

# ENGINEERED FOR GROWTH



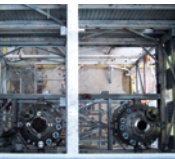
2005 ANNUAL REPORT

ENGlobal Corporation





ENGlobal Corporation provides engineering and systems services principally to the petroleum refining, petrochemical, pipeline, production, and process industries throughout the United States and internationally. The Company also supplies automation, polymers, and sulfur services, and control and analyzer systems to clients worldwide.



### Engineering

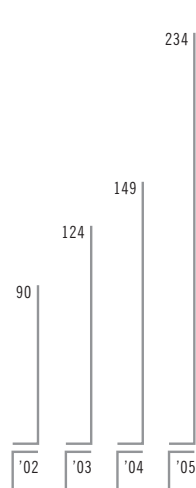
ENGlobal's engineering segment offers engineering consulting services to clients in the petroleum refining, petrochemical, pipeline, production and process industries for the development, management and turnkey execution of engineering projects and provides inspection services worldwide. Among various subsidiaries, the engineering segment provides (i) engineering services to the downstream petroleum refining and petrochemical industry, including refineries and processing plants, upstream and midstream pipeline companies and gas processing plants, (ii) inspection services to industrial plants worldwide, (iii) specialty services, including automation, polymers and sulfur, and (iv) Automated Fuel Handling Systems and services to branches of the U.S. military.



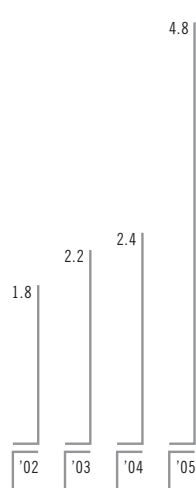
### Systems

ENGlobal's systems segment designs, assembles, programs, installs, integrates and services control, analytical and heat tracing systems for specific applications in the energy and processing related industries. Among various divisions, the systems segment provides (i) control and instrumentation system design, engineering, fabrication, assembly and testing in-house, (ii) design, programming and fabrication of online process analyzer systems, and (iii) products and services supporting process heat tracing systems.

**Total Revenues**  
(dollars in millions)



**Net Income**  
(dollars in millions)



**Shareholders' Equity**  
(dollars in millions)



*ENGlobal creates success for our clients, employees and stockholders by leading the way through safety, performance and accountability... from start to finish.*





GLOBAL THINKING...

GLOBAL SOLUTIONS



April 28, 2006

To Our Stockholders:

We are pleased to report that 2005 offered another year of growth for your Company, with both revenues and net income significantly exceeding results from the prior year. It is important to note that including our record performance last year, ENGlobal has achieved an average of 80.4% and 48.6% compounded annual growth rate in revenue and net profits since 2001. We commend the entire ENGlobal team for their efforts in achieving these outstanding results.

This Annual Report contains a substantial amount of financial information. In particular, the Selected Financial Data, on pages 20 and 21, provides an excellent summary of ENGlobal's financial performance over the last five years (2001-2005). The ENGlobal of today is obviously a far different Company than in 2001, having grown from roughly 200 to 1,875 employees and from 4 to 15 business locations over the course of these years.

In addition to our success, 2005 offered a major challenge to the Company brought on by Hurricane Rita, which made landfall between our Beaumont and Lake Charles offices. Hurricane Katrina also affected our Company, but to a lesser extent due to the location of our operations. While both hurricanes had an impact on our business, it is more important for us to remember that these events seriously impacted the lives of people we count on to do business.

We are particularly proud of the way our employees rebounded from the devastation. As one example, several dozen of our employees were required to relocate to other offices, spending considerable time away from their homes in less than ideal accommodations, all while fulfilling important tasks for the Company. We want to sincerely thank each of them for their past sacrifices, as well as for their continued dedication. From evacuation to recovery, those of us along the Gulf Coast have repeatedly witnessed the power of the human spirit in response to the many challenges.

ENGlobal's management team has worked hard to prepare for the unexpected. We recently established an Emergency Preparedness Committee – ENGlobal C.A.R.E.S., "Communicating Appropriate Responses in Emergency Situations." This Committee, consisting of senior managers, has developed action plans for a variety of emergency situations, beyond those directed by Mother Nature. We are utilizing the "Ready Business" program developed by the Department of Homeland Security, as well as lessons from our own experiences, to assist our clients, our employees and their families before, during and after times of crisis.

Forward Momentum

Activity in our industry continues to be positively impacted by growing demand for energy in the U.S. and worldwide. One statistic, as presented by the International Energy Agency, projects that the worldwide demand for crude oil will increase by 8 million barrels per day, to a total consumption of 90 MBPD, by the end of this decade. This picture is consistent across the broad spectrum of the

energy-related clients we serve, including refining, petrochemical, pipeline, power and renewable energy. In general, we expect our clients' capital and maintenance budgets for their facilities will continue to increase annually at double-digit rates, being driven by demand and positive project economics. ENGlobal is well positioned to take advantage of these trends.

We expect that a majority of our future growth will be provided by internal measures, as it has been in the past. We have reason to be confident in this area, given the quality of our business development team, the experience and capability of our technical staff, as well as the large amount of proposal activity currently underway. We are also optimistic that several of our 2004 and 2005 investments in the form of internal business start-ups will prove to be positive contributors for the Company beginning in 2006.

We are also expanding our Company into new sectors of the energy industry. As an example, ENGlobal is currently performing projects in the area of alternative energy, including those related to ethanol and biomass. We see this area strengthening and have even researched coal and the utilization of refinery petroleum coke (or "petcoke") as a feedstock for a variety of processes. These latter enterprises are in the early stages, but renewable energy offers a tremendous opportunity for ENGlobal. Renewable energy currently supplies 6% of the U.S. energy supply, with biomass sources accounting for 47% of the renewable sector.

Our focus in 2005 was on our internal growth initiatives, which in part resulted in no merger and acquisition activity for the year. However, we plan to continue to seriously consider strategic and accretive merger and acquisition opportunities that are available. In general, we expect that any future acquisitions will be larger in scope than in the past and will provide either additional competencies, or growth into new geographical regions. Our focus will be on expanding the capabilities already offered to our clients; however, we expect to remain primarily involved with energy-related projects and services over the next several years.

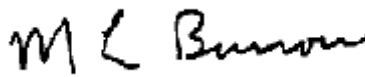
One of our biggest challenges in the future will be finding the technical personnel to work on our clients' projects - a problem facing our entire industry. One way ENGlobal is combating the manpower shortage is to recruit new engineering graduates. Fortunately, our clients are beginning to see the benefits of training these recruits on the job, rather than waiting until a certain level of experience is attained.

ENGlobal's management would like to thank its stockholders, clients, and employees, both old and new, for their continued support as we look forward to the year ahead. The year 2005 offered growth opportunities as well as significant challenges. The ENGlobal team has proven that it can succeed at both - we truly believe ENGlobal is "Engineered for Growth."

Sincerely,



William A. Coskey, P.E.  
Chairman of the Board



Michael L. Burrow, P.E.  
President and Chief Executive Officer

**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549**

**Form 10-K**

**ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934  
For the fiscal year ended December 31, 2005**

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 No. 001-14217**  
**ENGlobal Corporation**  
(Exact name of registrant as specified in its charter)

**Nevada**  
(State or other jurisdiction of  
incorporation or organization)

**88-0322261**  
(I.R.S Employer Identification No.)

**654 North Sam Houston Parkway East, Suite 400**  
(Address of principal executive offices)

**77060-5914**  
(Zip code)

Registrant's telephone number, including area code: (281) 878-1000  
Securities registered pursuant to Section 12(b) of the Exchange Act:

Title of each class  
**Common Stock, \$0.001 par value**

Name of each exchange on which registered  
**American Stock Exchange**

Securities registered pursuant to Section 12(g) of the Exchange Act:  
**None**

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act

Yes  No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15 (d) of the Act

Yes  No

Indicate by check mark whether the registrant: (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shortened period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes  No

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

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. (Check one):

Large accelerated filer  Accelerated filer  Non-accelerated filer

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

Yes  No

The aggregate market value of the registrant's common stock held by non-affiliates of the registrant on June 30, 2005 was \$42,561,564 (based upon the closing price for shares of common stock as reported by the American Stock Exchange on that date).

The number of shares outstanding of the registrant's common stock on March 23, 2006 is as follows:  
\$0.001 Par Value Common Stock 26,352,781 shares

**DOCUMENTS INCORPORATED BY REFERENCE**

Responses to Items 10, 11, 12, 13 and 14 of Part III of this report are incorporated herein by reference to certain information contained in the Company's definitive proxy statement for its 2006 Annual Meeting of Stockholders to be filed with the Securities and Exchange Commission on or before April 30, 2006.

**ENGlobal Corporation**  
**2005 ANNUAL REPORT ON FORM 10-K**

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## **PART I**

### **CAUTIONARY NOTICE REGARDING FORWARD-LOOKING STATEMENTS**

*This Annual Report on Form 10-K (“Report”), including “Management’s Discussion and Analysis of Financial Condition and Results of Operations,” as well as oral statements made by the Company and its officers, directors or employees, contains forward-looking statements within the meaning of Section 21E of the Securities Exchange Act of 1934, as amended (the “Exchange Act”). Such forward-looking statements are based on Management’s beliefs, current expectations, estimates and projections about the industries that the Company and its subsidiaries serve, the economy and the Company in general. The words “expect,” “anticipate,” “intend,” “plan,” “believe,” “seek,” “estimate” and similar expressions are intended to identify such forward-looking statements; however, this Report also contains other forward-looking statements in addition to historical information. Although we believe that the expectations reflected in the forward-looking statements are reasonable, such forward-looking statements are not guarantees of future performance and are subject to risks, uncertainties and other factors that may cause the actual results, performance or achievements of the Company to differ materially from historical results or from any results expressed or implied by such forward-looking statements. The Company cautions readers that the following important factors and the risks described in the section of this report entitled “Risk Factors”, among others, could cause the Company’s actual results to differ materially from the forward-looking statements contained in this Report: (i) the effect of changes in laws and regulations with which the Company must comply, and the associated costs of compliance with such laws and regulations, either currently or in the future, as applicable; (ii) the effect of changes in accounting policies and practices as may be adopted by regulatory agencies, as well as by the Financial Accounting Standards Board; (iii) the effect of changes in the Company’s organization, compensation and benefit plans; (iv) the effect on the Company’s competitive position within its market area of the increasing consolidation within its services industries, including the increased competition from larger regional and out-of-state engineering services organizations; (v) the effect of increases and decreases in oil prices; (vi) the availability of parts from vendors; (vii) our ability to increase or renew our line of credit; (viii) our ability to identify attractive acquisition candidates, consummate acquisitions on terms that are favorable to the Company and integrate the acquired businesses into the Company’s operations; (ix) the ability to hire and retain qualified personnel; (x) the ability to retain existing customers and get new customers and (xi) the effect of changes in the business cycle and downturns in local, regional and national economies. The Company cautions that the foregoing list of important factors is not exclusive. We are under no duty and have no plans to update any of the forward-looking statements after the date of this Report to conform such statements to actual results.*



## ITEM 1. BUSINESS

### *General*

ENGlobal Corporation (which may be referred to as “ENGlobal,” the “Company,” “we,” “us” or “our”) is a leading provider of engineering services and systems principally to the petroleum refining, petrochemical, pipeline, production and process industries throughout the United States and internationally. The services provided by our multi-disciplined staff span the lifecycle of a project and include feasibility studies, design, procurement and construction management. We also supply automation, control and instrumentation systems to our clients worldwide.

The Company was incorporated as Industrial Data Systems Corporation in the State of Nevada in June 1994. In December 2001, we merged with Petrocon Engineering, Inc. (“Petrocon”) and in June 2002, we changed the name of the Company from Industrial Data Systems Corporation to ENGlobal Corporation. Effective June 16, 2002, the Company’s trading symbol for its common stock, traded on the American Stock Exchange, changed from “IDS” to “ENG”.

In the last five years, the Company’s net revenue from continuing operations has grown from \$17.8 million in 2001 to \$233.6 million in 2005, a compounded annual growth rate of approximately 90.3%. Since the merger with Petrocon, the Company’s net revenue from continuous operations has grown from \$89.1 million in 2002, a compounded annual growth rate of approximately 37.9%. We have accomplished this growth by expanding our engineering and systems services and geographic presence through internal growth, including new initiatives and to a lesser extent, through a series of strategic acquisitions. We now have more than 1,700 full-time equivalent employees in offices strategically located in Houston, Beaumont, Freeport, Midland and Dallas, Texas; Baton Rouge and Lake Charles, Louisiana; and Tulsa, Cleveland and Blackwell, Oklahoma and Calgary, Alberta, Canada.

### *Available Information*

We file annual, quarterly and current reports, proxy statements and other information with the Securities and Exchange Commission (“SEC”). You can read and copy any materials filed with the SEC at its Public Reference Room at 100 F. Street, N.E., Washington, D.C. 20549. You can obtain information about the operations from the SEC Public Reference Room by calling the SEC at 1-800-SEC-0330. The SEC also maintains a website, which contains information we file electronically with the SEC, which can be accessed over the Internet at [www.sec.gov](http://www.sec.gov). Our common stock is listed on the American Stock Exchange (AMEX: ENG), and you can obtain information about ENGlobal at the offices of the American Stock Exchange, 86 Trinity Place, New York, New York 10006-1872 or at their website [www.amex.com](http://www.amex.com).

### *ENGlobal Website*

You can find financial and other information about ENGlobal at the Company’s website at the URL address [www.englobal.com](http://www.englobal.com). Copies of our annual reports on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, and amendments to those reports filed or furnished pursuant to Section 13(a) or 15(d) of the Exchange Act are provided free of charge through the Company’s website and are available as soon as reasonably practicable after filing electronically or otherwise furnishing reports to the SEC.

Information relating to corporate governance at ENGlobal, including: (i) our Code of Business Conduct and Ethics for all of our employees, including our Chief Executive Officer and Chief Financial Officer; (ii) our Code of Ethics for our Chief Executive Officer and Senior Financial Officers; (iii) information concerning our Directors, and our Board Committees, including Committee charters, and (iv) information concerning transactions in ENGlobal securities by Directors and officers, is available on our website under the Investor Relations link. Our website and the information contained therein or connected thereto are not intended to be incorporated into this Annual Report on Form 10-K. We will provide any of the foregoing information without charge upon written request to Investor Relations Officer, ENGlobal Corporation, 654 North Sam Houston Parkway East, Suite 400, Houston, Texas 77060-5914.

## ITEM 1. BUSINESS (Continued)

### *Business Segments*

During 2005, we operated two business segments: engineering and systems. The respective contributions to our total sales in 2005, 2004 and 2003 for the engineering and the systems segments are summarized below.

Segment <sup>(1)</sup>	Percentage of Revenues		
	2005	2004	2003
Engineering	92.3 %	89.8 %	87.6 %
Systems	7.7 %	10.2 %	12.4 %
	<u>100.0 %</u>	<u>100.0 %</u>	<u>100.0 %</u>

<sup>(1)</sup> Does not include manufacturing segment, which was sold in December 2003.

The shift in the percentage of revenue between the engineering and systems business segments highlights the growth of the engineering segment over the last three years. Revenues from the systems segment remained constant from 2003 to 2004, and increased 17.2% from 2004 to 2005. Engineering revenues increased 23.3% and 61.4%, respectively, from 2003 to 2004 and 2004 to 2005.

### *Engineering Segment*

	2005	2004	2003
	(Amounts in thousands)		
Revenues from external customers	\$ 215,698	\$ 133,630	\$ 108,380
Operating profit	\$ 17,752	\$ 10,512	\$ 10,716
Total assets	\$ 54,342	\$ 46,122	\$ 35,531

### *General*

Our engineering segment offers engineering consulting services to clients in the petroleum refining, petrochemical, pipeline, production and process industries for the development, management and turnkey execution of engineering projects and provides inspection services throughout the United States. The engineering segment is currently comprised of the following wholly-owned subsidiaries of ENGlobal Corporation: ENGlobal Engineering, Inc. (“EEI”), RPM Engineering, Inc. d/b/a ENGlobal Engineering, Inc. (“RPM”), ENGlobal Construction Resources, Inc. (“ECR”), ENGlobal Technical Services, Inc. (“ETS”), ENGlobal Automation Group, Inc. (“EAG”) and ENGlobal Canada ULC (“ENGlobal Canada”). EEI and RPM focus primarily on providing services to the downstream petroleum refining and petrochemical industry, including refineries and processing plants, upstream and midstream pipeline companies and gas processing plants. ECR primarily provides inspection services to industrial plants throughout the United States. ETS primarily provides Automated Fuel Handling Systems and services to branches of the U.S. military and public sector companies. EAG and ENGlobal Canada provide engineering services relating to the implementation of process controls, instrumentation, advanced automation and information technology projects. The engineering segment derives revenues primarily from fees charged for professional and technical services. As a service company, we are more labor than capital intensive. Our income results from our ability to generate revenues and collect cash under contracts for our employees’ time in excess of any subcontract, pass-thru materials and equipment, non-labor costs and our selling, general and administrative (SG&A) expenses.

The engineering segment has approximately 104 existing blanket service contracts pursuant to which it provides clients either with services on a time and materials basis or with services on a fixed fee, turnkey basis. Our engineering segment operates out of offices in Baton Rouge and Lake Charles, Louisiana; Beaumont, Dallas, Houston, Midland and Freeport, Texas; Tulsa, Cleveland and Blackwell, Oklahoma; and Calgary, Alberta. Our engineering segment also provides unique, custom-designed process related fabricated systems, designed to customer specifications.

During 2003, as part of our plan to extend our geographical range and to serve the downstream petrochemical industries, such as the petroleum refining, petrochemical and process industries in the Freeport, Texas area, we acquired selected assets of Petro-Chem Engineering, Inc. (“Petro-Chem”). Petro-Chem had a staff of 55 engineers, designers, inspectors and support personnel engaged on contract projects with several Freeport area clients. This acquisition allowed us to expand into the

## ITEM 1. BUSINESS (Continued)

Freeport area with experienced staff that has an established reputation. The Freeport office currently provides on-site engineering, design and support personnel to a leading chemical client that has facilities in Freeport and Port Arthur, Texas and in Geismar, Louisiana.

During 2004, the engineering segment continued its geographical expansion with new offices in Dallas and Midland, Texas and Cleveland, Oklahoma, plus an additional office in Tulsa, Oklahoma. In January, through ETS, we acquired certain assets of Engineering Design Group, Inc. ("EDGI") located in Tulsa, Oklahoma. As a result of this acquisition, ETS now provides design, installation and maintenance services for various government and public sector facilities, the most active sector being Automated Fuel Handling Systems serving the U.S. military. In August 2005, we announced the expansion of EEI's operation in the sulfur recovery business in Dallas, Texas. In September, through ECR, we acquired certain assets of AmTech Inspection located in Midland, Texas. The new division's revenues are derived primarily from providing inspectors for regional refining and pipeline operations. In October, again through ECR, we acquired certain assets of Cleveland Inspection Services, Inc. ("CIS") located in Cleveland, Oklahoma. As a result of this acquisition, we now provide inspection and construction management services in support of the oil and gas, utility and pipeline industries.

In March 2005, ENGlobal Engineering formed ENGlobal Automation Group, Inc. ("EAG") to provide services relating to the implementation of process control, advance automation and information technology projects providing our clients with a full range of services, including but not limited to, front-end engineering feasibility studies and the execution of turnkey engineering, procurement, and construction projects. By focusing on large-scope projects, EAG intends to pursue distributed control systems (DCS) conversion and new installation projects by utilizing its own resources as well as resources from both ENGlobal Engineering and ENGlobal Systems. EAG will promote our proven capabilities for plant automation services and products to respond to an industry progression toward replacing obsolete technology with newer DCS.

In June 2005, we formed ENGlobal Canada, based in Calgary, Alberta, Canada. ENGlobal Canada is a wholly-owned subsidiary of EAG.

Our engineering segment offers its expertise to a broad range of industrial clients. We participate in projects involving both the modification of existing facilities and construction of new facilities. Our predominant type of contract is a blanket services contract that typically provides our clients with engineering, procurement and project management services on a time and materials basis. We also enter into contracts to complete capital projects on a full service, turnkey basis. The engineering staff has the capability of developing a project from the initial planning stages through detailed design and construction management. The engineering services that we provide include:

- conceptual studies;
- project definition;
- cost estimating;
- engineering design;
- inspection;
- material procurement; and
- project and construction management.

