MONTHS ENDED JUNE 30, 2004 AND JUNE 30, 2003

Consolidated Overview:

	For the six months ended June 30			
	2004		2003	
Revenue	$ 7,015,325	100.0%	$ 6,716,390	100.0%
Cost of Revenue	6,329,305	90.2%	6,053,574	90.1
Gross Profit	$ 686,020	9.8%	$ 662,816	9.9%

Overall, sales for the six-months ended June 30, 2004 increased by 4.5% compared to the same period in 2003 due to increased marketing activity and the Management Services segment's growth of 7.9%. Gross profit as a percentage of sales remained fairly constant at 9.8 % for the 6 month period ended June 30, 2004. The increases in revenue are primarily due to scheduled increases in reimbursable labor cost under the Service Contract Act in the management services division.

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Management Services

	For the six months ended June 30,			
	2004		2003	
Revenue	$ 5,006,801	100.0%	4,637,617	100.0%
Cost of Revenue	4,961,793	99.1%	4,465,229	96.3%
Gross Profit	$ 45,008	0.9%	$ 172,388	3.7%

Sales in the Management Services segment increased approximately 7.9% while expenses increased 11.1% for the six-month period ended June 30, 2004 compared to 2003. In addition, the establishment of the collective bargaining agreement for the fire department which is run by Spectrum's largest subcontractor, Washington Group International, has increased costs for the period.

Engineering and Information Technology Services

	For the six months ended June 30,			
	2004		2003	
Revenue	$767,903	100.0%	$ 763,981	100.0%
Cost of Revenue	338,175	44.0%	448,801	58.7%
Gross Margin	$429,728	56.0%	$ 315,180	41.3%

Sales in the Engineering and Information Technology Services segment remained constant for the period ended June 30, 2004 as compared to the same period in 2003.

Second quarter revenues accelerated and made up the deficit recorded in first quarter revenues, which resulted in the flattening of the revenues year to date. Second quarter revenue increases were attributable to a ramp up in production and delivery of software enhancements and modifications as demand for these products continues to increase. Divisional revenues are projected to increase even more over the next quarter as Government "fall out" funding is identified to fund "unfunded" requirements generated at the Safe Range Users Conference held in May and as software license sales are realized

Gross profit as a percent of sales was 56%, an increase of more than 36% as compared to the same period in 2003. This increase in gross profit is attributable to the elimination of excess management salary costs associated with the departure of Donald Garrison, Vice President, and the restructuring of workflow and software production in the division. The segment also continues to enjoy high profit margin potential of firm-fixed priced contracts used to procure required software products. In addition, costs of revenues produced continues to decline as consultant staff are converted to company employees and strict financial management processes are put in place.

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Marketing and Status of Safe Borders

As of the end of second quarter, 2004, we have developed a core capability in three (3) of the five (5) basic modules for our Safe Borders product, as designed. The three modules with core capabilities are the: 1) Detection Analyses module, 2) Sensor Planning module, and 3) Airborne Mission Planning module. The core capabilities in the three developed modules are robust and functionally effective in their current state. The functionality, as built today, could be used by a mission planner to perform detection analysis, sensor planning or airborne mission planning.

To date, Safe Borders represents approximately 10,000 Lines of Code (LOC). It is designed and developed as an object oriented (OO) application and is written in Delphi's development environment. By comparison Safe Range represents 70,000 LOC (structured), but this must be qualified by the fact that Safe Range is not an OO application. By being written as an OO application, much efficiency is realized in the OO LOC metric. Object oriented applications (OO) provide numerous other benefits.

Safe Borders is being designed as a component-based application framework. This will allow custom applications to be built quickly, providing a rapid response to new user requirement and/or changing user requirements.

At the beginning of the program in 2003, Safe Borders had limited functionality (or proof-of-concept) prototypes. These prototypes were used to elicit market reaction and market requirements. Today, we have a fairly robust demonstration product, as well as supporting collateral, web site and customer lead lists.

Promising third quarter activities include delivering a Safe Borders presentation/demonstration at a joint meeting of the Customs and Border Protection (CBP), Applied Technology Division and the Immigrations and Customs Enforcement, Office of Air and Marine Interdiction, C2ISR (Command, Control Intelligence Surveillance Reconnaissance) section at the invitation of the Acting Assistant Commissioner, CBP. In addition, Spectrum will be attending an Industry Days function (by specific invitation) conducted by the U.S. Coast Guard (USCG), Deepwater Program, August 31 - September 2, 2004. The Deepwater Program is the USCG's multi-billion dollar program to replace all ships and aircraft (to include Unmanned Aerial Vehicles - UAVs) over the next 10 years.