We provide services for major energy-related firms at facilities such as chemical plants, crude oil refineries, electric power generation facilities, cross-country pipelines, pipeline facilities and production processing facilities.

The engineering segment offers a wide range of services from a single source provider. The segment uses an internal virtual private network so that employees in one location can work on projects based in other offices. This "work sharing" capability allows us to provide a greater depth and breadth of expertise to our clients and helps stabilize the workload in our various offices.

### Competition

Our engineering segment competes with a large number of firms of various sizes, ranging from the industry's largest firms, which operate on a worldwide basis, to much smaller regional and local firms. Many of our competitors are larger than we are and have significantly greater financial and other resources available to them than we do.

Competition is primarily centered on performance and the ability to provide the engineering, planning and project execution skills required to complete projects in a timely and cost efficient manner. The technical expertise of our management team

## ITEM 1. BUSINESS (Continued)

and technical personnel and the timeliness and quality of our support services, are key competitive factors. Larger projects, especially international work, typically include pricing alternatives designed to shift risk to the service provider, or at least to cause the service provider to share a portion of the risks associated with cost overruns in service delivery. These alternatives include fixed-price, guaranteed maximum price, incentive fee, competitive bidding and other “value based” pricing arrangements.

### *Systems Segment*

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	<b>2005</b>	<b>2004</b>	<b>2003</b>
	<b>(Amounts in thousands)</b>		
Revenues to external customers	\$ 17,887	\$ 15,258	\$ 15,339
Operating profit (loss)	\$ 309	\$ 585	\$ (38)
Total assets	\$ 6,159	\$ 7,806	\$ 3,913

### *General*

Our systems segment designs, assembles, programs, installs, integrates and services control and instrumentation systems for specific applications in the energy and processing related industries. The systems segment currently consists of ENGlobal Systems, Inc. (“ESI”). Beginning in 2005, the operations of ENGlobal Constant Power, ENGlobal Technologies, Inc. and Senftleber & Associates, LP were merged into ESI. The systems segment derives revenues primarily from fees on contracts for the design and assembly of control and instrumentation systems. Income from the systems segment is derived from our ability to generate revenues and collect cash on fixed-price contracts in excess of our costs for labor, materials and equipment and transportation costs, plus our SG&A expenses.

ESI’s control and instrumentation systems are custom designed and include both conventional pneumatic and hydraulic control systems, as well as electronic, microprocessor-based controls employing programmable logic. Typical applications for control and instrumentation systems include oil and gas production safety systems; refinery, petrochemical and chemical plant controls; online process; analyzer packaging; fire and gas detection systems; pipeline facility controls; data acquisition systems; and control systems for various processing equipment. We perform all facets of control and instrumentation system design, engineering, assembly and testing in-house. Field installation and technical staff perform start-up and commissioning services, modification to existing systems, on-site training and routine maintenance procedures for client operating personnel.

ESI previously provided products and services supporting the advanced automation and environmental technology fields. Advanced automation services provided by ESI included automation technology audits, consulting, advanced process controls and process computer services, multivariable control, optimization (on-line and off-line), neural net applications, operator training simulators, expert systems and on-site support. In January 2006, EAG assumed responsibility for the provision of these services.

In January 2006 ESI acquired certain assets of Analyzer Technology International, Inc. (“ATI”), a Houston-based analyzer systems provider of online process analyzer systems. ATI will relocate its operation to ESI’s Houston facility, which the Company expects will enable ESI’s clients to perform a more efficient factory adaptable test by temporarily connecting both control and analyzer systems onsite prior to delivery. The addition of ATI will provide ESI with a greater presence in the process analyzer sector, especially for larger downstream opportunities of foreign grassroots projects.

### *Competition*

The systems segment has been impacted by price variations attributable to cyclical conditions in the oil and gas, petroleum and processing industries. In addition, during 2005, a large percentage of ESI’s revenues were derived from fabrication, which has a lower profit margin than other services. ESI’s control systems and modular facilities compete with similar systems built by other companies, most of which compete primarily on the basis of pricing.

We believe that pricing, technical competence and ability to provide superior service are the primary bases of competition.

## ITEM 1. BUSINESS (Continued)

### *Acquisitions and Sales*

We have grown our business over the past several years through both internal initiatives and through strategic mergers and acquisitions. These mergers and acquisitions have allowed us to (i) expand our client base and the range of services that we provide to our clients; and (ii) gain access to new geographic areas. We expect to continue evaluating and assessing acquisition opportunities that will either complement our existing business base or that will provide the Company with additional capabilities or geographical coverage. We believe that strategic acquisitions will enable us to more efficiently serve the technical needs of national and international clients and strengthen our financial performance. The following table lists the businesses we have acquired during the three-year period ended December 31, 2005.

<u>Name/Location/Business Unit</u>	<u>Date Acquired</u>	<u>Primary Services</u>
Petro-Chem Engineering Freeport, TX Operates as a Division of ECR	July 2003	Onsite Design and Engineering
Senftleber & Associates, L.P. Washington, TX Operates as a Division of EAG	October 2003	Onsite Programmers
Engineering Design Group, Inc. Tulsa, OK Operates as ETS, formerly EDG	January 2004	Automated Fuel Handling & Tank Gauging Systems
AmTech Inspection, LLC Midland, TX Operates as a Division of ECR	September 2004	Onsite Inspection and Plant Process Safety Mgt
Cleveland Inspection Services, Inc. Cleveland, OK Operates as a Division of ECR	October 2004	Onsite Pipeline Inspection
Instrument Services Company, LLC Tulsa, OK Operates as a Division of ETS	November 2004	Onsite Instrument and Electrical Technicians
InfoTech Engineering, LLC Baton Rouge, LA Operates as a Division of EAG	December 2004	Advanced Automation System Design

### *Business Strategy*

Our objective is to strengthen the Company's position as a leading engineering and consulting services provider while enhancing the services we offer and expanding our geographic presence. To achieve this objective, we have developed a strategy comprised of the following key elements:

- *Continue to Recruit and Retain Qualified Personnel.* We believe recruiting and retaining qualified, skilled professionals is crucial to our success and growth. As a result, we have dedicated staff focused on recruiting personnel with experience in the energy industry. We have also used inter-company recruiting to retain key personnel.



## ITEM 1. BUSINESS (Continued)

- *Improve Utilization of Resources.* We have developed a work-sharing program through the use of an internal virtual private network that gives our clients access to technical resources located in any of our offices and allows for higher utilization of our resources. We believe the work-sharing program has reduced employee turnover and provides for a more stable work environment. We are also moving toward standardization of engineering processes and procedures among our offices, which we believe will enhance our work-sharing ability and provide our clients with more consistent and higher quality services.
- *Pursue Foreign Technical Resources.* Our engineering operations continue to test the use of offshore technical resources to establish longer-term access to professional engineering and design work in lower cost countries such as Mexico, India and the Far East. If these tests are ultimately successful, it will allow us to lower our contract bid prices and enhance our competitive position.
- *Enhance and Strengthen Our Ability to Perform Engineering, Procurement and Construction Projects.* We rely heavily on repeat business and referrals from existing customers, industry members and manufacturing representatives. The engineering segment's strategy is to increase revenues by developing and marketing its ability to perform full service turnkey projects, also called EPC (Engineering, Procurement and Construction) projects. The engineering segment has traditionally been responsible only for the engineering portion of its projects, which usually represents between five to fifteen percent of a project's total installed cost.
- *Maintain High Quality Service.* To maintain high quality service, we focus on being responsive to our customers, working diligently and responsibly, and maintaining schedules and budgets. The Company has a quality control and assurance program to maintain standards and procedures for performance and documentation and to audit and monitor compliance with procedures and quality standards.
- *Expand and Enhance Technical Capabilities.* We believe that it is important to develop our capabilities in advanced computer-aided process simulation, design and drafting. To achieve this objective, we have purchased computer hardware and software from several suppliers in order to have the latest platforms for the design of plant systems. This initiative should enhance our marketing position with many of our customers who are currently utilizing these design platforms.
- *Pursue Balanced Growth.* We continue to pursue balanced growth for our business, utilizing both external acquisitions as well as internal measures as a means of future growth. The internal measures will include an active business development program, together with initiatives to start new business operations. We also pursue acquisitions that will allow us to offer expanded engineering and control system services to a broad energy complex, increase our technical capabilities, grow our business geographically and improve our market share.
- *Continue to Increase Name Recognition.* We intend to continue to present a more cohesive image and continue to increase name recognition. All of ENGlobal's operating subsidiaries have adopted "ENGlobal" as part of their name, and newly acquired entities will adopt ENGlobal as a part of their name within 12 to 18 months of their acquisition.

### ***Sales and Marketing***

Our various subsidiaries derive revenues primarily from two sources: (1) in-house direct sales and (2) referrals from existing customers and industry members and manufacturing representatives. Our in-house sales managers are assigned to industry segments and territories within the United States. Management believes that this method of selling should result in increased account penetration and enhanced customer service, which should, in turn, create and maintain the foundation for long-term customer relationships. Our growth depends in large measure on our ability to attract and retain qualified sales representatives and sales management personnel. Management believes that in-house marketing allows for more accountability and control, thus increasing profitability.

Products and services are also promoted through general and trade advertising, participation in trade shows and through on-line Internet communication via our corporate home page at [www.englobal.com](http://www.englobal.com). The ENGlobal site provides information

## **ITEM 1. BUSINESS (Continued)**

about both of our operating segments. We use in-house resources to maintain and update our website and our subsidiaries' web sites on an ongoing basis. Through the ENGlobal website, we seek to provide visitors with a single point of contact for obtaining information on the services and products offered by the ENGlobal family of companies.

Our business development department focuses on building long-term relationships with customers and providing customers with product application, engineering and after-the-sale services. Additionally, we seek to capitalize on cross-selling opportunities between our various subsidiaries. Sales leads are often jointly developed and pursued by the sales personnel from a number of these subsidiaries.

Much of our business is repeat business and we are introduced to new customers in most cases by referrals from existing customers and industry members. The Company believes that our acquisition program, although small, has the benefit of expanding our existing customer base.

We currently employ 17 full-time professional in-house marketers in our business development department who concentrate on the engineering services segment, and 6 full-time professional in-house marketers in our systems segment. We have retained business development agents in the Middle East and the United Kingdom. We have also formed alliances, which include marketing activities, with other engineering and construction firms in Mexico City and South America.

### ***Customers***

Our customer base consists primarily of Fortune 500 companies representing a variety of industries in the United States. While we do not have continuing dependence on any single client or a limited group of clients, one or a few clients may contribute a substantial portion of our revenues in any given year or over a period of several consecutive years due to major engineering projects. For example, during 2005, 37% of our total revenues were attributable to a large EPC project completed by our engineering segment and our systems segment for one major refining and petrochemical client and its subsidiaries.

We have had success undertaking new projects for prior clients and providing ongoing services to clients following the completion of the projects.

Nevertheless, in order to generate revenues in future years, we must continue efforts to obtain new engineering projects. Historically, we have not generated significant revenues from government clients. We hope that our 2004 acquisition of Engineering Design Group, Inc. will allow us to increase revenues from the government market beyond the \$2.0 million in revenue that we generated in 2005.

In recent years, the continuing trend among engineering clients and their industry counterparts has been toward outsourcing and sole sourcing. This trend has fostered the development of ongoing, longer-term arrangements with clients, rather than one-time limited engagements. These arrangements are often referred to as partnering relationships, alliances or sole source contracts, and vary in scope, duration and degree of commitment. For example, engagements may provide for:

- a minimum number of work man-hours over a specified period;
- the provision of at least a designated percentage of the client's requirements;
- the designation of the Company as the client's sole source of engineering at specific locations; or
- a non-binding preference or intent, or a general contractual framework, for what the parties expect will be an ongoing relationship.

Despite their variety, we believe that these partnering relationships have a stabilizing influence on our service revenues. At present, we maintain some form of partnering or alliance arrangement with 16 major oil and chemical companies. Most of our projects are specific in nature and we generally have multiple projects with the same clients. If we were to lose one or more of our significant clients and were unable to replace them with other customers or other projects, our business would be materially adversely affected.

In the systems segment, our clients include end-users and operators of facilities relating to oil and gas products, pipelines, refineries, chemical companies and processing plants. Other clients include equipment manufacturers, construction

## ITEM 1. BUSINESS (Continued)

contractors and other engineering firms that incorporate our control systems into facilities and products that they design, construct and manufacture. As in the engineering segment, in any given year, a small number of clients may account for a large percentage of the systems segment's revenues for that year, depending on the number of major projects undertaken. Though the systems segment frequently receives work from repeat clients, its client list may vary significantly from year to year.

Our ten largest customers, who vary from one period to the next, accounted for 78% of our total revenue in both 2005 and 2004.

We do not have any long-term commitments from these clients and sales of products from the systems segment are typically made according to the client's specifications on a purchase order basis. Our potential revenues are, therefore, dependent on continuing relationships with these customers.

### *Contracts*

We generally enter into two principal types of contracts with our clients: time and materials contracts and fixed-price contracts. In fiscal 2005, 88% and 12% of our net revenue was derived from time and materials and fixed-price contracts, respectively. Our various clients determine which type of contract we will enter into for a particular engagement.

- *Time and Materials.* Under our time and materials contracts, we are paid for labor at either negotiated hourly billing rates or reimbursed for allowable hourly rates and for other expenses. Profitability on these contracts is driven by billable headcount and cost control. Some of these contracts may have upper limits, referred to as "not to exceed." If our costs generate billings that exceed the contract ceiling or are not allowable, we will not be able to obtain reimbursement for any excess cost. Further, the continuation of each contract partially depends upon the customer's discretionary periodic assessment of our performance on that contract.
- *Fixed-Price.* Under a fixed-price contract, we provide the customer a total project for an agreed-upon price, subject to project circumstances and changes in scope. Fixed-price contracts carry certain inherent risks, including risks of losses from underestimating costs, delays in project completion, problems with new technologies and economic and other changes that may occur over the contract period. Another risk includes our ability to secure written change orders prior to commencing work on such orders, which may prevent our getting paid for work performed. Consequently, the profitability of fixed-price contracts may vary substantially.

### *Backlog*

Backlog represents gross revenue of all awarded contracts that have not been completed and will be recognized as revenues over the life of the project. Although backlog reflects business that we consider to be firm, cancellations or scope adjustments may occur. Further, most contracts with clients may be terminated at will, in which case the client would only be obligated to us for services provided through the termination date. We have adjusted backlog to reflect project cancellations, deferrals and revisions in scope and cost (both upward and downward) known at the reporting date; however, future contract modifications or cancellations may increase or reduce backlog and future revenues. As a result, no assurances can be given that the amounts included in backlog will ultimately be realized.

At December 31, 2005, our backlog was \$170 million compared to an estimated \$135 million at December 31, 2004. We estimate that approximately 75% of the backlog at December 31, 2005 will be recognized during fiscal 2006.

The backlog at December 31, 2005 consists of \$165 million with commercial customers and \$5 million with the United States Federal Government. Backlog on the federal programs includes only the portion of the contract award that has been funded by the U.S. Government.

Backlog includes gross revenue under two types of contracts: (1) contracts for which work authorizations have been received on a fixed-price basis and not-to-exceed projects that are well defined, and (2) time and material evergreen contracts at an assumed 12 month run-rate, where we place employees at our clients' site to perform day-to-day project efforts.

## **ITEM 1. BUSINESS (Continued)**

### ***Customer Service and Support***

We provide service and technical support to our customers in varying degrees depending upon the business line and on customer contractual arrangements. The Company's technical staff provides initial telephone support services for its customers. These services include isolating and verifying reported product failures and authorizing repair services in support of customer requirements. We also provide on-site engineering support if a technical issue cannot be resolved over the telephone. On projects for which we have provided engineering systems, we provide worldwide start-up and commissioning services. We also provide the manufacturers' limited warranty coverage for products we re-sell.

### ***Dependence Upon Suppliers***

Our ability to provide clients with services and systems in a timely and competitive manner depends on the availability of products and parts from our suppliers at competitive prices and on reasonable terms. Our suppliers are not obligated to have products on hand for timely delivery nor can they guarantee product availability in sufficient quantities to meet our demands. There can be no assurance that we will be able to obtain necessary supplies at prices or on terms we find acceptable. However, in an effort to maximize availability and maintain quality control, we generally procure components from multiple distributors.

For example, all of the product components used by our systems segment are fabricated using components and materials that are available from numerous domestic suppliers. There are approximately 36 principal suppliers of these components, each of whom can be replaced by an equally viable competitor. No one manufacturer or vendor provides products that account for 10% or more of our revenues. Thus, we anticipate little or no difficulty in obtaining components in sufficient quantities and in a timely manner to support our manufacturing and assembly operations. Units produced through the systems segment are normally not produced for inventory and component parts are typically purchased on an as-needed basis.

Despite the foregoing, some of our subsidiaries rely on certain suppliers for necessary components and there can be no assurance that these components will continue to be available on acceptable terms. If a subsidiary terminates a long-standing supply relationship, it may be difficult to obtain alternative sources of supply without a material disruption in our ability to provide products and services to our customers. While we do not believe that such a disruption is likely, if it did occur, it could have a material adverse effect on our financial condition and results of operations.

### ***Patents, Trademarks, Licenses***

Our success depends in part upon our ability to protect our proprietary technology, which we do primarily through protection of our trade secrets and confidentiality agreements. The U.S. Patent and Trademark Office approved our application for the uses of "ENGlobal" and "Integrated Rack" in September 2004 and March 2005, respectively. In addition, we have pending trademark applications on file with the U.S. Patent and Trademark Office for the names "Flare-Mon" and "Purchased Data." There can be no assurance that the protective measures we currently employ will be adequate to prevent the unauthorized use or disclosure of our technology, or the independent third party development of the same or similar technology. Although our competitive position to some extent depends on our ability to protect our proprietary and trade secret information, we believe that other factors, such as the technical expertise and knowledge base of our management and technical personnel, as well as the timeliness and quality of the support services we provide, will also help us to maintain our competitive position.

### ***Government Regulations***

The Company and certain of our subsidiaries are subject to various foreign, federal, state, and local laws and regulations relating to our business and operations, and various health and safety regulations as established by the Occupational Safety and Health Administration. The Company and members of its professional staff are subject to a variety of state, local and foreign licensing, registration and other regulatory requirements governing the practice of engineering. Currently, we are not aware of any situation or condition relating to the regulation of the Company, its subsidiaries, or personnel that we believe is likely to have a material adverse effect on our results of operations or financial condition.

### ***Employees***

As of December 31, 2005, the Company and its subsidiaries employed 1,724 individuals. Of these employees, 23 were employed in sales and marketing; 918 were employed in engineering and related positions; 174 were employed in technical production positions; 273 were employed as inspectors; 256 were employed as project support staff; and 80 were employed

## ITEM 1. BUSINESS (Continued)

in administration, finance and management information systems. We believe that our ability to recruit and retain highly skilled and experienced technical, sales and management personnel has been and will continue to be, critical to our ability to execute our business plan. None of our employees is represented by a labor union or is subject to a collective bargaining agreement. We believe that relations with our employees are good.

### ITEM 1A. RISK FACTORS

Set forth below and elsewhere in this Report and in other documents we file with the SEC are risks and uncertainties that could cause actual results to differ materially from the results contemplated by the forward-looking statements contained in this Report. You should be aware that the occurrence of any of the events described in these risk factors and elsewhere in this Report could have a material adverse effect on our business, financial condition and results of operations and that upon the occurrence of any of these events, the trading price of our common stock could decline.

***We are engaged in highly competitive businesses and must typically bid against competitors to obtain engineering and service contracts.***

We are engaged in highly competitive businesses in which customer contracts are typically awarded through competitive bidding processes. We compete with other general and specialty contractors, both foreign and domestic, including large international contractors and small local contractors. Some competitors have greater financial and other resources than we do, which, in some instances, gives them a competitive advantage over us.

***The failure to attract and retain key professional personnel could adversely affect the Company.***

Our success depends on attracting and retaining qualified personnel in a competitive environment. We are dependent upon our ability to attract and retain highly qualified managerial, technical and business development personnel. Competition for key personnel is intense. We cannot be certain that we will retain our key managerial, technical and business development personnel or that we will attract or assimilate key personnel in the future. Failure to retain or attract such personnel would materially adversely affect our businesses, financial position, results of operations and cash flows. This is a major risk factor that could materially impact our operating results.

***Our business and operating results could be adversely affected by our inability to accurately estimate the overall risks, revenue or costs on a contract.***

We generally enter into two principal types of contracts with our clients: time and materials contracts and fixed-price contracts. Under our fixed-price contracts, we receive a fixed-price irrespective of the actual costs we incur and, consequently, we are exposed to a number of risks. These risks include underestimation of costs, problems with new technologies, unforeseen expenditures or difficulties, delays beyond our control and economic and other changes that may occur during the contract period. Our ability to secure change orders on scope changes and our ability to invoice for such changes poses an additional risk. In fiscal 2005, approximately 12% of our net revenue was derived from fixed-price contracts.

Under our time and materials contracts, we are paid for labor at negotiated hourly billing rates or reimbursement at specified mark-up hourly rates and negotiated rates for other expenses. Profitability on these contracts is driven by billable headcount and cost control. Some time and materials contracts are subject to contract ceiling amounts, which may be fixed or performance-based. If our costs generate billings that exceed the contract ceiling or are not allowable under the provisions of the contract or any applicable regulations, we may not be able to obtain reimbursement for all of our costs.

Revenue recognition for a contract requires judgment relative to assessing the contract's estimated risks, revenue and costs, and technical issues. Due to the size and nature of many of our contracts, the estimation of overall risk, revenue and cost at completion is complicated and subject to many variables. Changes in underlying assumptions, circumstances or estimates may also adversely affect future period financial performance. This is a major risk factor that could materially impact our operating results.



## ITEM 1A. RISK FACTORS (Continued)

### ***Economic downturns could have a negative impact on our businesses.***

Demand for the services offered by us has been and is expected to continue to be, subject to significant fluctuations due to a variety of factors beyond our control, including demand for engineering services in the petroleum refining, petroleum chemical and pipeline industries and in other industries that we provide services to. During economic downturns in these industries, our customer's ability to engage us may decline significantly. We cannot be certain that economic or political conditions will be generally favorable or that there will not be significant fluctuations adversely affecting our industry as a whole or key markets targeted by us.

### ***Our dependence on one or a few customers could adversely affect us.***

One or a few clients have in the past and may in the future contribute a significant portion of our consolidated revenues in any one year or over a period of several consecutive years. In 2005, approximately 44% of our revenues were from one client, approximately 12% of our revenues were from another client and another 12% were from a third client. As our backlog frequently reflects multiple projects for individual clients, one major customer may comprise a significant percentage of our backlog at any point in time. Because these significant customers generally contract with us for specific projects, we may lose these customers from year to year as their projects with us are completed. If we do not replace them with other customers or other projects, our business could be materially adversely affected. Additionally, we have long-standing relationships with many of our significant customers. Our contracts with these customers, however, are on a project-by-project basis and the customers may unilaterally reduce or discontinue their purchases at any time. The loss of business from any one of such customers could have a material adverse effect on our business or results of operations.

### ***Additional acquisitions may adversely affect our ability to manage our business.***

Acquisitions have contributed to our growth over the past three years and we plan to continue making acquisitions in the future on terms management considers favorable to us. The successful acquisition of other companies involves an assessment of future revenue opportunities, operating costs, economies and earnings after the acquisition is complete, potential industry and business risks and liabilities beyond our control. This assessment is necessarily inexact and its accuracy is inherently uncertain. In connection with our assessments, we perform reviews of the subject acquisitions we believe to be generally consistent with industry practices. These reviews, however, may not reveal all existing or potential problems, nor will they permit a buyer to become sufficiently familiar with the target companies to assess fully their deficiencies and capabilities. We cannot assure you that we will identify, finance and complete additional suitable acquisitions on acceptable terms. We may not successfully integrate future acquisitions. Any acquisition may require substantial attention from our management, which may limit the amount of time that management can devote to day-to-day operations. Our inability to find additional attractive acquisition candidates or to effectively manage the integration of any businesses acquired in the future could adversely affect our ability to grow profitably or at all.

### ***Seasonality of our industry may cause our revenues to fluctuate.***

Holidays and employee vacations during our fourth quarter exert downward pressure on revenues for that quarter, which is only partially offset by the year-end efforts on the part of many clients to spend any remaining funds budgeted for engineering services or capital expenditures during the year. The annual budgeting and approval process under which these clients operate is normally not completed until after the beginning of each new year, which can depress results for the first quarter. Principally due to these factors, our revenues during the first and fourth quarters generally tend to be lower than in the second and third quarters.

### ***Liability claims could result in losses.***

Providing engineering and design services involves the risk of contract, professional errors and omissions and other liability claims, as well as adverse publicity. Further, many of our contracts will require us to indemnify our clients not only for our negligence, if any, but also for the concurrent negligence and in some cases, sole negligence of our clients. We currently maintain liability insurance coverage, including coverage for professional errors and omissions. However, claims outside of or exceeding our insurance coverage may be made. A significant claim could result in unexpected liabilities, take management time away from operations, and have a material adverse impact on our cash flow.

## ITEM 1A. RISK FACTORS (Continued)

***If the operating result of either segment is adversely affected, an impairment of goodwill could result in a write down.***

Based on factors and circumstances impacting ENGlobal and the business climate in which it operates, the Company may determine that it is necessary to re-evaluate the carrying value of its goodwill by conducting an impairment test in accordance with SFAS No. 142. The Company has assigned goodwill to its two segments based on estimates of the relative fair value of each segment. If changes in the industry, market conditions, or government regulation negatively impact either of the Company's segments resulting in lower operating income, if assets are harmed, if anticipated synergies or cost savings are not realized with newly acquired entities, or if any circumstance occurs which results in the fair value of either segment declining below its carrying value, an impairment to goodwill would be created. In accordance with SFAS No. 142, the Company would be required to write down the carrying value of goodwill.

***Our Board of Directors may authorize future sales of ENGlobal common stock, which could result in a decrease in value to existing stockholders of the shares they hold.***

Our Articles of Incorporation authorize our board of directors to issue up to an additional 48,058,056 shares of common stock and an additional 2,265,167 shares of preferred stock. These shares may be issued without stockholder approval unless the issuance is 20% or more of our outstanding common stock, in which case the American Stock Exchange requires stockholder approval. We may issue shares of stock in the future in connection with acquisitions or financings. In addition, we may issue options as incentives under our 1998 Incentive Option Plan. Future issuances of substantial amounts of common stock, or the perception that these sales could occur, may affect the market price of our common stock. In addition, the ability of the board of directors to issue additional stock may discourage transactions involving actual or potential changes of control of the Company, including transactions that otherwise could involve payment of a premium over prevailing market prices to holders of our common stock.

***Our backlog is subject to unexpected adjustments and cancellations and is, therefore, an uncertain indicator of our future revenues or earnings.***

As of December 31, 2005, our backlog was approximately \$170 million. We cannot assure investors that the revenues projected in our backlog will be realized or, if realized, will result in profits. Projects may remain in our backlog for an extended period of time prior to project execution and, once project execution begins, it may occur unevenly over the current and multiple future periods. In addition, project terminations, suspensions or reductions in scope may occur from time to time with respect to contracts reflected in our backlog. Such backlog reductions would reduce the revenue and profit we actually receive from contracts reflected in our backlog. Future project cancellations and scope adjustments could further reduce the dollar amount of our backlog and the revenues and profits that we actually earn.

***Our dependence on subcontractors and equipment manufacturers could adversely affect us.***

We rely on third-party subcontractors as well as third-party suppliers and manufacturers to complete our projects. To the extent that we cannot engage subcontractors or acquire supplies or materials, our ability to complete a project in a timely fashion or at a profit may be impaired. If the amount we are required to pay for these goods and services exceeds the amount we have estimated in bidding for fixed-price or cost-plus contracts, we could experience losses in the performance of these contracts. In addition, if a subcontractor or supplier is unable to deliver its services or materials according to the negotiated terms for any reason, including the deterioration of its financial condition or over-commitment of its resources, we may be required to purchase the services or materials from another source at a higher price. This may reduce the profit to be realized or result in a loss on a project for which the services or materials were needed.

***If we are not able to successfully manage our growth strategy, our business and results of operations may be adversely affected.***

We have grown rapidly over the last several years. Our growth presents numerous managerial, administrative, operational and other challenges. Our ability to manage the growth of our operations will require us to continue to improve our management information systems and maintain discipline in our internal systems and controls. Industry trends and our strategy to pursue larger fixed-price EPC projects, our ability to manage and measure project performance will require us to strengthen our internal project and cost control systems within operations that have traditionally operated in a cost plus environment. In addition, our growth will increase our need to attract, develop, motivate and

## **ITEM 1A. RISK FACTORS (Continued)**

retain both our management and professional employees. The inability of our management to effectively manage our growth or the inability of our employees to achieve anticipated performance could have a material adverse effect on our business.

*If we are not able to successfully manage internal growth initiatives, our business and results of operations may be adversely affected.*

Our growth strategy is to use our technical expertise in conjunction with industry trends. To support this strategy, the Company may elect to fund internal growth initiatives targeted at markets that the Company believes may have significant potential needs for the Company's services. The downside risks are that such initiatives could have a negative effect on current earnings until such initiatives reach critical mass or that industry trends have been misread or delayed and continued funding could have a negative impact on long term earnings.

*A small number of stockholders own a significant portion of our outstanding common stock, thus limiting the extent to which other stockholders can effect decisions subject to stockholder vote.*

Directors, executive officers and principal stockholders of ENGlobal and their affiliates, beneficially own approximately 40% of our outstanding common stock on a fully diluted basis. Accordingly, these stockholders, as a group, are able to affect the outcome of stockholder votes, including votes concerning the adoption or amendment of provisions in our Articles of Incorporation or bylaws and the approval of mergers and other significant corporate transactions. The existence of these levels of ownership concentrated in a few persons makes it unlikely that any other holder of common stock will be able to affect the management or direction of the Company. These factors may also have the effect of delaying or preventing a change in management or voting control of the Company.

## **ITEM 1B. UNRESOLVED STAFF COMMENTS**

Not applicable.

## **ITEM 2. PROPERTIES**

### *Facilities*

We lease space in 15 buildings in the U.S. and Canada totaling approximately 365,000 square feet, and we own an office building in Baton Rouge, Louisiana with 27,500 square feet. The leases have remaining terms ranging from monthly to six years and are at what we consider to be commercially reasonable rental rates. Our principal office locations are in Houston and Beaumont, Texas, and Tulsa, Oklahoma. We have other offices in Freeport, Midland and Dallas, Texas, Baton Rouge and Lake Charles, Louisiana, Cleveland and Blackwell, Oklahoma and Calgary, Alberta Canada. Approximately 214,000 square feet of our total office space is designated for our professional, technical and administrative personnel. We believe that our office and other facilities are well maintained and adequate for existing and planned operations at each operating location.

Our systems segment performs fabrication assembly in two shop facilities. One facility is in Houston, Texas with approximately 62,600 square feet of space and a second facility is in Beaumont, Texas with approximately 30,000 square feet of space.

During 2005, we leased approximately 14,000 square feet of office space in Beaumont, Texas from a joint venture owned one-third by each of: ENGlobal Engineering, Inc., Michael L. Burrow (the Company's CEO), and a stockholder of the Company who owns less than 1% of the Company's stock. We believe that this lease was at a commercially reasonable rental rate. The lease was renewed in August 2005. In September 2005, the building was damaged by Hurricane Rita and all tenants have relocated to other locations. No further lease payments have been made by the Company since September 2005 and the insurance claim filed by PEI Investments remains unsettled.

**ITEM 2. PROPERTIES (Continued)**

Below is a complete listing of the space leased and owned with the expiration dates of the leases.

<u>Location</u>	<u>Square Feet</u>	<u>Lease Expiration Date</u>
Beaumont	42,880	2011
	30,250	2008
	23,616	2010
	13,590	Month to Month
**	2,300	2006
Houston	62,641	2008
	48,979	2011
Midland	4,400	2008
Richardson	14,323	2008
Lake Charles	12,183	2006
	1,140	2007
Tulsa	68,882	2008
	678	2007
Cleveland	8,600	2006
Blackwell	1,800	Month to Month
Freeport	23,000	2007
Baton Rouge	27,500	Owned
Calgary, Alberta	5,157	2010
	<u>391,919</u>	

\*\* Began January 10, 2006

In March 2005, we entered into a lease agreement for the relocation of our corporate headquarters and Houston engineering office to a 33,759 square foot facility in North Houston. Effective June 1, 2005, approximately 60 employees moved to our new location at 654 North Sam Houston Parkway E, Suite 400, Houston, Texas 77060-5914, which can accommodate up to 150 employees with appropriate space planning. We executed a six-year lease requiring aggregate lease payments in excess of \$2.3 million, with a right of refusal covering all remaining space in the building. In the second quarter of 2006, we expect to lease additional space in the same building for planned growth.

**ITEM 3. LEGAL PROCEEDINGS**

During 2005, the Company and its subsidiaries were successful in obtaining the dismissal of all but one of the remaining petitions filed against the Company and its subsidiaries in 2003, on behalf of former employees of Barnard and Burk, Inc. The Company believes that the remaining petition is without merit and immaterial to the Company's business and financial condition and plans to vigorously defend itself in this lawsuit.

**ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS**

Not applicable.

## PART II

### ITEM 5. MARKET FOR REGISTRANT'S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES

#### *Market Information and Holders*

The Company's common stock has been quoted on the American Stock Exchange ("AMEX") since June 16, 1998, and is currently traded under the symbol "ENG." From its initial listing on AMEX on June 16, 1998 to June 15, 2002, the Company's stock was traded under the symbol "IDS." Newspaper stock listings identify us as "ENGlobal."

The following table sets forth the high and low sales prices of our common stock for the periods indicated.

	Fiscal Year Ended December 31			
	2005		2004	
	High	Low	High	Low
First Quarter	2.87	2.04	2.32	1.96
Second Quarter	4.03	2.01	2.43	1.44
Third Quarter	9.10	3.69	1.75	1.20
Fourth Quarter	8.75	5.87	3.19	1.21

The foregoing figures, based on information published by AMEX, do not reflect retail mark-ups or markdowns and may not represent actual trades.

In connection with our December 2001 merger with Petrocon, we issued 2,500,000 shares of Series A Preferred Stock, \$0.001 par value per share, to Equus II Incorporated. In 2002 and 2003, we issued dividends to Equus in the form of 234,833 shares of Series A Preferred Stock. Effective August 2003, the Company exercised its right to convert all outstanding Series A Preferred Stock to 1,149,089 shares of common stock. The Series A Preferred Stock had fixed terms that were specific to the 2001 merger with Petrocon. Therefore, the Company intends to seek stockholder approval to eliminate the 2,265,167 shares of available and unissued Series A Preferred Stock from its capital structure.

As of March 24, 2006, approximately 200 stockholders of record held the Company's common stock. We do not have current information regarding the number of holders of beneficial interest holding our common stock.

#### *Equity Compensation Plan Information*

The following table sets forth certain information concerning the Company's equity compensation plans as of December 31, 2005. See Note 11 in the attached financial statements.

	Number of Securities to be Issued Upon Exercise of Outstanding Options, Warrants and Rights (a)	Weighted-Average Exercise Price of Outstanding Options, Warrants and Rights (b)	Number of Securities Remaining Available for Future Issuance Under Equity Compensation Plans [Excluding Securities in Column (a)] (c)
Equity compensation plans approved by security holders	1,438,234 <sup>(1)</sup>	3.07	509,260

<sup>(1)</sup> Includes options issued through our 1998 Incentive Plan. For a brief description of the material features of the Plan, see Note 11 of the Notes to the Consolidated Financial Statements. Some of these options, also granted through the 1998 Incentive Plan were options granted as replacement options for outstanding Petrocon incentive options pursuant to the terms of the December 2001 Merger Agreement with Petrocon.



**ITEM 5. MARKET FOR REGISTRANT'S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES (Continued)**

***Dividend Policy***

The Company has never declared or paid a cash dividend on its common stock. The Company intends to retain any future earnings for reinvestment in its business and does not intend to pay cash dividends in the foreseeable future. In addition, restrictions contained in our loan agreements governing our credit facility with Comerica Bank preclude us from paying any dividends on our common stock while any debt under those agreements is outstanding. The payment of dividends in the future will depend on numerous factors, including the Company's earnings, capital requirements, operating and financial position and general business conditions.

Dividends on outstanding shares of Series A Preferred Stock were paid on the last day of May in 2002 and 2003 in shares of stock of Series A Preferred Stock at a rate of 0.08 shares for each outstanding share of Series A Preferred Stock. The Company elected to convert all shares of preferred stock to 1,149,089 shares of common stock in August 2003.

## ITEM 6. SELECTED FINANCIAL DATA

### *Summary Selected Historical Consolidated Financial Data*

The following tables set forth our selected financial data. The data for the years ended December 31, 2005, 2004, and 2003 have been derived from the audited financial statements appearing elsewhere in this document. The data as of December 31, 2003, 2002 and 2001 and for the years ended December 31, 2002 and 2001 have been derived from audited financial statements not appearing in this document. You should read the selected financial data set forth below in conjunction with our financial statements and the notes thereto included in Part II, Item 8, Part II, Item 7, "Management's Discussion and Analysis of Financial Condition and Results of Operations," and other financial information appearing elsewhere in this document. In addition, the merger with Petrocon in December 2001 should be considered in connection with your review of this information.

Note: Due to the sale of Thermaire, all items related to the previously reported manufacturing segment have been reclassified to discontinued operations in order to provide comparative results. Previously reported amounts will not agree to the amounts presented below except net income.

	<b>Years Ended December 31,</b>				
	<b>2005</b>	<b>2004</b>	<b>2003</b>	<b>2002</b>	<b>2001</b>
	<b>(in thousands, except per share amounts)</b>				
<b>Statement of Operations</b>					
Revenues					
Engineering	\$ 215,698	\$ 133,630	\$ 108,380	\$ 74,971	\$ 14,235
Systems	17,887	15,258	15,339	14,151	3,575
Total revenues	<u>233,585</u>	<u>148,888</u>	<u>123,719</u>	<u>89,122</u>	<u>17,810</u>
Costs and expenses					
Engineering	189,696	117,606	93,579	62,877	10,433
Systems	15,616	13,090	13,167	11,840	3,107
Selling, general and administrative	19,689	13,700	12,439	10,632	2,836
Total costs and expenses	<u>225,001</u>	<u>144,396</u>	<u>119,185</u>	<u>85,349</u>	<u>16,376</u>
Operating income	8,584	4,492	4,534	3,773	1,434
Interest income (expense), net	(800)	(590)	(784)	(821)	14
Other income (expense), net	116	118	(355)	143	14
Foreign currency gain (loss)	(2)	-	-	-	-
Income from continuing operations before provision for income taxes	7,898	4,020	3,395	3,095	1,462
Provision for income taxes	3,116	1,656	1,110	1,197	595
Income from operations	4,782	2,364	2,285	1,898	867
Income (loss) from discontinued operations, net of taxes	-	-	(154)	(146)	115
Income from disposal of discontinued operations	-	-	26	-	-
Net income	<u>\$ 4,782</u>	<u>\$ 2,364</u>	<u>\$ 2,157</u>	<u>\$ 1,752</u>	<u>\$ 982</u>

**ITEM 6. SELECTED FINANCIAL DATA (Continued)**

	Years Ended December 31,				
	2005	2004	2003	2002	2001
	(in thousands, except per share amounts)				
<b>Per Share Data</b>					
Basic earnings (loss) per share					
Continuing operations	\$ 0.20	\$ 0.10	\$ 0.09	\$ 0.07	\$ 0.07
Discontinued operations	-	-	-	-	-
Net income per share	<u>\$ 0.20</u>	<u>\$ 0.10</u>	<u>\$ 0.09</u>	<u>\$ 0.07</u>	<u>\$ 0.07</u>
Weighted average common shares outstanding – basic	24,300	23,455	23,301	22,861	13,236
Diluted earnings (loss) per share					
Continuing operations	\$ 0.19	\$ 0.10	\$ 0.09	\$ 0.07	\$ 0.07
Discontinued operations	-	-	-	-	-
Net income per share	<u>\$ 0.19</u>	<u>\$ 0.10</u>	<u>\$ 0.09</u>	<u>\$ 0.07</u>	<u>\$ 0.07</u>
Weighted average common shares outstanding – diluted	25,250	23,786	23,734	23,013	13,236
<b>Cash Flow Data</b>					
Operating activities, net	\$ (920)	\$ (2,391)	\$ 6,557	\$ 1,302	\$ 744
Investing activities, net	(2,417)	(1,811)	(471)	(1,290)	5
Financing activities, net	3,492	4,170	(6,122)	(1,182)	253
Exchange rate changes	(4)	-	-	-	-
Net change in cash and cash equivalents	<u>\$ 151</u>	<u>\$ (32)</u>	<u>\$ (36)</u>	<u>\$ (1,170)</u>	<u>\$ 1,002</u>
<b>Balance Sheet Data</b>					
Working capital	\$ 21,825	\$ 14,503	\$ 6,505	\$ 8,416	\$ 5,703
Property and equipment, net	\$ 6,861	\$ 5,262	\$ 4,302	\$ 4,779	\$ 4,095
Total assets	\$ 75,936	\$ 57,261	\$ 42,530	\$ 40,068	\$ 38,286
Long-term debt, net of current portion	\$ 5,228	\$ 15,585	\$ 7,506	\$ 12,580	\$ 1,357
Long-term capital leases, net of current portion	\$ -	\$ -	\$ 12	\$ 17	\$ 48
Stockholders' equity	\$ 39,865	\$ 20,051	\$ 18,175	\$ 13,389	\$ 11,846

## **ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATION**

The following discussion is qualified in its entirety by, and should be read in conjunction with, our Consolidated Financial Statements including the Notes thereto, included elsewhere in this Annual Report on Form 10-K. Note 18 to the Financial Statements contains segment information.