Manufacturing Segment

	For the six months ended June 30,			
	2004		2003	
Revenue	$1,240,621	100.0%	$1,314,792	100.0
Cost of Revenue	1,029,337	81.9%	1,139,544	86.7%
Gross Profit	$ 211,284	18.1%	$ 175,248	13.3%

Sales in the Manufacturing segment decreased 5.6% for the six-month period ended June 30, 2004 as compared to the same period in 2003. We are currently producing several First Articles items, such as specialized containers and aircraft maintenance stands. We have also been qualified on numerous First Article Acceptance Tests. A First Article item is similar to a prototype developed under an awarded contract and must be approved by the customer prior to full production. An Acceptance Test is a verification of our manufacturing and quality control procedures to ensure that the product being delivered meets

all customer requirements and specifications. Once full production begins on these items; notably the Advanced Medium Range Air-to-Air Missile (AMRAAM) container and the AMRAAM component containers, among others, sales are expected to increase.

Gross profits improved significantly by 20.5% during this same six-month reporting period based primarily on a conscious business decision to continuously improve every facet of our manufacturing processes. While subtly shifting to the pursuit of more profitable longer-term contracts, other improvements were implemented; such as "In-Time Manufacturing", and processes were revised to further enhance the quality, efficiency, and cost-effectiveness of our operations. All manufacturing personnel completed a 16-hour course of instruction on Lean Manufacturing and Quality Principles during June, funded by the State of Florida. Spectrum continues to apply judicious cost reduction and sound fiscal management practices necessary to reduce overall expense while ensuring delivery and quality standards are maintained

The shift in marketing emphasis to the acquisition of substantially more profitable prototype manufacturing efforts requires a great deal of recurring engineering and rapid manufacturing support. Coupled with the pursuit of prototype and developmental work, business development personnel are concentrating on long-term, multi-year type contract vehicles, which will provide a smoother workflow while at the same time providing opportunities to accept variable quick-reaction/rapid response workload.

In June, the manufacturing division expanded into a new facility at 97 Hill Avenue adjacent to the corporate headquarters at 91 Hill Avenue. This move increases our entire manufacturing space by 33,000 square feet. It adds a new capability for a full metal treatment line and doubles our painting capacity.

	June 30, 2004	June 30, 2003	Increase
Selling, general and administrative expenses	$ 41,005,374	$ 439,640	9,227%

Selling, general and administrative expenses - Selling, general and administrative ("SG&A") expenses increased 9,227% for the six-month period ended June 30, 2004, as compared to the same period in 2003.

During the quarter ended June 30, 2004, there was $25,965,620 recorded for stock-based consulting compensation. In the quarter ended March 31, 2004, the company previously recorded $11,418,038 for stock-based consulting compensation. The impact caused an expense to the Company; however, the grant of the options year-to-date also increased additional paid-in capital by $37,161,563. In addition, the Company recorded $2,266,545 of investor relations expenses as of June 30, 2004. These expenses were not present in the same quarter ended 2003.

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The Company had increased legal costs of $420,840, accounting fees of $104,131 and director's fees and expenses of $45,445 year to date. All of these costs are associated with the public filings with the Securities and Exchange Commission, the costs of management of a public company and the response to the SEC informal inquiry.

These types of expenses were not present in the quarter ended June 30, 2003.

Other Income and Expenses

Interest income and expense, net - Net interest expense was $101,693 and $149,145 for the six-month period ended June 30, 2004 and 2003, respectively. The reduction of $47,452, or a reduction of 31.8%, is due to the decrease of all principal balances eliminated except the debt on the real estate, as well as the increased interest income earned on the funds held in near-term investments. Other income and expense, net - Net other income was $97,194 and $71,538 for the six-month period ended June 30, 2004 and 2003, respectively. The increase of other income in the amount of $25,656 is attributed primarily to the decrease of monthly expenses associated with corporate consultants for 2004 as compared to the same period in 2003.

Capital and liquidity

During the six months ending June 30, 2004 cash and equivalents increased $5,352,483, as compared to December 31, 2003. At June 30, 2004, cash and equivalents totaled $6,049,442, as compared with $264,832 at June 30, 2003. As of June 30, 2004, the Company had $22,543,386 in certificates of deposit and short-term government-backed securities as a result investing funds received from the exercise of stock options by Robert Genovese.

At June 30, 2004, working capital was $28,727,967, as compared to negative working capital of