### ***Overview***

We furnish engineering consulting and control system services to the petroleum refining, petrochemical, pipeline, production and processing industries. Our business consists of two segments: engineering and systems. Our engineering segment offers engineering consulting services to clients for the development, management and turnkey execution of engineering projects, construction management, and inspection services. Our systems segment designs, assembles, programs, installs, integrates and services control and instrumentation systems for specific applications in the energy and processing related industries.

The Company's revenue is composed of engineering, construction and procurement service revenue and product sales. The Company recognizes service revenue as soon as the services are performed. The majority of the Company's engineering services have historically been provided through cost-plus contracts whereas a majority of the Company's product sales are earned on fixed-price contracts.

In the course of providing our services, we routinely provide engineering, materials, equipment and may provide construction services on a subcontractor basis. Generally, these materials, equipment and subcontractor costs are passed through to our clients and reimbursed, along with fees, which in total are at margins lower than those of our normal core business. In accordance with industry practice and generally accepted accounting principles, all costs and fees are included in revenue. The use of subcontractor services can change significantly from project to project; therefore, changes in revenue may not be indicative of business trends.

For analytical purposes only, we have historically segregated from our total revenue the revenues derived from material assets or companies acquired during the first 12 months following their respective dates of acquisition and referred to such revenue as "Acquisition" revenue. We also segregate gross profits and SG&A expenses derived from material assets or company acquisitions on the same basis as we segregate revenues. We analyze, for internal purposes only, the percentage of our revenue that comes from staffing services versus the percentage that comes from engineering services, as engineering services have a higher margin than staffing services.

Operating SG&A expense includes management and staff compensation, office costs such as rents and utilities, depreciation, amortization, travel and other expenses generally unrelated to specific client contracts, but directly related to the support of a segment's operation.

Corporate SG&A expense is comprised primarily of marketing costs, as well as costs related to the executive, governance/investor relations, finance, accounting, safety, human resources, project controls and information technology departments and other costs generally unrelated to specific client projects, but which can vary as costs are incurred to support corporate activities and initiatives.

**ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATION (Continued)**

***Results of Operations***

The following table sets forth, for the periods indicated, certain financial data derived from our consolidated statements of operations and indicates the percentage of total revenue for each item. The manufacturing segment is reported in "Income/(Loss) from Discontinued Operations."

	Years Ended December 31,					
	2005		2004		2003	
	Amount	%	Amount	%	Amount	%
	(in thousands)					
Revenue						
Engineering	\$ 203,640	87.2	\$ 124,507	83.6	\$ 106,895	86.4
Systems	17,887	7.7	13,965	9.4	14,892	12.0
Acquisition	12,058	5.2	10,416	7.0	1,932	1.6
Total revenue	<u>\$ 233,585</u>	100.0	<u>\$ 148,888</u>	100.0	<u>\$ 123,719</u>	100.0
Gross profit						
Engineering	\$ 24,780	12.2	\$ 14,351	11.5	\$ 14,652	13.7
Systems	2,271	12.7	2,168	15.5	2,109	14.2
Acquisition	1,222	10.1	1,673	16.1	212	11.0
Total gross profit	<u>\$ 28,273</u>	12.1	<u>\$ 18,192</u>	12.2	<u>\$ 16,973</u>	13.7
Selling, general and administrative						
Non-acquisition	\$ 18,863	8.5	\$ 11,866	8.0	\$ 12,274	9.9
Acquisition	826	6.9	1,834	1.2	165	0.1
Total	<u>\$ 19,689</u>	8.4	<u>\$ 13,700</u>	9.2	<u>\$ 12,439</u>	10.1
Income from continuing operations	\$ 4,782	2.1	\$ 2,364	1.6	\$ 2,285	1.8
Income (loss) on discontinued operations	-	-	-	-	(128)	(0.1)
Net income	<u>\$ 4,782</u>	2.1	<u>\$ 2,364</u>	1.6	<u>\$ 2,157</u>	1.7

Total revenue increased 56.9% or \$84.7 million from 2004 to 2005.

Overall gross profit increased 55.5%, or \$10.1 million, from 2004 to 2005.

Total SG&A expense increased 43.8%, or \$6.0 million, in 2005. Income from continuing operations increased 102.3%, or \$2.4 million.

**ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATION (Continued)**

***Year Ended December 31, 2005 Compared to Year Ended December 31, 2004***

*Total Revenue*

Engineering revenue accounted for 87.2% of our total revenue for the year, increasing \$79.1 million from \$124.5 million in 2004 to \$203.6 million in 2005.

The increase in engineering revenue was primarily brought about by increased activity in the engineering and construction markets. Refining related activity has been particularly strong, including projects to satisfy environmental mandates, expand existing facilities and utilize heavier sour crude. Acquisitions in the fourth quarter of 2004, together with our client's increased demand for in-house technical and inspection resources, stimulated growth in our staffing services division where revenues increased 58.8%, or \$21.4 million, from \$36.4 million in 2004 to \$57.8 million in 2005.

Revenue from procurement services increased 55.5%, or \$21.3 million, from 2004 to 2005 and contributed 25.1%, or \$21.3 million, of the increase in total engineering revenue during the same period. The level of procurement services will vary depending on the volume of procurement activity our customers choose to do themselves as opposed to using our services on the larger EPC contracts.

In 2005, the Company was awarded two significant fixed-price engineering, procurement and construction ("EPC") projects in the refining industry that includes procurement and subcontractor activities within our scope of work. The shift to more fixed-price, EPC type projects is expected to continue into 2006 and beyond as clients look to sole source responsibility on the larger projects.

The systems segment contributed 7.7% of our total revenue for the year, as its revenue increased \$3.9 million, or 27.9%, from \$14.0 million in 2004 to \$17.9 million in revenue in 2005. A general turnaround in the oil and gas industry has helped to increase the demand for ESI's services. Projects from one major supplier of distributed control systems ("DCS") equipment, together with projects from a large engineering and construction firm, contributed most of the increase in revenue in 2005. The completion of turnkey remote instrument enclosures ("RIE's") from projects awarded in the fourth quarter of 2004 contributed \$4.7 million to ESI's revenue in 2005. Backlog for ESI at December 31, 2005 reached \$9.1 million.

Acquisition revenue, representing only 5.2% of total revenue for 2005, increased 15.8%, or \$1.6 million, during the comparable periods, primarily from nine months of revenue generated in 2005 through acquisitions completed in the 4<sup>th</sup> quarter of 2004.

We formerly operated a third segment, the manufacturing segment. Certain assets of this segment were sold in December 2003 and its financial results during 2003 are reported in "Income/(Loss) from Discontinued Operations."

*Gross Profit*

Total gross profit increased \$10.1 million, or 55.5%, from \$18.2 million in 2004 to \$28.3 million in 2005 although, as a percentage of total revenue, decreased slightly from 12.2% to 12.1% during the same period.

Gross profit from engineering increased \$10.4 million, or 72.2%, from \$14.4 million in 2004 to \$24.8 million in 2005 and, as a percentage of revenue, increased from 11.5% in 2004 to 12.2% in 2005. Gross profit was negatively impacted by approximately \$249,000 during 2005 due to start-up expenses and non-reimbursable proposal activity conducted by two of the Company's internal start-up initiatives, ENGlobal Sulfur Group and ENGlobal Automation Group. The staffing services division increased gross profit \$2.4 million, or 55.8%, from \$4.3 million in 2004 to \$6.7 million in 2005 on margins remaining relatively stable over the comparable periods, although such margins are approximately 1% lower than average margins on all other engineering revenues.

## ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATION (Continued)

We earn a lower margin on procurement services as compared to the margin we earn on our core engineering services. In 2005, \$21.5 million, or 25.1% of the increase in our total revenue was from procurement services, providing a 1.7% gross profit margin. Comparably, gross profit margin on core engineering services was 12.1%. In 2004, procurement services produced a .4% gross profit margin. Due to the increase in procurement services in 2005 over 2004, our overall gross profit, as a percentage of total revenue, was negatively impacted by 4.0% and 3.6%, respectively.

Again, the shift to more fixed-price EPC type projects will negatively impact engineering gross profit as a percentage of revenue because higher historical cost plus margins on engineering labor recognized during the period in which it was earned will now be combined with the lower margins on procurement services and construction subcontractor charges and recorded throughout the overall duration and completion of the projects.

Gross profit for our systems segment increased \$103,000, or 4.5%, from \$2.2 million in 2004 to \$2.3 million in 2005. However, as a percent of revenue, gross profit decreased by 2.8% from 15.5% in 2004 to 12.7% in 2005. The lower margin in 2005 is a result of several factors. The increase in the workload created a shortage in shop labor which was filled by hiring contract labor leading to inefficiencies and rework. This led to overruns in shop labor on projects, thus dropping margins below already tight budgeted margins. Secondly, with the increase in proposal work, estimates of material and labor cost were underestimated, thus causing lower profit margins. Lastly, market pressures have driven down margins on projects overall. Corrective measures have been taken during the first quarter of 2006 to replace all contract labor with more stable, direct-hire employees. Additional staffing and systems within the estimating and proposal group should improve proposal pricing.

During the fourth quarter, ESI experienced delays in receiving major components for a project that were being supplied by a third party vendor. As a result, the work ESI expected to perform on such project during 2005 will be completed in 2006, resulting in a corresponding delay in our recognition of revenues and profits.

One current project representing 25% of the systems segment's backlog at December 31, 2005 has a 13.6% budgeted margin.

### Selling, General and Administrative ("SG&A") Expenses

Selling, general and administrative expenses increased \$6.0 million, or 43.8%, from \$13.7 million in 2004 to \$19.7 million in 2005, primarily due to increases in salaries and burdens, facilities and office expenses, and travel. However, as a percent of revenue, SG&A decreased .8% from 9.2% in 2004 to 8.4% in 2005.

Salaries and burden expenses increased \$3.6 million in 2005 over 2004. \$1.0 million of this increase was related to additional incentives paid under the 2005 incentive plans. An additional \$1.0 million of the increase was due to increases in corporate salaries, primarily in Business Development, Accounting and Project Controls, to support Company growth. The remainder of the increase came from increases in operation salaries and burdens primarily due to increases in administrative staffing from acquisitions, EAG's start-up during the year, ESI's expansion into the Beaumont area, and increases in their administrative support staffing in the Houston facility; plus additional overhead due to the growth of EEI's offices in Beaumont and Tulsa.

Facilities and office expenses increased \$1.4 million in 2005 over 2004 due to the expansion of EEI's offices in Tulsa, Houston, Dallas, and Beaumont to meet both current and projected growth requirements, plus the additional cost of facilities utilized by acquisitions made in the fourth quarter of 2004.

Increased business development activity pushed marketing and travel expenses up by almost \$500,000 in 2005 over similar expenses in 2004.

### Operating Profit

Operating profit increased \$4.1 million to \$8.6 million in 2005 as compared to \$4.5 million in 2004, increasing, as a percentage of total revenue, from 3.0% in 2004 to 3.7% in 2005. Although operating profit for 2005 exceeded operating

**ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATION (Continued)**

profit for 2004, our net operating profit for the fourth quarter of 2005 was down approximately \$1.2 million, or 39%, over third quarter operating results, primarily due to losses of approximately \$659,000 in start-up expenses and non-reimbursable proposal activity conducted by two of the Company's internal start-up initiatives, ENGlobal Sulfur Group and EAG. For 2005, the combined operating loss for both groups was approximately \$817,000.

Other Income (Expense)

Other income decreased from \$118,000 in 2004 to \$116,000 in 2005. The income in 2004 resulted from a legal settlement. The income in 2005 was derived from distributions from PEI Investments, insurance proceeds from Hurricane Rita losses, and income from the sale of assets, partially offset by a reclassification of financing costs.

***Year Ended December 31, 2004 Compared to Year Ended December 31, 2003***

Total Revenue

Total engineering revenue accounted for 83.6% of our total revenue for the year, increasing \$17.6 million from \$106.9 million in revenue in 2003 to \$124.5 million in revenue in 2004.

Revenue from procurement services increased \$9.2 million in 2004, or 52% of the total increase in engineering revenue. This was the result of additional revenue of \$25.5 million on a co-generation project that began in 2003, offset by \$16.3 million in lower revenue from a cyclohexane project that began in 2002. The remaining increase of \$8.4 million in revenue came from an additional \$4.9 million through the Tulsa office, \$2.4 million through the Beaumont office and \$1.1 million from all other office locations. Our engineering segment has been successful in obtaining major projects in the petroleum refining industry in the mid-continent area for the Tulsa office, but we do not currently have a project that would replace the co-generation project when it is completed in the Beaumont office.

In 2005, the Company was awarded two significant projects to be completed primarily out of our Tulsa office. Coffeyville Resources Refining & Marketing, LLC ("CRRM") has entered into an agreement with ENGlobal for detailed engineering and procurement services for CRRM's ultra low sulfur diesel fuel facilities at its Coffeyville, Kansas refinery on a cost reimbursable basis. We estimate that the agreement will result in approximately 150,000 man-hours in engineering and related activities in addition to a significant amount of revenue attributable to the procurement of materials and equipment. The project began in January 2005 and is scheduled to conclude in the third quarter of 2006. Frontier Refining, Inc. has awarded ENGlobal a contract to provide lump sum turnkey services for engineering, procurement and construction for modifications to produce ultra low sulfur diesel at Frontier's Cheyenne, Wyoming refinery. The Company estimates revenue from the Frontier contract to be approximately \$7 million. The project began in February 2005 and is scheduled to complete in the spring of 2006.

The systems segment contributed 9.4% of our total revenue for the year, as its revenue declined \$900,000 from \$14.9 million in 2003 to \$14.0 million in revenue in 2004. Our systems segment began 2005 with a project backlog of \$7.6 million, representing the largest booking of new work in the segment's history.

During the fourth quarter of 2004, the systems segment was awarded projects totaling \$2.8 million from Honeywell to build eight turnkey remote instrument enclosures ("RIEs") of which six units are scheduled for completion during the second quarter and additional units following in the third and fourth quarters of 2005. In the first quarter of 2005, Honeywell awarded the Company three additional turnkey RIEs totaling \$1.6 million with one unit scheduled for delivery in the second quarter and two units scheduled for delivery in the fourth quarter of 2005.

Revenue from acquired companies accounted for 7.0% of our total revenue during 2004, increasing by \$8.5 million or 447% from \$1.9 million in revenue in 2003 to \$10.4 million in revenue in 2004. Revenue recognized from acquired assets or companies during the first 12 months of their operation within ENGlobal is referred to as "Acquisition" revenue. Acquisition revenue in 2004 includes revenue of \$3.6 million, \$3.3 million, \$1.7 million, \$1.3 million and \$500,000 from EDG, CIS, Petro-Chem, Senftleber and AmTech, respectively.



## ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATION (Continued)

We formerly operated a third segment, the manufacturing segment. Certain assets of this segment were sold in December 2003 and March 2005 and its financial results during 2003 and 2004 are reported in "Income/(Loss) from Discontinued Operations."

### Gross Profit

Gross profit from our engineering segment decreased \$301,000 from \$14.7 million in 2003 to \$14.4 million in 2004. Gross profit declined as a percent of revenue from 13.7% in 2003 to 11.5% in 2004. This decrease was the result of higher non-project labor cost invested in estimating larger EPC projects and in internal growth initiatives such as low sulfur diesel. Margins from our field service operations were lower by .3% primarily due to the impact of integration costs and recognition of lower profits on \$3.3 million in revenue generated by the acquisition of CIS during the last quarter of 2004.

Gross profit for our systems segment increased \$100,000 or 4.8% from \$2.1 million in 2003 to \$2.2 million in 2004. Competitive market pressures on pricing, project management, cost containment against project budgets, and stronger support service controls continue to provide challenges for management in response to growth initiatives and record backlog levels. The acquisition of contract rights and other assets from InfoTech during the fourth quarter of 2004 could have a short-term negative impact on the systems segment's gross profit until new employees and new projects are fully integrated into the Company's operations.

Gross profits from acquisitions increased \$1.5 million or 689.2% from \$200,000 in 2003 to \$1.7 million in 2004. Gross profit from acquired assets or companies during their first 12 months of operations within the Company is recorded and referred to as "Acquisition" gross profit. Acquisition gross profit in 2004 includes gross profit of \$800,000, \$400,000, \$200,000, \$200,000, and \$100,000 from EDG, CIS, Petro-Chem, Senftleber and AmTech, respectively.

### Selling, General and Administrative ("SG&A") Expenses

Selling, general and administrative expenses not related to acquisitions decreased \$300,000 from \$16.8 million in 2003 to \$16.5 million in 2004. Depreciation expenses of \$401,400 were reclassified from SG&A expenses to direct costs for presentation in the consolidated statements of income included herein in 2004. As depreciation expense in 2003 related to direct costs was immaterial, no reclassification was made for that year.

In March 2004, the Company announced organizational changes intended to reduce overhead and enhance profitability. The Company eliminated four operational facilities and consolidated offices to improve efficiency. For example, effective January 2004, within the systems segment, ECP relocated offices and shop facilities into the same facility as ESI resulting in improved shop personnel utilization, reduction of duplicative overhead functions and reduction of facility expenses. As a result, during 2004, the systems segment SG&A expenses decreased \$500,000 or 28.6% from \$2.0 million in 2003 to \$1.5 million in 2004. Corporate SG&A charges increased \$198,000 due to additional software enhancements to our billings system to meet client format demands, plus \$222,000 related to proposal and internal growth initiatives. Engineering SG&A expenses increased \$80,000 due to numerous miscellaneous items.

SG&A expenses from acquisitions increased \$1.7 million from \$165,000 in 2003 to \$1.8 million in 2004. SG&A expenses from acquired assets or companies during their first 12 months of operations within the Company have been recorded and are referred to as "Acquisition" under SG&A expenses. Acquisition SG&A in 2004 includes \$1.3 million, \$250,000, and \$150,000 from EDG, CIS, Petro-Chem respectively, plus \$100,000 for all other acquisition activity.

### Operating Profit

Operating profit remained constant at \$4.5 million in 2003 and 2004, decreasing as a percentage of total revenue from 3.7% in 2003 to 3.0% in 2004.

### Other Income (Expense)

Other income (expense) changed from \$355,000 expense in 2003 to \$118,000 income in 2004. The expense in 2003 was the result of a book basis loss on the sale of the vacant office building in Baton Rouge, as compared to the income in 2004, which resulted from a legal settlement.

**ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATION (Continued)**

***Liquidity and Capital Resources***

Historically, we have satisfied our cash requirements through operations and borrowings under a revolving credit facility. The Company's current credit facility is with Comerica Bank ("Comerica") and consists of a line of credit maturing July 27, 2007. The loan agreement positions Comerica as senior to all other debt. The line of credit is limited to \$22.0 million subject to loan covenant restrictions. The Comerica Credit Facility is collateralized by substantially all the assets of the Company. As of December 31, 2005, the outstanding balance on the line of credit was \$3.8 million and we had working capital of \$22.0 million. Our total long-term debt outstanding on December 31, 2005 was \$5.2 million (see Note 8), a decrease from \$15.6 million as of December 31, 2004. Under the terms and conditions of our revolving credit facility, as of December 31, 2005, we have additional borrowing capacity of approximately \$12.0 million after consideration of borrowing base limitations and outstanding letters of credit of \$6.2 million at December 31, 2005.

On September 29, 2005, we entered into and closed on a definitive agreement to issue and sell 2,000,000 shares of our \$.001 par value per share Common Stock in a private placement to Tontine Capital Partners, L.P., a Delaware limited partnership. The purchase agreement provided \$14,000,000 in gross proceeds which were used to pay down our existing line-of-credit debt.

The Company has been awarded a significant project with a central states refinery and entered into an Agreement for Engineering and Procurement Services to provide detailed engineering and procurement services for ultra low sulphur diesel fuel facilities on a cost reimbursable basis. The terms of the agreement require that any progress payments made by our client for engineered and manufactured project items must be secured by one or more irrevocable stand-by letters of credit issued on the account of ENGlobal. The project began in January 2005 and is scheduled to complete in the third quarter of 2006.

The following table summarizes our contractual obligations as of December 31, 2005:

	<b>Payments Due by Period</b>					<b>Total</b>
	<b>2006</b>	<b>2007</b>	<b>2008</b>	<b>2009</b>	<b>2010 and thereafter</b>	
	<b>(in thousands)</b>					
Long-term debt <sup>1</sup>	\$ 910	\$ 4,724	\$ 486	\$ 403	\$ -	\$ 6,523
Operating leases	2,227	2,482	1,520	1,507	1,772	9,508
Total contractual cash obligations	<u>\$ 3,137</u>	<u>\$ 7,206</u>	<u>\$ 2,006</u>	<u>\$ 1,910</u>	<u>\$ 1,772</u>	<u>\$ 16,031</u>

<sup>1</sup>Long-term debt includes future interest payments assuming the existing long-term debt and revolving credit facility remain outstanding with the interest rate in effect at December 31, 2005. The Company's interest rate on its revolving credit facility fluctuates with the prime rate.

***Cash Flow***

Operating activities required the use of \$920,000 and \$2.4 million in net cash for the fiscal years ended December 31, 2005 and December 31, 2004, respectively. Though a decline in revenues would be likely to adversely impact our cash flow from operations, we believe that future cash flows, our ability to manage the timing of acquisitions, and our borrowing capacity under our line of credit will allow us to meet cash requirements in 2006 and beyond. Future uses of cash in operations will continue to be primarily for labor and material costs required in connection with contract performance.

Our cash flow has been negatively impacted beginning in the fourth quarter of 2005 by a slow-down in our ability to invoice certain clients primarily due to the temporary relocation of the accounting department to Houston in early October followed by its relocation to Beaumont in mid-November. In addition, we have experienced slower collections of our accounts receivable from our Beaumont and Lake Charles customers as a result of Hurricanes Rita and Katrina. The accounting and invoice functions are fully restored and we believe the collection situation is temporary pending recovery from the hurricanes.

**ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATION (Continued)**

Investing activities used cash totaling \$2.4 million in 2005, compared to \$1.8 in 2004 and \$500,000 in 2003. In 2005, our investing activities consisted of capital additions of \$3.2 million primarily for computers and leasehold improvements to our offices. In the first quarter of 2005, we completed the sale of the Thermaire building, receiving \$823,000 in cash from the sale. We used \$625,000 in the fourth quarter of 2004 to complete the acquisitions of EDGI, AmTech, Cleveland Inspection Services, Inc., and InfoTech. Future investing activities are anticipated to remain consistent with prior years and include capital additions for leasehold improvements, technical applications software, and equipment, such as upgrades to computers. On December 31, 2005, we amended our line of credit to permit an increase in annual capital expenditure limits from \$2.5 million to \$3.25 million.

Financing activities provided cash totaling \$3.5 million and \$4.2 million in 2005 and 2004, respectively. Financing activities used \$6.1 million during 2003. Our primary financing mechanism is our revolving line of credit. The line of credit has been used principally to finance accounts receivable. During 2005, our borrowings, on the line of credit were \$92.2 million, and we repaid an aggregate of \$101.9 million on our short-term and long-term bank and other debt. On September 30, 2005, we reduced our outstanding line of credit by \$13.5 million using cash generated from working capital and the sale of 2,000,000 shares of our Common Stock in a private placement.

Future cash flows from financing activities are anticipated to be borrowings, payments on the line of credit and payments on long-term debt instruments. Line of credit fluctuations are a function of timing related to operations, obligations and payments received on accounts receivable. Payments on long-term debt, including interest for the coming year, are estimated to be \$910,000.

In addition, our cash flow was impacted during the fourth quarter of 2005 by our decision to pay \$1.0 million in insurance renewals rather than financing that payment, by investing \$1.0 million in capital expenditures and by funding our

growth. We also extended hardship allowances in an aggregate amount of \$192,000 to a number of our employees to assist them with hurricane recovery. Most of this amount has been repaid.

The Company's requirement on its letters of credit for a major project has declined from \$6.9 million in January 2006 to \$3.1 million in February 2006. We believe that all letter of credit obligations on this project will be fulfilled by May 2006.

There were no significant non-cash transactions in 2005. In 2004, non-cash transactions include \$2.6 million notes payable issued related to acquisitions and \$592,000 note payable issued for treasury stock. During 2003, our preferred stock was converted to common stock valued at \$27 million. We also acquired insurance with notes payable of \$198,000, \$1.1 million, and \$1.1 million in 2005, 2004, and 2003, respectively.

The Company believes that it has available necessary cash for operations for the next 12 months. Cash and the availability of cash could be materially restricted if circumstances prevent the timely internal processing of invoices into accounts receivable, if such accounts are not collected timely, or if our project mix shifts from cost reimbursable to fixed cost contracts during significant periods of growth.

If losses occur, we may not be able to meet our monthly fixed charge ratio covenant under our credit facility with Comerica. In that event, if we are unable to obtain a waiver or amendment of the covenant, we may be unable to make further borrowings and may be required to repay all loans then outstanding under the credit facility.

We do not hold any derivative financial instruments for trading purposes or otherwise. Furthermore, we have not engaged in energy or commodity trading activities and do not anticipate doing so in the future, nor do we have any transactions involving unconsolidated entities or special purpose entities.

## ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATION (Continued)

### *Asset Management*

We typically sell our products and services on short-term credit and seek to minimize our credit risk by performing credit checks and conducting our own collection efforts. Our trade accounts receivable increased to \$46.2 million from \$30.8 million as of December 31, 2005 and 2004, respectively, primarily due to increased revenue growth. The number of days outstanding for trade accounts receivable decreased from 62 days at December 31, 2004 to 59 days at December 31, 2005. Our actual bad debt expense has been approximately 0.05% and 0.02% of revenues for the periods ending December 31, 2005 and 2004. We increased our allowance for doubtful accounts from \$476,000 to \$503,000 or 1.5% and 1.1% of the trade accounts receivable balance for 2004 and 2005, respectively.

### *Related Party Transactions*

ENGlobal Engineering, Inc. leases office space from PEI Investments, a joint venture in which ENGlobal Engineering, Inc. has a one-third interest, Michael L. Burrow (the Company's CEO) has a one-third interest, and a stockholder who owns less than 1% of the Company's common stock has a one-third interest. Rentals paid under the lease were \$105,000, \$135,000 and \$135,000 for 2005, 2004 and 2003, respectively. The lease was renewed in August 2005. In September 2005, the building was damaged by Hurricane Rita and all tenants have relocated to other locations. No further lease payments have been made by the Company since September 2005 and the insurance claim filed by PEI Investments remains unsettled.

### *Risk Management*

In performing services for our clients, we could potentially be liable for breach of contract, personal injury, property damage or negligence, including professional errors and omissions. We often agree to indemnify our clients for losses and expenses incurred as a result of our negligence and, in certain cases, the concurrent negligence of our clients. Our quality control and assurance program includes a control function to establish standards and procedures for performance and for documentation of project tasks, and an assurance function to audit and to monitor compliance with procedures and quality standards. We maintain liability insurance for bodily injury and third-party property damage, professional errors and omissions, and workers compensation coverage, which we consider sufficient to insure against these risks, subject to self-insured amounts.

### *Seasonality*

Holidays and employee vacations during our fourth quarter exert downward pressure on revenues for that quarter, which is only partially offset by the year-end efforts on the part of many clients to spend any remaining funds budgeted for engineering services or capital expenditures during the year. The annual budgeting and approval process under which these clients operate is normally not completed until after the beginning of each new-year, which can depress results for the first quarter. Principally due to these factors, our revenues during the first and fourth quarters generally tend to be lower than in the second and third quarters.

### *Critical Accounting Policies*

#### Revenue Recognition

Because the majority of the Company's revenues are recognized under cost-plus contracts, significant estimates are generally not involved in determining revenue recognition. In addition, most of our contracts are with Fortune 500 companies. As a result, collection risk is generally not a relevant factor in the recognition of revenue.

Our revenues are largely composed of engineering service revenue and product sales. The majority of our services are provided through time-and-material contracts (also referred to as cost-plus contracts), many of which have not-to-exceed provisions that place a cap on the revenue that we may receive under a particular contract. These time and material billings are produced every two weeks.

On occasion, we serve as purchasing agent by procuring subcontractors, material and equipment on behalf of a client and passing the cost on to the client with no mark-up or profit. In accordance with Statement of Position ("SOP") 81-1, revenues and costs for these type purchases are not included in total revenues and costs. For financial reporting this "pass-through" type of transaction is reported net.

## ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATION (Continued)

Profits and losses on fixed-fee contracts are recorded on the percentage-of-completion method of accounting, measured by the percentage-of-contract costs incurred to date to estimated total contract costs for each contract. Contract costs include amounts paid to subcontractors. Anticipated losses on uncompleted construction contracts are charged to operations as soon as such losses can be estimated. Changes in job performance, job conditions, estimated profitability and final contract settlements may result in revisions to costs and income and are recognized in the period in which the revisions are determined.

The asset, "costs and estimated earnings in excess of billings on uncompleted contracts," represents revenues recognized in excess of amounts billed on fixed-fee contracts. The liability "billings in excess of costs and estimated profits on uncompleted contracts" represents amounts billed in excess of revenues recognized on fixed-fee contracts.

### Goodwill

A change in assumptions in the estimation of the fair market value of the segments would unlikely give rise to an impairment of goodwill without deteriorating operating results in the segments.

In conjunction with each acquisition, we must allocate the cost of the acquired entity to the assets and liabilities assumed based on their estimated fair values at the date of acquisition. As additional information becomes available, adjustments may be made to the original estimates within a short time subsequent to the acquisition. Goodwill is not amortized but instead is periodically assessed for impairment. The impairment testing entails estimating current market value of the segments, based on management's estimate of market conditions including pricing, demand, competition, operating costs and other factors. Determining the fair value of assets and liabilities acquired involves professional judgment and is ultimately based on management's assessment of the value of the assets acquired. We believe our estimates for these items are reasonable, but there is no assurance that actual amounts will not vary significantly from estimated amounts. Consistent with SFAS 142, we have not amortized goodwill related to the merger with Petrocon, but instead tested the balance for impairment.

### Change Orders

Change orders are modifications of an original contract that effectively change the provisions of the contract without adding new provisions. Either we or our clients may initiate change orders. Change orders may include changes in specifications or design, manner of performance, equipment, materials, scope of work, and/or the period of completion of the project.

Change orders occur when changes are experienced once a contract is begun. Change orders are sometimes documented and the terms of change orders are agreed with the client before the work is performed. Other times, circumstances may require that work progress without the client's written agreement before the work is performed. Costs related to change orders are recognized when they are incurred. Change orders are included in the total estimated contract revenue when it is probable that the change orders will result in a bona fide addition to value that can be reliably estimated.

We have a favorable history of negotiating and collecting for work performed under change orders and our bi-weekly billing cycle has proven to be timely enough to properly account for change orders.

### ***Recent Accounting Pronouncements***

In December 2004, the FASB issued Statement of Financial Accounting Standards No. 123, (revised 2004) "Share-Based Payment" ("SFAS 123(R)"). This statement is a revision of Statement of Financial Accounting Standards No. 123, "Accounting for Stock-Based Compensation" as amended ("SFAS123"), and requires entities to measure the cost of employee services received in exchange for an award of equity instruments based on the grant-date fair value of the award. The cost will be recognized over the period during which an employee is required to provide services in exchange for the award (usually the vesting period). SFAS 123(R) covers various share-based compensation arrangement rights and employee share purchase plans. SFAS 123(R) eliminates the ability to use the intrinsic value

**ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATION (Continued)**

methods of accounting for share options, as provided in Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees" ("APB 25"). SFAS 123(R) is effective as of the beginning of the first interim period that begins after June 15, 2005, with early adoption encouraged. The Company is currently evaluating the statement's transition methods and does not expect this statement to have an effect materially different than that of the pro forma SFAS 123 disclosures provided in Note 11 to the Company's Consolidated Financial Statements.

In December 2004, the FASB issued Statement of Financial Accounting Standards No. 153, "Exchanges of Non-monetary Assets, an amendment of APB Opinion No. 29" ("SFAS 153"). This Statement amends APB Opinion No. 29 to permit the exchange of non-monetary assets to be recorded on a carry over basis when the non-monetary assets do not have commercial substance. This is an exception to the basic measurement principal of measuring a non-monetary asset exchange at fair value. A non-monetary asset exchange has commercial substance if the future cash flows of the entity are expected to change significantly as a result of the exchange. SFAS 153 is effective for non-monetary asset exchanges occurring in fiscal periods beginning after June 15, 2005. The adoption of this standard is not expected to impact the Company's Consolidated Financial Statements.

In January 2003, the Financial Accounting Standard Board ("FASB") issued Interpretation No. 46 ("FIN 46"), "Consolidation of Variable Interest Entities." FIN 46 clarifies the application of Accounting Research Bulletin No. 51, "Consolidated Financial Statements," and addresses consolidation by business enterprises of variable interest entities (more commonly known as "Special Purpose Entities" or "SPE's"). In December 2003, FASB issued FIN No. 46R which replaced FIN 46 and clarified ARB 51. This interpretation provides guidance on how to identify a variable interest entity and determine when the assets, liabilities, non-controlling interests and results of operations of a variable interest entity should be consolidated by the primary beneficiary. The primary beneficiary is the enterprise that will absorb a majority of the variable interest entity's expected losses or receive a majority of the expected residual returns as a result of holding variable interests. This FIN requires the consolidation of results of variable interest entities in which the Company is the primary beneficiary of the variable interest entity. As of December 31, 2005, the Company did not own an interest in a variable interest entity that met the consolidation requirements and as such the adoption of FIN No. 46R did not have any effect on the financial condition, results of operations, or liquidity of the Company. Interests in entities acquired or created after December 31, 2003 will be evaluated based on FIN No. 46R criteria and consolidated, if required.

**ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

As of December 31, 2005 and 2004, the Company did not participate in any derivative financial instruments or other financial and commodity instruments for which fair value disclosure would be required under SFAS No 107. There are no investments at December 31, 2005. Accordingly, the Company has no quantitative information concerning the market risk of participating in such investments.

As of December 31, 2005 and 2004, the Company did not participate in any derivative financial instruments or other financial and commodity instruments for which fair value disclosure would be required under SFAS No. 133.

The Company's primary interest rate risk relates to its variable-rate line of credit debt obligation, which totaled \$3.8 million and \$13.5 million as of December 31, 2005 and 2004, respectively. Assuming a 10% increase in the interest rate on this variable-rate debt obligation (i.e., an increase from the actual average interest rate of 6.19% as of December 31, 2005, to an average interest rate of 6.81%), annual interest expense would have been approximately \$47,000 higher in 2005 based on the annual average balance. The Company does not have any interest rate swap or exchange agreements.

The Company has no market risk exposure in the areas of interest rate risk from investments because the Company did not have an investment portfolio as of December 31, 2005.

Currently, the Company does not engage in foreign currency hedging activities. Transactions in Canadian dollars in our Canadian subsidiary have been translated into U.S. dollars using the current rate method, such that assets and liabilities

**ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK (Continued)**

are translated at the rates of exchange in effect at the balance sheet date and revenue and expenses are translated at the average rates of exchange during the appropriate fiscal period. As a result, the carrying value of the Company's investments in Canada is subject to the risk of foreign currency fluctuations. Additionally, any revenues received from the Company's international operations in other than U.S. dollars will be subject to foreign exchange risk.

**ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA**

The audited consolidated balance sheets for ENGlobal Corporation, as of December 31, 2005 and 2004 and statements of income, cash flows and stockholders' equity for the three-year period ended December 31, 2005, are attached hereto and made part hereof.

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**REPORT OF  
INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM**

To the Board of Directors and Stockholders  
ENGlobal Corporation

We have audited the accompanying consolidated balance sheets of ENGlobal Corporation as of December 31, 2005 and 2004, and the related consolidated statements of income, stockholders' equity and cash flows for each of the years in the three-year period ended December 31, 2005. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement. The Company has determined that it is not required to have, nor were we engaged to perform, an audit of its internal controls over financial reporting. Our audit included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of ENGlobal Corporation and Subsidiaries as of December 31, 2005 and 2004, and the results of their operations and their cash flows for each of the years in the three-year period ended December 31, 2005, in conformity with U.S. generally accepted accounting principles.

*Hein & Associates LLP*

HEIN & ASSOCIATES LLP

Houston, Texas  
March 17, 2006

# ENGLOBAL CORPORATION AND SUBSIDIARIES

## CONSOLIDATED BALANCE SHEETS

DECEMBER 31, 2005 AND 2004

<u>ASSETS</u>		
	<u>2005</u>	<u>2004</u>
<b>Current Assets</b>		
Cash	\$ 159,414	\$ 8,006
Trade receivables, net	46,248,458	30,839,597
Prepaid expenses and other current assets	1,600,369	1,984,274
Costs and estimated earnings in excess of billings on uncompleted contracts	4,148,275	1,113,330
Deferred tax asset	305,258	640,380
Inventories	153,968	172,715
Assets held for sale	-	678,106
Federal income taxes receivable	52,818	118,000
Total Current Assets	52,668,560	35,554,408
<b>Property and Equipment, net</b>	6,861,361	5,262,370
<b>Goodwill</b>	15,454,583	15,284,220
<b>Non-current Deferred Tax Asset</b>	74,892	-
<b>Other Assets</b>	876,534	1,159,750
Total Assets	\$ 75,935,930	\$ 57,260,748
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>		
<b>Current Liabilities</b>		
Accounts payable	\$ 15,211,331	\$ 10,512,123
Accrued compensation and benefits	9,799,074	6,059,221
Notes payable	-	839,606
Deferred rent	361,292	-
Current portion of long-term debt	547,934	622,410
Current portion of capital lease	-	4,371
Billings and estimated earnings in excess of costs on uncompleted contracts	3,775,625	2,313,954
Other liabilities	1,148,079	699,601
Total Current Liabilities	30,843,335	21,051,286
<b>Long-Term Debt, net of current portion</b>	5,227,976	15,585,152
<b>Deferred Tax Liability</b>	-	573,380
Total Liabilities	36,071,311	37,209,818
<b>Commitments and Contingencies (Notes 9, 10, 12, 16, 19 and 20)</b>		
<b>Stockholders' Equity</b>		
Series A redeemable convertible preferred stock - \$0.001 par value, with fair value of \$1.00 per share; 2,265,167 shares authorized 2005 and 2004, respectively; 0 shares issued and outstanding 2005 and 2004, respectively	-	-
Common stock - \$0.001 par value; 75,000,000 shares authorized; 26,289,567 and 23,466,839 shares outstanding and 26,941,944 and 24,119,216 issued at December 31, 2005 and 2004, respectively	26,941	24,119
Additional paid-in capital	27,230,332	12,198,215
Retained earnings	13,203,208	8,420,827
Treasury stock - 652,377 shares at cost	(592,231)	(592,231)
Accumulated other comprehensive income (loss)	(3,631)	-
Total Stockholders' Equity	39,864,619	20,050,930
Total Liabilities and Stockholders' Equity	\$ 75,935,930	\$ 57,260,748

See accompanying notes to these consolidated financial statements.

**ENGLOBAL CORPORATION AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENTS OF INCOME**

	<b>Years Ended December 31,</b>		
	<b>2005</b>	<b>2004</b>	<b>2003</b>
<b>Operating Revenues</b>			
Engineering	\$ 215,698,073	\$ 133,630,281	\$ 108,380,100
Systems	17,886,760	15,257,960	15,339,002
Total Revenue	<u>233,584,833</u>	<u>148,888,241</u>	<u>123,719,102</u>
<b>Direct Costs</b>			
Engineering	189,696,352	117,606,309	93,578,716
Systems	15,615,821	13,089,874	13,166,811
Total Direct Costs	<u>205,312,173</u>	<u>130,696,183</u>	<u>106,745,527</u>
<b>Gross Profit</b>	28,272,660	18,192,058	16,973,575
<b>Selling, General, and Administrative Expenses</b>	19,688,765	13,700,088	12,439,408
<b>Operating Income</b>	8,583,895	4,491,970	4,534,167
Interest Expense	(800,072)	(590,227)	(784,227)
Other income (expense)	114,538	118,409	(355,175)
Income from Continuing Operations before Provisions for Income Taxes	7,898,361	4,020,152	3,394,765
<b>Provision for Income Taxes</b>	3,115,980	1,655,763	1,109,496
<b>Income from Continuing Operations</b>	4,782,381	2,364,389	2,285,269
<b>Income/(Loss) from Discontinued Operations</b>			
Loss from operations of discontinued segment, net of tax of \$75,066	-	-	(154,615)
Gain from sale of discontinued segment, net of tax of \$12,834	-	-	26,434
Net Income	4,782,381	2,364,389	2,157,088
Preferred Dividends	-	-	131,100
<b>Net Income Available for Common Stock</b>	<u>\$ 4,782,381</u>	<u>\$ 2,364,389</u>	<u>\$ 2,025,988</u>
Basic Earnings per Share from Continuing Operations	\$ 0.20	\$ 0.10	\$ 0.09
Basic Earnings per Share from Discontinued Operations	-	-	-
Basic Earnings per Share from Net Income Available for Common Stock	<u>\$ 0.20</u>	<u>\$ 0.10</u>	<u>\$ 0.09</u>
Weighted Average Common Shares Outstanding for Basic	<u>24,300,114</u>	<u>23,454,545</u>	<u>23,300,600</u>
Diluted Earnings per Share from Continuing Operations	\$ 0.19	\$ 0.10	\$ 0.09
Diluted Earnings per Share from Discontinued Operations	-	-	-
Diluted Earnings per Share from Income Available for Common Stock	<u>\$ 0.19</u>	<u>\$ 0.10</u>	<u>\$ 0.09</u>
Weighted Average Common Shares Outstanding for Diluted	<u>25,250,487</u>	<u>23,785,939</u>	<u>23,733,807</u>

See accompanying notes to these consolidated financial statements.

**ENGLOBAL CORPORATION AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY**  
**FOR YEARS ENDED DECEMBER 31, 2005, 2004 AND 2003**

	Common Stock		Additional Paid-In Capital	Accumulated Comprehensive Income (Loss)	Retained Earnings	Treasury Stock	Total Stockholders' Equity
	Shares	Stock					
<b>BALANCES-JANUARY 1, 2003</b>	<u>22,861,199</u>	<u>\$ 22,862</u>	<u>\$ 9,335,471</u>	<u>\$ -</u>	<u>\$ 4,030,448</u>	<u>\$ -</u>	<u>\$ 13,388,781</u>
Preferred stock dividend	-	-	-	-	(131,098)	-	(131,098)
Conversion of preferred stock 2.38 preferred shares to each common share	1,149,089	1,148	2,733,685	-	-	-	2,734,833
Exercise of stock options	24,000	24	25,226	-	-	-	25,250
Net income	-	-	-	-	2,157,088	-	2,157,088
<b>BALANCES-DECEMBER 31, 2003</b>	<u>24,034,288</u>	<u>24,034</u>	<u>12,094,382</u>	<u>-</u>	<u>6,056,438</u>	<u>-</u>	<u>18,174,854</u>
Exercise of options	38,242	38	42,474	-	-	-	42,512
Common stock purchased for treasury	(652,377)	-	-	-	-	(592,231)	(592,231)
Common stock issued through employee stock purchase plan	46,686	47	61,359	-	-	-	61,406
Net income	-	-	-	-	2,364,389	-	2,364,389
<b>BALANCES-DECEMBER 31, 2004</b>	<u>23,466,839</u>	<u>24,119</u>	<u>12,198,215</u>	<u>-</u>	<u>8,420,827</u>	<u>(592,231)</u>	<u>20,050,930</u>
Exercise of options	727,793	728	1,484,981	-	-	-	1,485,709
Common stock issued through employee stock purchase plan	94,935	94	231,044	-	-	-	231,138
Common stock issued through private placement	2,000,000	2,000	13,071,092	-	-	-	13,073,092
Tax benefit of non-qualified options exercised	-	-	245,000	-	-	-	245,000
Net income	-	-	-	-	4,782,381	-	4,782,381
Comprehensive income: Foreign currency translation adjustment	-	-	-	(3,631)	-	-	(3,631)
<b>BALANCES-DECEMBER 31, 2005</b>	<u>26,289,567</u>	<u>\$ 26,941</u>	<u>\$ 27,230,332</u>	<u>\$ (3,631)</u>	<u>\$ 13,203,208</u>	<u>\$ (592,231)</u>	<u>\$ 39,864,619</u>

See accompanying notes to these consolidated financial statements.

**ENGLOBAL CORPORATION AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENTS OF CASH FLOWS**

	Years Ended December 31,		
	2005	2004	2003
<b>Cash Flows from Operating Activities</b>			
Net income	\$ 4,782,381	\$ 2,364,389	\$ 2,157,088
Adjustments to reconcile net income to net cash provided by (used in) operating activities -			
Depreciation and amortization	1,836,376	1,246,532	824,476
Deferred income tax expense	(313,150)	254,000	542,000
(Gain) Loss on disposal of property, plant and equipment	(131,732)	2,564	312,307
Changes in current assets and liabilities, net of acquisitions -			
Trade receivables	(15,462,947)	(10,595,425)	(3,947,817)
Inventories	18,747	(54,375)	110,056
Costs and estimated earnings in excess of billings	(2,980,859)	(90,604)	1,020,877
Prepaid expenses and other assets	630,559	231,401	372,419
Accounts payable	4,699,207	691,093	5,695,662
Accrued compensation and benefits	3,739,853	1,713,253	403,724
Billings in excess of costs and estimated earnings	1,461,670	1,939,616	(437,506)
Other liabilities	326,655	128,114	(280,166)
Income taxes receivable (payable)	473,523	(221,610)	(215,619)
Net cash provided by (used in) operating activities	<u>(919,717)</u>	<u>(2,391,052)</u>	<u>6,557,501</u>
<b>Cash Flows from Investing Activities</b>			
Purchase of property and equipment	(3,229,925)	(1,195,588)	(1,146,351)
Proceeds from sale of property	-	-	554,866
Additional consideration for acquisitions	(26,368)	(625,000)	(424,900)
Proceeds from sale of equipment	15,400	9,897	-
Proceeds from sale of Thermaire	823,350	-	545,198
Net cash used in investing activities	<u>(2,417,543)</u>	<u>(1,810,691)</u>	<u>(471,187)</u>
<b>Cash Flows from Financing Activities</b>			
Borrowings on line of credit	92,151,545	134,571,349	127,650,133
Payments on line of credit	(101,907,187)	(126,597,915)	(132,178,422)
Proceeds from issuance of common stock	15,034,940	103,918	25,250
Short-term borrowings (repayments)	(1,037,399)	(1,071,885)	(484,023)
Capital lease repayments	(4,371)	(12,478)	(4,364)
Long-term debt repayments	(745,229)	(2,822,679)	(1,130,544)
Net cash provided by (used in) financing activities	<u>3,492,299</u>	<u>4,170,310</u>	<u>(6,121,970)</u>
<b>Effect of Exchange Rate Changes on Cash</b>	<u>(3,631)</u>	<u>-</u>	<u>-</u>
Net Change in Cash and Cash Equivalents	151,408	(31,433)	(35,656)
<b>Cash and Cash Equivalents – beginning of year</b>	8,006	39,439	75,095
<b>Cash and Cash Equivalents – end of year</b>	<u>\$ 159,414</u>	<u>\$ 8,006</u>	<u>\$ 39,439</u>
<b>Non-Cash Transactions</b>			
Stock issued for preferred dividend	\$ -	\$ -	\$ 146,833
Insurance acquired with notes payable	197,794	1,092,096	1,085,363
Conversion of preferred stock to common stock	-	-	2,734,834
Acquisition of assets of EDG, AmTech, CIS and InfoTech with issuance of notes payable	-	2,575,000	-
Acquisition of treasury stock with note payable	-	592,231	-
<b>Supplemental Cash Flow Information</b>			
Cash paid during the year for -			
Interest	\$ 890,266	\$ 420,627	\$ 771,793
State and federal income taxes	2,959,133	1,196,761	734,615
Dividend payment	-	-	105,040
Refund from state franchise taxes	48,531	-	-

See accompanying notes to these consolidated financial statements.

# ENGLOBAL CORPORATION AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

### NOTE 1 – BACKGROUND AND BASIS OF PRESENTATION

#### Basis of Presentation

Our consolidated financial statements are prepared in accordance with accounting principles generally accepted in the United States of America. Our Company consolidates all of its wholly-owned subsidiaries and all significant inter-company accounts and transactions have been eliminated in the consolidation.

#### Organization

Brief descriptions of the active companies included in the consolidated group follow:

ENGlobal Corporation (“ENGlobal”) – our public holding company.

ENGlobal Corporate Services, Inc. (“ECS”) – provides the corporate oversight function.

ENGlobal Engineering, Inc. (“EEI”) – provides general engineering, construction and procurement services for industrial customers primarily in the United States with specialties in the areas of distributive control systems, power distribution, process design and process safety management.

ENGlobal Construction Resources, Inc. (“ECR”) – provides technical and inspection personnel within client facilities for the petroleum industry.

RPM Engineering, Inc. d/b/a ENGlobal Engineering, Inc. (“RPM”) – provides engineering services primarily in southeast Louisiana.

ENGlobal Systems, Inc. (“ESI”) – provides design, fabrication, installation, start-up, checkout and maintenance of specialized systems such as programmable logic controller (PLC) systems integration, supervisory controls and data acquisition (SCADA) and triple modular redundancy (TMR) systems, distribution control system (DCS), and analyzer systems.

ENGlobal Automation Group, Inc. (“EAG”) – formerly ENGlobal Technologies, Inc. (“ETI”) – provides service relating to the implementation of process controls, advanced automation, and information technology projects.

ENGlobal Technical Services, Inc. (“ETS”) – formerly ENGlobal Design Group, Inc. (“EDG”) – provides design, installation and maintenance of various government and public sector facilities, the most active sector being Automated Fuel Handling Systems serving the U.S. Military.

ENGlobal Canada, ULC – provides engineering services relating to the implementation of process controls, instrumentation, advanced automation and information technology projects.

### NOTE 2 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

#### Cash

Cash includes cash in bank at December 31, 2005. The Company’s banking system provides for daily replenishment of major bank accounts for check-clearing requirements. Accordingly, there were negative book balances of \$2.0 million on December 31, 2005 and \$3.3 million on December 31, 2004. Such balances result from outstanding checks that have not yet been paid by the bank and are reclassified to accounts payable in the accompanying consolidated balance sheets.

#### Inventories

Inventories carried by our ESI subsidiary are composed primarily of raw materials and component parts (enclosures, electronics, PC boards and wire) and are carried at the lower of cost or market value, with cost determined on the first-in, first-out (“FIFO”) method of accounting. Inventory is classified as assets held for sale on December 31, 2005 pending a sale of the ENGlobal Constant Power division of ESI which occurred in January, 2006.

## ENGLOBAL CORPORATION AND SUBSIDIARIES

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

#### NOTE 2 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

##### Revenue Recognition

The Company's revenue is composed of engineering, construction and procurement service revenue and product sales. The Company recognizes service revenue as soon as the services are performed. The majority of the Company's engineering services have historically been provided through cost-plus contracts whereas a majority of the Company's product sales are earned on fixed-fee contracts.

On occasion, the Company, serving as an agent for the client, procures materials and equipment on behalf of the client and the cost of such materials and equipment is reimbursed with no mark-up or profit. In accordance with Statement of Position (SOP) 81-1, revenue and cost for these types of purchases are not included in total revenue and cost. For financial reporting, this "pass-through" type of transaction is reported net. During 2005 and 2004, pass-through transactions totaled \$20.6 million and \$15.9 million, respectively.

Profits and losses on fixed-fee contracts are recorded on the percentage-of-completion method of accounting, measured by the percentage-of-contract cost incurred to date relative to estimated total direct contract cost. Direct contract cost includes professional compensation and related benefits, materials, subcontractor services and other direct cost of projects. Any freight charges and inspection costs are directly charged to the project to which the charges relate. The cost recognized for labor includes all actual employee compensation plus a burden factor to cover estimated variable labor expenses for the year. These variable labor expenses consist of payroll taxes, self-insured medical plan expenses, workers compensation insurance, general liability insurance, and employee benefits for paid time off. The actual periodic cost for these expenses is adjusted at the end of each quarter to provide consistent cost recognition throughout the year.

Variable costs such as travel, repairs and maintenance, supplies and depreciation directly related to producing revenues are included to arrive at gross profit.

Under the percentage-of-completion method, revenue recognition is dependent upon the accuracy of a variety of estimates, including the progress of engineering and design efforts, material installation, labor productivity, cost estimates and others. These estimates are based on various professional judgments made with respect to the factors noted and are difficult to accurately determine until projects are significantly underway. Due to uncertainties inherent to the estimation process, it is possible that actual completion costs may vary materially from estimates. Anticipated losses on uncompleted contracts are charged to operations as soon as such losses can be estimated. Changes in job performance, job conditions, estimated profitability and final contract settlements may result in revisions to costs and income and are recognized in the period in which the revisions are determined.

Selling, general and administrative cost includes management and staff compensation, office cost such as rents and utilities, depreciation, amortization, travel and other expenses that are unrelated to specific client contracts, but directly relate to the support of each segment's operations.

Occasionally, it is appropriate under SOP 81-1 to combine or segment contracts. Contracts are combined in those limited circumstances when they are negotiated as a package in the same economic environment with an overall profit margin objective and constitute, in essence, an agreement to do a single project. In such cases, we recognize revenue and cost over the performance period of the combined contracts as if they were one. Contracts may be segmented if the customer had the right to accept separate elements of a contract and the total economic returns and risks of the separate contract elements are similar to the economic returns and risks of the overall contract. For segmented contracts, we recognize revenue as if they were separate contracts over the performance periods of the individual elements or phases.

## ENGLOBAL CORPORATION AND SUBSIDIARIES

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

#### NOTE 2 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

We have three major types of contracts:

##### Cost-Plus, Labor Plus Fixed Mark-up

Under cost-plus, labor plus fixed mark-up contracts, clients are charged based on actual labor rates plus a fixed mark-up that includes estimated recoverable direct and indirect cost and a profit component, which is applied as a percentage of the recoverable labor, to arrive at a total dollar estimate in negotiating a cost-plus, labor plus fixed mark-up contract. We recognize revenue based on a multiple of the actual total number of labor hours completed on a project multiplied by the actual labor rates and multiplied by the negotiated fixed mark-up percentage, plus other non-labor costs at cost plus a fixed mark-up that we negotiate at the time of contract award. Aggregate revenue from cost-plus, labor plus fixed mark-up contracts may vary in scope and we generally must obtain a change order in order to receive additional revenue relating to any additional costs that exceed the original contract estimate (see “Change Orders”).

##### Cost-Plus, Fixed Labor Rate

Under cost-plus, fixed labor rate contracts, clients are charged based on fixed labor rates by work classification (Project Manager, Sr. Engineer, Designer, CADD Operator, etc.) whereby the fixed labor rate includes estimated recoverable direct and indirect cost plus a profit component. In negotiating cost-plus, fixed labor rate contracts the total dollar estimate is a multiple of the fixed labor rates times the recoverable work class labor man-hours estimated to complete the project. We recognize revenues based on a multiple of the fixed labor rates times the actual total number of labor hours completed on a project, plus other non-labor costs at cost plus a fixed rate negotiated at the time of contract award. Aggregate revenues from cost-plus, fixed labor rate contracts may vary in scope and we generally must obtain a change order in order to receive additional revenues relating to any additional cost that exceed the original contract estimate (see “Change Orders”).

##### Fixed-price

Under fixed-price contracts, clients are charged an agreed amount negotiated in advance of a specific scope of work, be it related to engineering, construction and procurement service revenue or product sales. We recognize revenue on fixed-price contracts using the percentage-of-completion method described above. Prior to completion, gross profit recognition on any fixed-price contract is dependent upon the accuracy of our estimates and will increase to the extent that current estimates of aggregate actual cost are below the amounts previously estimated. Conversely, if the Company’s current estimated cost exceeds prior estimates, gross profit will decrease and we may realize a loss on a project. In order to increase aggregate revenue on a contract, we generally must obtain a change order to receive payment for additional cost (see “Change Orders”).

##### Change Orders

Change orders are modifications of an original contract that effectively change the provisions of the contract without adding new provisions. Either we or our clients may initiate change orders. Change orders may include changes in specifications or design, manner of performance, equipment, materials, scope of work and/or the period of completion of the project.

Change orders occur when changes are experienced after work on a contract has begun. Change orders are documented and the terms of change orders are agreed with the client before the work is performed. Circumstances, at times, may require that work progress without the client’s written agreement before the work is performed. Cost related to change orders is recognized when they are incurred. Change orders are included in the total estimated contract revenue when it is probable that the change orders will result in a bona fide addition to value that can be reliably estimated.

##### Inspection and Acceptance (Cost-plus Contracts)

Generally, other than on fixed-price contracts, clients inspect and accept work as executed based on designated milestones or billing cycles, although such acceptance does not waive the client’s right to a claim under a warranty provision for work deficiencies that fail to meet industry standards. If we are required to remedy defective work, the client normally reimburses all cost except for the labor cost necessary to correct such defects.



## ENGLOBAL CORPORATION AND SUBSIDIARIES

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

#### NOTE 2 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

##### Inspection and Acceptance (Fixed-price Contracts)

Generally, clients inspect and accept work based on designated milestones, although such acceptance does not waive the client's right to a claim under a warranty provision for work deficiencies. If we are required to remedy defective work, the client normally reimburses all costs except for the labor cost necessary to correct such defects.

##### Contract Termination Provisions

Generally, our clients may terminate at any time and for any reason any part of the Company's project work by giving proper notice, specifying the part of the work to be terminated and the effective date of the termination. If any part of the work on a project is terminated, the client, with respect to such work, is required to reimburse the Company for all cost incurred prior to the effective date of termination and for all additional amounts that are directly related to the work performed. The client is required to issue a change order with respect to any termination.

##### Property and Equipment

All property and equipment is stated at cost, adjusted for accumulated depreciation. Depreciation is calculated using a straight-line method over the estimated useful lives of the related assets. The useful life is estimated to be 3 years for computers and autos, 5 years for software, furniture and fixtures, 10 years for machinery and equipment, and 39 years for buildings. Leasehold improvements are amortized over the term of the related lease.

##### Goodwill

In July 2001, the FASB issued SFAS No. 142, "Goodwill and Other Intangible Assets." SFAS 142 requires that goodwill and intangible assets with indefinite useful lives no longer be amortized, but instead tested for impairment at least annually. SFAS 142 also requires that intangible assets with estimable useful lives be amortized over their respective estimated useful lives to their estimated residual values and reviewed for impairment in accordance with SFAS No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets."

The Company adopted SFAS 142 effective January 1, 2002. Upon adoption, the Company tested goodwill for impairment at January 1, 2002 according to the provisions of SFAS 142, which resulted in no impairment identified. The Company tested goodwill for impairment at December 31, 2004 and 2005 resulting in no impairment of goodwill.

In 2004, acquisitions of assets of several companies resulted in an increase of \$1,725,000 to goodwill. Acquisitions of the assets of Engineering Design Group, Inc. ("EDGI"), InfoTech, and Cleveland Inspection Services, Inc. ("CIS") resulted in increases to goodwill of \$139,000, \$270,000 and \$1,316,000, respectively. In 2005, goodwill increased \$170,000.

##### Long-lived Assets

The Company reviews long-lived assets and certain identifiable intangible assets for impairment annually or whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. An impairment loss would be recognized when estimated future cash flows expected to result from the use of the asset and its eventual disposition is less than its carrying amount. The Company has not identified any such impairment losses.

##### Software Development Costs

Under the provisions of SOP-98-1 ENGlobal capitalizes costs associated with software developed or obtained for internal use when both the preliminary project stage is completed and when management authorizes funding for the project which is deemed probable of completion. Costs include 1) external direct costs of materials and services incurred in obtaining and developing the software, and 2) payroll and payroll related costs for employees who are directly associated with and devote time to the project. Capitalization of these costs ceases no later than the point at which the project is substantially complete and ready for its intended use. At that time, the costs are reclassified to fixed assets. Amortization of such costs is provided on the straight-line basis over 5 years.

The project controls system upgrade was completed at the end of 2004 and amortization began in January 2005.

## ENGLOBAL CORPORATION AND SUBSIDIARIES

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

#### NOTE 2 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

##### Dispositions – Assets Held for Sale

During 2005, the building previously occupied by Thermaire was sold. The sale resulted in proceeds of \$823,350 and a gain of \$119,000 which amount is included in other income. As of December 31, 2004, the building was the sole asset recorded as “assets held for sale” in the amount of \$678,106.

##### Income Taxes

The Company accounts for deferred income taxes in accordance with the asset and liability method, whereby deferred income taxes are recognized for the tax consequences of temporary differences by applying enacted statutory tax rates applicable to future years to differences between the financial statement and tax bases of its existing assets and liabilities. The provision for income taxes represents the current tax payable or refundable for the period plus or minus the tax effect of the net change in the deferred tax assets and liabilities during the period.

##### Stock Based Compensation

The Company applies SFAS No. 123, *Accounting for Stock-Based Compensation*, as amended by SFAS 148, which encourages, but does not require, companies to recognize compensation expense for grants of stock, stock options, and other equity instruments to employees based on fair value. The Company has elected to record compensation expense in accordance with Accounting Principles Board (APB) Opinion No. 25, which calculates compensation as the difference between an option’s exercise price and the current price of the underlying stock. (For equity instruments issued to employees, see Note 10 that contains required pro forma disclosure of the impact of adopting SFAS No. 123)

In December 2004, the FASB issued Statement of Financial Accounting Standards No. 123, (revised 2004) “Share-Based Payment” (“SFAS 123R”). This statement is a revision of Statement of Financial Accounting Standards No. 123, “Accounting for Stock-Based Compensation” as amended (“SFAS 123”), and requires entities to measure the cost of employee services received in exchange for an award of equity instruments based on the grant-date fair value of the award. The cost will be recognized over the period during which an employee is required to provide services in exchange for the award (usually the vesting period). SFAS 123R covers various share-based compensation arrangement rights and employee share purchase plans. SFAS 123R eliminates the ability to use the intrinsic value methods of accounting for share options, as provided in APB No. 25. SFAS 123R is effective as of the beginning of the first annual reporting period that begins after June 15, 2005.

The Company will adopt SFAS 123(R) in its first quarter of 2006 utilizing the modified prospective method. The modified prospective method requires that compensation expense be recorded for all unvested stock options and restricted stock awards as of December 31, 2005 over the requisite service period (generally the vesting schedule). At December 31, 2005, the Company had approximately 423,400 unvested stock options and awards that vest through 2008. The Company is currently in the process of evaluating the impact of the adoption of SFAS 123(R). For equity instruments issued to employees, see Note 11 that contains required pro forma disclosure of the impact of adopting SFAS No. 123.

# ENGLOBAL CORPORATION AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

### NOTE 2 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

#### Earnings Per Share

Earnings per share was computed as follows:

	<b>Reconciliation of Earnings per Share Calculation</b>					
	<b>2005</b>		<b>2004</b>		<b>2003</b>	
	<b>Basic</b>	<b>Diluted</b>	<b>Basic</b>	<b>Diluted</b>	<b>Basic</b>	<b>Diluted</b>
Income from continuing operations	\$ 4,782,381	\$ 4,782,381	\$ 2,364,389	\$ 2,364,389	\$ 2,285,269	\$ 2,285,269
Preferred dividends	-	-	-	-	131,100	131,100
Income available for common stock from continuing operations	4,782,381	4,782,381	2,364,389	2,364,389	2,154,169	2,154,169
Loss from discontinued operations	-	-	-	-	(128,181)	(128,181)
Net income available for common stock	<u>\$ 4,782,381</u>	<u>\$ 4,782,381</u>	<u>\$ 2,364,389</u>	<u>\$ 2,364,389</u>	<u>\$ 2,025,988</u>	<u>\$ 2,025,988</u>
Weighted average number of shares outstanding for basic	24,300,114		23,454,545		23,300,600	
Weighted average number of shares outstanding for diluted	25,250,487		23,785,939		23,733,807	
Net income (loss) per share available for common stock						
Income from continuing operations	\$ 0.20	\$ 0.19	\$ 0.10	\$ 0.10	\$ 0.09	\$ 0.09
Gain (loss) from discontinued operations	-	-	-	-	-	-
Net income available for common stock	\$ 0.20	\$ 0.19	\$ 0.10	\$ 0.10	\$ 0.09	\$ 0.09

Diluted earnings per share are computed including the impact of all potentially dilutive securities. The following table sets forth the shares outstanding for the earnings per share calculations for the years ended December 31, 2005, 2004 and 2003.

	<b>2005</b>	<b>2004</b>	<b>2003</b>
Common stock issued – beginning of year	23,466,839	24,034,288	22,861,199
Weighted average common stock issued (repurchased)	833,275	(579,743)	439,401
Shares used in computing basic earnings per share	24,300,114	23,454,545	23,300,600
Assumed conversion of dilutive stock options	950,373	331,394	433,207
Shares used in computing diluted earnings per share	<u>25,250,487</u>	<u>23,785,939</u>	<u>23,733,807</u>

#### Use of Estimates

The preparation of the Company's consolidated financial statements in conformity with accounting principles generally accepted in the United States of America requires the Company's management to make estimates and assumptions that affect the amounts reported in these financial statements and accompanying results. Actual results could differ from these estimates.

#### Fair Value of Financial Instruments

The fair value of financial instruments, primarily accounts receivable, notes receivable and accounts payable, closely approximate the carrying values of the instruments due to the short-term maturities of such instruments. Based on the borrowing rate currently available to the Company for loans with similar terms, we believe the fair value of the long-term obligations approximate their carrying value.

#### Comprehensive Income

Comprehensive income is defined as all changes in stockholders' equity, exclusive of transactions with owners, such as capital investments. Comprehensive income includes net income or loss, changes in certain assets and liabilities that are reported directly in equity, such as translation adjustments on investments in foreign subsidiaries and certain changes in minimum pension liabilities. The cumulative translation adjustment is included in accumulated other comprehensive income. (See Note 4)

## ENGLOBAL CORPORATION AND SUBSIDIARIES

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

#### NOTE 2 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

##### Reclassifications

Amounts in prior years' financial statements are reclassified as necessary to conform to the current year's presentation. Such reclassifications had no effect on net income. Certain categories of depreciation expense were reclassified in 2004 to direct costs. As depreciation expense in 2003 related to direct costs was immaterial, no reclassification was made for that year.

#### NOTE 3 – RECENT ACCOUNTING PRONOUNCEMENTS

In December 2004, the FASB issued Statement of Financial Accounting Standards No. 123, (revised 2004) "Share-Based Payment" ("SFAS 123(R)"). This statement is a revision of Statement of Financial Accounting Standards No. 123, "Accounting for Stock-Based Compensation" as amended ("SFAS123"), and requires entities to measure the cost of employee services received in exchange for an award of equity instruments based on the grant-date fair value of the award. The cost will be recognized over the period during which an employee is required to provide services in exchange for the award (usually the vesting period). SFAS 123(R) covers various share-based compensation arrangement rights and employee share purchase plans. SFAS 123(R) eliminates the ability to use the intrinsic value methods of accounting for share options, as provided in Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees" ("APB 25"). SFAS 123(R) is effective as of the beginning of the first interim period of the first annual period that begins after June 15, 2005, with early adoption encouraged. The Company is currently evaluating the statement's transition methods and does not expect this statement to have an effect materially different than that of the pro forma SFAS 123 disclosures provided in Note 10 to the Company's Consolidated Financial Statements.

In December 2004, the FASB issued Statement of Financial Accounting Standards No. 153, "Exchanges of Non-monetary Assets, an amendment of APB Opinion NO. 29" ("SFAS 153"). This Statement amends APB Opinion No 29 to permit the exchange of non-monetary assets to be recorded on a carry over basis when the non-monetary assets do not have commercial substance. This is an exception to the basic measurement principal of measuring a non-monetary asset exchange at fair value. A non-monetary asset exchange has commercial substance if the future cash flows of the entity are expected to change significantly as a result of the exchange. SFAS 153 is effective for non-monetary asset exchanges occurring in fiscal periods beginning after June 15, 2005. The adoption of this standard is not expected to impact the Company's Consolidated Financial Statements.

In January 2003, the Financial Accounting Standard Board ("FASB") issued Interpretation No. 46 ("FIN 46"), "Consolidation of Variable Interest Entities." FIN 46 clarifies the application of Accounting Research Bulletin No. 51, "Consolidated Financial Statements," and addresses consolidation by business enterprises of variable interest entities (more commonly known as Special Purpose Entities or SPE's). In December 2003, FASB issued

FIN No. 46R which replaced FIN 46 and clarified ARB 51. This interpretation provides guidance on how to identify a variable interest entity and determine when the assets, liabilities, non-controlling interests and results of operations of a variable interest entity should be consolidated by the primary beneficiary. The primary beneficiary is the enterprise that will absorb a majority of the variable interest entity's expected losses or receive a majority of the expected residual returns as a result of holding variable interests. This FIN requires the consolidation of results of variable interest entities in which the Company is the primary beneficiary of the variable interest entity. As of December 31, 2004 and 2005, the Company did not own an interest in a variable interest entity that met the consolidation requirements and as such the adoption of FIN No. 46R did not have any effect on the financial condition, results of operations, or liquidity of the Company. Interests in entities acquired or created after December 31, 2005 will be evaluated based on FIN No. 46R criteria and consolidated, if required.

#### NOTE 4 – COMPREHENSIVE INCOME (LOSS)

Comprehensive income (loss) represents net earnings and any revenue, expenses, gains and losses that, under accounting principles generally accepted in the United States of America, are excluded from net earnings and recognized directly as a component of stockholders' equity.

**ENGLOBAL CORPORATION AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**NOTE 4 – COMPREHENSIVE INCOME (LOSS) (Continued)**

Accumulated other comprehensive income is as follows:

	<b>2005</b>	<b>2004</b>	<b>2003</b>
	<b>(in thousands)</b>		
Net income	\$ 4,782	\$ 2,364	\$ 2,157
Other comprehensive income:			
Foreign currency translation adjustment	(4)	-	-
Comprehensive income	\$ 4,778	\$ 2,364	\$ 2,157

**NOTE 5 – PROPERTY AND EQUIPMENT**

Property and equipment consisted of the following at December 31, 2005 and 2004:

	<b>2005</b>	<b>2004</b>
	<b>(in thousands)</b>	
Land	\$ 202	\$ 202
Building	1,359	1,359
Computer equipment and software	6,374	4,038
Shop equipment	904	783
Furniture and fixtures	477	303
Building and leasehold improvement	1,561	692
Autos and trucks	191	169
	11,068	7,546
Accumulated depreciation and amortization	(4,254)	(2,645)
	6,814	4,901
Project controls and software upgrade in process	47	361
Property and equipment, net	\$ 6,861	\$ 5,262

Depreciation and amortization expense were \$1,836,000, \$1,246,000, and \$824,000 in 2005, 2004 and 2003, respectively.

**NOTE 6 – DETAIL OF CERTAIN BALANCE SHEET ACCOUNTS**

The components of trade receivables as of December 31, 2005 and 2004 are as follows:

	<b>2005</b>	<b>2004</b>
	<b>(in thousands)</b>	
Amounts billed at December 31	\$ 28,964	\$ 21,204
Amounts billable at December 31, billed January of the following year	16,523	9,177
Retainage	1,265	935
Less: Allowance for uncollectible accounts	(503)	(476)
Trade receivables, net	\$ 46,249	\$ 30,840

## ENGLOBAL CORPORATION AND SUBSIDIARIES

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

#### NOTE 6 – DETAIL OF CERTAIN BALANCE SHEET ACCOUNTS (Continued)

The components of other liabilities as of December 31, 2005 and 2004 are as follows:

	2005	2004
	(in thousands)	
Reserve for known contingencies	\$ -	\$ 51
Accrued interest	144	161
Sales taxes	322	6
State taxes	408	198
Other	274	284
Other liabilities	\$ 1,148	\$ 700

#### NOTE 7 – FIXED-PRICE CONTRACTS

Costs, estimated earnings and billings on uncompleted contracts consisted of the following at December 31, 2005 and 2004:

	2005	2004
	(in thousands)	
Costs incurred on uncompleted contracts	\$ 23,426	\$ 8,292
Estimated earnings on uncompleted contracts	4,437	1,584
Earned revenues	27,863	9,876
Less: Billings to date	27,490	(11,077)
Net costs and estimated earnings in excess of billings on uncompleted contracts	\$ 373	\$ (1,201)
Costs and estimated earnings in excess of billings on uncompleted contracts	\$ 4,148	\$ 1,113
Billings in excess of costs and estimated earnings on uncompleted contracts	(3,775)	(2,314)
Net costs and estimated earnings in excess of billings on uncompleted contracts	\$ 373	\$ (1,201)

#### NOTE 8 – LINE OF CREDIT AND DEBT

The Company had a Credit Facility with Comerica Bank (“Comerica”) that consisted of a line of credit maturing on July 27, 2007 (the “Comerica Credit Facility”). The loan agreement positioned Comerica as senior to all other debt. The line of credit is limited to \$22.0 million, subject to loan covenant restrictions. The Comerica Credit Facility is collateralized by substantially all the assets of the Company. The outstanding balance on the line of credit as of December 31, 2005 and 2004 was \$3.8 million and \$13.5 million, respectively. At the election of the Company, the interest rate will be the lesser of prime or a three tiered Eurodollar rate, plus 150, 175, or 200 basis points, respectively, based on the ratio of total funded debt to EBITDA for the trailing 12 months of less than 2.00, between 2.00 and 2.50, and greater than 2.50, respectively. The commitment fee on the unused line of credit is 0.250%. The remaining borrowings available under the line of credit as of December 31, 2005 and 2004, respectively, were \$12.0 and \$4.0 million after consideration of loan covenant restrictions.

The Comerica Credit Facility contains covenants requiring the Company, as of the end of each calendar month, to maintain certain ratios, including total average funded debt to EBITDA; total average funded debt to total liabilities, plus net worth; and total funded debt to accounts/unbilled receivables. The Company is also required, as of the end of each quarter, to maintain minimum

## ENGLOBAL CORPORATION AND SUBSIDIARIES

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

#### NOTE 8 – LINE OF CREDIT AND DEBT (Continued)

levels of net worth, plus the Company must comply with an annual limitation on capital expenditures. The Company was in compliance with all covenants under the Comerica Credit Facility as of December 31, 2005.

#### Letters of credit

As of December 31, 2005, the Company had \$6.2 million outstanding in standby letters of credit issued to a refining client to cover contractual obligations funded by the client for progress payments made to equipment manufacturers for major project items. We expect obligations under standby letters of credit to decrease each month until the obligations are fully released in May 2006. As of February 23, 2006, the Company had \$3.1 million outstanding in standby letters of credit.

Long-term debt consisted of the following at December 31, 2005 and 2004:

	2005	2004
	(in thousands)	
Comerica Credit Facility – Line of credit, prime (7.25% at December 31, 2005), maturing in July 2007	\$ 3,774	\$ 13,530
The following notes are subordinate to the credit facility and are unsecured:		
Sterling Planet and EDGI – Notes payable, interest at 5%, principal payment installments of \$15,000 plus interest due quarterly, maturing in December 2008	195	255
Significant PEI Shareholders (See Note 19)	188	385
Cleveland Inspection Services, Inc., CIS Technical Services and F.D. Curtis – Notes payable, discounted at 5% interest, principal in installments of \$100,000 due quarterly, maturing in October 2009	1,444	1,762
InfoTech Engineering, Inc. – Note payable, interest at 5%, principal payments in installments of \$65,000 plus interest due annually, maturing in December 2007	130	195
Miscellaneous	45	80
Total long-term debt	5,776	16,207
Less: Current maturities	(548)	(622)
Long-term debt, net of current portion	\$ 5,228	\$ 15,585

Maturities of long-term debt as of December 31, 2005, are as follows:

	<b>Maturities</b>
	<b>(in thousands)</b>
Years Ending December 31,	
2006	\$ 548
2007	4,396
2008	444
2009	388
Total long-term debt	\$ 5,776

#### NOTE 9 – OPERATING LEASES

The Company leases equipment and office space under long-term operating lease agreements.

The future minimum rental payments on operating leases (with initial or remaining non-cancelable terms in excess of one year) as of December 31, 2005 are as follows:

## ENGLOBAL CORPORATION AND SUBSIDIARIES

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

#### NOTE 9 – OPERATING LEASES (Continued)

	<u>Operating</u> <u>(in</u> <u>thousands)</u>
Years Ending December 31,	
2006	\$ 2,227
2007	2,482
2008	1,520
2009	1,507
2010 and after	<u>1,772</u>
Total minimum lease payments	<u>\$ 9,508</u>

Rent expense for the years ended December 31, 2005, 2004 and 2003 was \$2,167,000, \$1,754,000 and \$1,268,000, respectively.

#### NOTE 10 – EMPLOYEE BENEFIT PLANS

The Company sponsors a 401(k) profit sharing plan for its employees. Effective October 1, 2005, the Company amended the Plan to implement a mandatory matching contribution equal to 25% of employee contributions up to 4% of employee compensation for non-regular employees. For regular employees, the Company makes mandatory matching contributions equal to 50% of employee contributions up to 4% of employee compensation. The Company, as determined by the Board of Directors, may make other discretionary contributions. The employees may elect to make contributions pursuant to a salary reduction agreement upon meeting age and length-of-service requirements. The Company made contributions of approximately \$401,000, \$221,000, and \$144,000, respectively, for the years ended December 31, 2005, 2004, and 2003. Effective April 1, 2006, the Company will increase its matching contributions to the ENGlobal Corporation 401(k) Plan equal to 50% of regular employee contributions up to 6% of employee compensation, and all other employees will be matched at 33.33% of employee contribution up to 6% of compensation, as defined.

On June 17, 2004, ENGlobal shareholders ratified the Company's adoption of the 2004 Employee Stock Purchase Plan ("Plan"). Beginning April 2004, the Company provided eligible employees with the opportunity and a convenient means to purchase shares of the Company's Common Stock as an incentive to exert maximum efforts for the success of the Company. ENGlobal intends that options to purchase stock granted under the Plan qualify as options granted under an "employee stock purchase plan" as defined in Section 423(b) of the Code. The Plan is construed so as to be consistent with Section 423 of the Code, including Section 423(b)(5) which requires that all participants have the same rights and privileges with respect to options granted under the Plan. The cash deferred by participants into the plan has been used to meet the Company's cash requirements or has been applied to the reduction of the Company's long-term debt. Because of requirements of SFAS 123(R), and probable reduction of benefits that would be required, the Company elected to terminate the Plan effective December 31, 2005.

#### NOTE 11 – STOCK OPTION PLAN

The Company has an incentive plan that provides for the issuance of options to acquire up to 2,650,000 shares of common stock. The incentive plan ("Option Plan") provides for grants of non-statutory options, incentive stock options, restricted stock awards and stock appreciation rights. No compensation cost has been recognized for grants under the Option Plan because the exercise price of the options granted to employees equaled or exceeded the market price of the stock on the date of the grant. Had the method prescribed by SFAS No. 123 been applied, the Company's net income available to common stockholders for the years ended December 31, 2005, 2004 and 2003 would have been changed to the pro forma amount indicated below:



# ENGLOBAL CORPORATION AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

### NOTE 11 – STOCK OPTION PLAN (Continued)

	<b>2005</b>	<b>2004</b>	<b>2003</b>
Net income available for common stock-as reported	\$ 4,782,381	\$ 2,364,389	\$ 2,025,988
Compensation expenses if the fair value method had been applied to the grants	(538,273)	(112,830)	(64,492)
Net income available for common stock-pro forma	\$ 4,244,108	\$ 2,251,559	\$ 1,961,496
Net income per share-as reported			
Basic	\$ 0.20	\$ 0.10	\$ 0.09
Diluted	\$ 0.19	\$ 0.10	\$ 0.09
Net income available per share-pro forma			
Basic	\$ 0.17	\$ 0.10	\$ 0.08
Diluted	\$ 0.17	\$ 0.10	\$ 0.08

The fair value of each option granted is estimated on the date of grant using the Black-Scholes option-pricing model with the following weighted average assumptions used for grants in 2005, 2004, and 2003: dividend yield of 0%, expected volatility of 74.5% to 79.1%, 56% and 73%, and risk-free interest rates of 3.42% to 4.50%, 5% and 5% for each year presented, and expected lives of two to four years. The maximum term of each option is ten years.

The following table summarizes total aggregate stock option activity for the period December 31, 2002 through December 31, 2005.

	<b>Number of Shares Outstanding</b>	<b>Weighted Average Exercise Price</b>
Balance at December 31, 2002	1,254,929	1.79
Granted	120,000	2.09
Exercised	(51,710)	1.02
Canceled or expired	(66,051)	1.00
Balance at December 31, 2003	1,257,168	2.11
Granted	386,000	2.01
Exercised	(87,332)	1.03
Canceled or expired	(28,686)	1.19
Balance at December 31, 2004	1,527,150	2.10
Granted	425,000	3.79
Exercised	(492,019)	.99
Canceled or expired	(21,897)	1.88
Balance at December 31, 2005	1,438,234	3.07

## ENGLOBAL CORPORATION AND SUBSIDIARIES

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

#### NOTE 11 – STOCK OPTION PLAN (Continued)

The following table summarizes information concerning outstanding and exercisable Company common stock options at December 31, 2005.

Exercise Prices	Options Outstanding	Weighted Average Exercise Price	Average Remaining Contractual Life	Options Exercisable	Weighted Average Exercise Price
\$ 0.96	179,884	\$ 0.96	4.8	179,884	\$ 0.96
\$ 1.00	20,000	\$ 1.00	5.2	20,000	\$ 1.00
\$ 1.25	80,000	\$ 1.25	3.95	80,000	\$ 1.25
\$ 1.81	60,000	\$ 1.81	8.5	60,000	\$ 1.81
\$ 1.87	60,000	\$ 1.87	7.3	60,000	\$ 1.87
\$ 1.97	25,000	\$ 1.97	8.2	25,000	\$ 1.97
\$ 2.05	266,850	\$ 2.05	8.2	158,450	\$ 2.05
\$ 2.32	60,000	\$ 2.32	7.4	60,000	\$ 2.32
\$ 2.39	100,000	\$ 2.39	9.1	40,000	\$ 2.39
\$ 2.50	75,000	\$ 2.50	9.2	30,000	\$ 2.50
\$ 3.75	150,000	\$ 3.75	9.5	-	\$ -
\$ 4.26	61,766	\$ 4.26	.7	61,766	\$ 4.26
\$ 6.24	199,734	\$ 6.24	1.8	199,734	\$ 6.24
\$ 6.71	100,000	\$ 6.71	9.9	40,000	\$ 6.71
	<u>1,438,234</u>			<u>1,014,834</u>	

Available for grant at December 31, 2005	509,260
Weighted-average fair value of options at grant date, granted in 2005	\$ 3.52
Weighted-average fair value of options at grant date, granted in 2004	\$ 2.15
Weighted-average fair value of options at grant date, granted in 2003	\$ 2.01
Weighted-average remaining vesting life of all options outstanding at December 31, 2005	1.5 years

For 2002 through 2004, the summary above does not include 234,774 non-qualified options issued at the time of the Merger to replace existing options issued by Petrocon in consideration for services. Such options had an exercise price of \$4.26 per share. In September 2005, these options were exercised.

Replacement warrants of 305,102 (not included in the table above) with an exercise price of \$6.24 expired in October 2003.

#### NOTE 12 – RELATED-PARTY TRANSACTIONS

The Company leases office space from PEI Investments, a joint venture in which ENGlobal Engineering, Inc. has a one-third interest, Michael L. Burrow (the Company's CEO) has a one-third interest, and a stockholder who owns less than 1% of the Company's common stock has a one-third interest. Rentals paid under these leases were \$105,000, \$135,000, and \$135,000 for 2005, 2004 and 2003, respectively. The lease was renewed in August, 2005. In September 2005, the building was damaged by Hurricane Rita and all tenants have relocated to other locations. No further lease payments have been made by the Company since September 2005 and the insurance claim filed by PEI Investments remains unsettled.

## ENGLOBAL CORPORATION AND SUBSIDIARIES

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

#### NOTE 13 – CONCENTRATION OF CREDIT RISK AND MAJOR CUSTOMERS

The Company provides engineering and fabricated systems and services primarily to major integrated oil and gas companies throughout the world. It also fabricates power systems and battery chargers. The Company performs ongoing credit evaluations of its customers and generally does not require collateral. Management reviews all trade receivable balances that exceed 30 days past due and based on its assessment of current credit worthiness, estimate what portion, if any seems doubtful for collection. A valuation allowance that reflects management's best estimate of the amounts that will not be collected is established.

For the years ended December 31, 2005, 2004, and 2003, the Company had sales in the engineering segment totaling approximately \$84.8 million, \$87.9 million and \$45.2 million attributable to a single customer. . In 2005, approximately 44% of our revenues were from one client, approximately 12% of our revenues were from another client and another 12% were from a third client. During 2004 and 2003, a single customer represented approximately 59% and 36% of total sales, respectively. At December 31, 2005 the Company had amounts due from two customers totaling \$8.3 million with neither customer exceeding 10% of trade receivables. At December 31, 2004, the Company had amounts due from one customer totaling \$7.0 million; no other customer exceeded 10% of trade receivables at that date. At December 31, 2003, one customer had amounts in excess of 10% of trade receivables, totaling \$5.1 million.

#### NOTE 14 – REDEEMABLE PREFERRED STOCK

ENGlobal has a class of preferred stock with 5,000,000 shares originally authorized for issuance. The Company issued to Equus II Incorporated 2,500,000 shares of preferred stock in 2001 and stock dividends totaling 88,000 shares in 2002 and 146,833 shares in 2003. Par value for the preferred stock was \$0.001 with a fair value of \$1.00 per share at the time of issuance. The preferred shares outstanding were converted into 1,149,089 shares of common stock in August 2003. Following the conversion, the Company reduced the authorized shares of preferred stock to 2,265,167.

#### NOTE 15 – FEDERAL INCOME TAXES

The components of income tax expense (benefit) from continuing operations for the years ended December 31, 2005, 2004 and 2003 were as follows:

	<u>2005</u>	<u>2004</u> <u>(in thousands)</u>	<u>2003</u>
Current			
Federal	\$ 3,016	\$ 975	\$ 536
State	413	427	30
	<u>3,429</u>	<u>1,402</u>	<u>566</u>
Deferred			
Federal	(313)	254	543
	<u>\$ 3,116</u>	<u>\$ 1,656</u>	<u>\$ 1,109</u>

## ENGLOBAL CORPORATION AND SUBSIDIARIES

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

#### NOTE 15 – FEDERAL INCOME TAXES (Continued)

The components of the deferred tax asset (liability) consisted of the following at December 31, 2005 and 2004:

	<u>2005</u>	<u>2004</u>
	<u>(in thousands)</u>	
Deferred tax asset		
Allowance for doubtful accounts	\$ 171	\$ 162
Net operating loss carryforward	474	-
Accruals not yet deductible for tax purposes	310	478
Alternative minimum tax credit carryforward	194	-
Deferred tax assets	<u>1,149</u>	<u>640</u>
Deferred tax liabilities		
Depreciation	(436)	(558)
Prepaid expenses	(293)	-
Goodwill	(40)	(15)
Deferred tax liability	<u>(769)</u>	<u>(573)</u>
Deferred tax asset, net	<u>\$ 380</u>	<u>\$ 67</u>

The following is a reconciliation of expected to actual income tax expense from continuing operations:

	<u>2005</u>	<u>2004</u>	<u>2003</u>
	<u>(in thousands)</u>		
Federal income tax expense at 34%	\$ 2,685	\$ 1,147	\$ 1,154
State and foreign taxes, net of tax effect	273	212	2
Nondeductible expenses	9	53	31
Other	149	244	(78)
	<u>\$ 3,116</u>	<u>\$ 1,656</u>	<u>\$ 1,109</u>

The Company has a net operating loss carryforward at December 31, 2005 of approximately \$1,393,000. Earlier utilization of the net operating loss on the Company's 2002 and 2003 consolidated tax returns was disallowed by the IRS which resulted in a reinstated carryforward that will be available for utilization in 2006 through 2010. The Company believes, based on favorable market conditions in the foreseeable future, that the net operating loss will be fully utilized.

#### NOTE 16 - ACQUISITIONS

Assets acquired and liabilities assumed by the Company in acquisitions have been recorded on the Company's Consolidated Balance Sheets as of the respective acquisition dates based upon their estimated fair values at such dates. The results of operations of our acquisitions have been included in the Company's Consolidated Statement of Income since their respective dates of acquisition. The excess of the purchase price over the estimated fair values of the underlying assets acquired and liabilities assumed has been allocated to goodwill.

One of the Company's subsidiaries, ENGlobal Technical Services, Inc. ("ETS") (formerly known as ENGlobal Design Group, Inc. ("EDG")), purchased certain assets of Tulsa-based Engineering Design Group, Inc. ("EDGI") effective February 1, 2004. The Company expects that the acquisition of these assets will enhance its capabilities related to various government and public sector facilities. ETS's most active sector is the Automated Fuel Handling Systems that serve the U.S. Military. In connection with the purchase, the Company acquired \$344,000 in tangible assets including furniture and fixtures, computer equipment and software. The Company also assumed a liability for \$44,000 in accrued compensated absences for former EDGI employees hired at the time of the purchase, issued two \$150,000 notes bearing interest at 5% maturing in December 2008 and a \$2.5 million five-year

## **ENGLOBAL CORPORATION AND SUBSIDIARIES**

### ***NOTES TO CONSOLIDATED FINANCIAL STATEMENTS***

#### ***NOTE 16 – ACQUISITIONS (Continued)***

contingent promissory note, with payments due annually, as part of an earn-out based on revenues of the ETS operations over the next five years. ETS did not pay any cash or issue any stock in the transaction. The original consideration given for the purchase of certain EDGI assets approximated the fair value of the net assets acquired; therefore no goodwill arose from the transaction. Principal and interest on the \$2.5 million five-year contingent promissory note is being charged to goodwill. As of December 31, 2005, \$218,000 in principal and interest payments on the contingent promissory note has been charged to goodwill and is being amortized over 15 years for tax purposes.

In October 2004, one of the Company's subsidiaries, ENGlobal Construction Resources, Inc., purchased the name and certain assets of Cleveland Inspection Services, Inc. ("CIS"). CIS provides inspection and construction management services in support of the oil and gas, utility, and pipeline industries. The Company paid \$2.5 million consisting of cash, discounted promissory notes and the assumption of certain designated contract obligations and entered into non-compete agreements with CIS and its principals in exchange for approximately \$1.0 million in machinery and equipment, furniture and fixtures, computer equipment, software and other intangible assets. The acquisition resulted in approximately \$1.3 million in goodwill which is being recorded and amortized over 15 years for tax purposes.

In December 2004, ESI purchased contract rights and other assets of InfoTech Engineering Company, LLC, a limited liability company ("InfoTech"), headquartered in Baton Rouge, Louisiana. The Company paid \$325,000 in cash, a promissory note in the amount of \$225,000 and entered into a non-compete agreement with the former owner in exchange for approximately \$55,000 in computer equipment and certain intangible assets. The acquisition resulted in approximately \$270,000 in goodwill which is being recorded and amortized over 15 years for tax purposes. The InfoTech acquisition expands ESI's capability in controls system integration in both the automation and process control services. InfoTech's primary experience is in the onshore and offshore oil and gas and petrochemical industries.

Two acquisitions were completed in 2003, Senfteleber & Associates, L.P. and Petro-Chem Engineering, Inc. Through the Petro-Chem transaction, selected assets were acquired expanding the Company's presence in Freeport, Texas and surrounding area. The new Freeport operations began in June as a division of EEI. Senfteleber, a limited partnership, provides support in the pipeline industry in Houston. The Senfteleber acquisition occurred in November as a subsidiary of ETI. The acquisitions had an aggregate cost of \$425,000. Goodwill was created with both transactions: \$115,000 for Petro-Chem and \$428,000 for Senfteleber.

#### ***NOTE 17 – SALE OF THERMAIRE***

The Company completed its sale of assets of its subsidiary, Thermaire, Inc., d/b/a Thermal Corporation, the only company in the manufacturing segment, to a medium-sized HVAC equipment manufacturer in December 2003. The disposition had been actively pursued since November 2001 in order to permit the Company to strategically focus on its core operations. This discontinued segment had reported losses from operations of \$154,000 in 2003. The sale resulted in the receipt of \$545,000 in cash and a \$26,000 gain, net of tax. The 37,000 square foot office and manufacturing facility owned by Thermaire was not included in the transaction and has been separately listed for sale.

In March 2005, the Company completed the sale of the building formerly occupied by Thermaire, Inc. The Company received proceeds of \$823,350. The Company realized a gain on the sale of the building of \$119,000.

#### ***NOTE 18 – SEGMENT INFORMATION***

With the sale of the manufacturing segment, the Company operates in two business segments: engineering and systems. The engineering segment provides services primarily to major integrated oil and gas companies that for the most part are located in the United States. The systems segment operates primarily full-service systems/controls engineering and integration with some uninterruptible power systems and battery chargers that for the most part are located in the United States. Sales, operating income, identifiable assets, capital expenditures and depreciation for each segment are set forth in the following table. The amount in the

# ENGLOBAL CORPORATION AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

### NOTE 18 – SEGMENT INFORMATION (Continued)

corporate segment includes those activities that are not allocated to the operating segments and include costs related to business development, executive functions, finance, accounting, safety, human resources and information technology that are not specifically identifiable with the two segments. The inter-company elimination column includes the amount of administrative costs allocated to the segments. The Corporate function supports both business segments and therefore cannot be specifically assigned to either. A significant portion of Corporate costs are allocated to each segment based on each segment's revenues and subsequently eliminated in consolidation.

#### Financial information about geographic areas

Revenues from the Company's non-U.S. operations are currently not material. Long-lived assets located in Canada are currently not material.

Segment information for 2005, 2004 and 2003 was as follows:

	Engineering	Systems	Corporate (in thousands)	Intercompany Eliminations	Total
<b>2005</b>					
Net sales from external customers \$	215,699	\$ 17,886	\$ -	\$ -	\$ 233,585
Operating profit (loss)	17,752	309	732	(10,209)	8,584
Depreciation and amortization	1,256	101	479	-	1,836
Tangible assets	52,602	5,460	2,419	-	60,481
Goodwill	14,756	699	-	-	15,455
Capital expenditures	2,569	172	489	-	3,230
<b>2004</b>					
Net sales from external customers \$	133,630	\$ 15,258	\$ -	\$ -	\$ 148,888
Operating profit (loss)	10,512	585	2,267	(8,872)	4,492
Depreciation and amortization	706	108	432	-	1,246
Tangible assets	31,971	6,673	3,332	-	41,976
Goodwill	14,585	699	-	-	15,284
Capital expenditures	1,378	20	67	-	1,465
<b>2003</b>					
Net sales from external customers \$	108,380	\$ 15,339	\$ -	\$ -	\$ 123,719
Operating profit (loss)	10,716	(38)	762	(6,906)	4,534
Depreciation and amortization	375	89	360	-	824
Tangible assets	22,642	3,049	3,048	-	28,762
Goodwill	12,889	864	-	-	13,753
Capital expenditures	902	105	139	-	1,146

Tangible assets include cash, accounts receivable, costs in excess of billings, prepaid expenses, income tax receivables, deferred tax assets, property and equipment and deferred financing. Goodwill, investments in subsidiaries, and inter-company accounts receivables and payables are excluded.

## ENGLOBAL CORPORATION AND SUBSIDIARIES

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

#### NOTE 19 – COMMITMENTS AND CONTINGENCIES

In connection with the 2001 merger of Petrocon Engineering, Inc. (“Petrocon”) and a wholly-owned subsidiary of ENGlobal Corporation, certain former Petrocon shareholders (the “Significant PEI Shareholders”) entered into an Indemnification Escrow Agreement, an Option Escrow Agreement, a Voting Agreement and a Significant PEI Shareholder Voting Agreement (collectively, the “2001 Agreements”). In August 2004, the Company and the requisite percentage of Significant PEI Shareholders entered into a Termination Agreement (the “Termination Agreement”) terminating the 2001 Agreements. The 2001 Agreements included the following:

##### *Indemnification Escrow.*

Pursuant to the Indemnification Escrow Agreement, 1,000,000 shares of ENGlobal common stock owned by the Significant PEI Shareholders were deposited into an escrow to serve as a fund against which the Company could make claims for indemnity pursuant to the Merger Agreement with Petrocon. Pursuant to the terms of the Termination Agreement, the remaining shares in the Indemnification Escrow agreement will be released pro rata to the Significant PEI Shareholders.

##### *Voting Agreement.*

ENGlobal, the Significant PEI Shareholders, and certain other parties entered into a Voting Agreement which obligated the parties thereto to vote for certain persons to serve on the Board of Directors of ENGlobal. Pursuant to the terms of the Termination Agreement, the Voting Agreement has been terminated.

##### *Significant PEI Shareholder Voting Agreement.*

The Significant PEI Shareholders entered into a Significant PEI Shareholders Voting Agreement governing the manner in which they would designate three ENGlobal director nominees under the Voting Agreement and vote shares held in escrow. Pursuant to the terms of the Termination Agreement, the Significant PEI Shareholders Voting Agreement has been terminated.

##### *Option Escrow.*

Pursuant to the Option Escrow Agreement, the Significant PEI Shareholders deposited 1,737,473 shares of ENGlobal common stock into an escrow account. The Option Escrow Agreement required that if ENGlobal issued shares of its common stock on the exercise of incentive options granted as replacement options for outstanding Petrocon incentive options (“Replacement Options”), a like number of shares of ENGlobal common stock would be surrendered from the escrow account to ENGlobal. As a result, no dilution to ENGlobal stockholders would occur upon the exercise of Replacement Options.

The Company’s management has since determined that, due to the cost and complexity associated with administering the 2001 Agreements, it would be in the best interest of the Company and its stockholders to terminate the same. Pursuant to the terms of the Termination Agreement, ENGlobal purchased the 652,377 shares being held in escrow underlying the Replacement Options with an exercise price of \$0.96 per share for a discounted payment of \$592,231, payable over three years to the Significant PEI Shareholders. ENGlobal also terminated its rights to any of the remaining shares held in escrow and those shares were distributed to the Significant PEI Shareholders. The transaction resulted in 652,377 shares of Treasury Stock and a decrease in Shareholders’ Equity of \$592,231 until such time as the replacement options are exercised and the exercise price is remitted to the Company. As of December 31, 2005, remaining payments due to Significant PEI Shareholders are \$188,000.

##### *Employment Agreements*

The Company has employment agreements with certain of its executive officers and certain other officers, the terms of which expire through January 2009. Such agreements provide for minimum salary levels. During the last twelve months the Company executed new employment agreements with certain other officers. If the Company terminates the employment of the employee for any reason other than 1) termination for cause, 2) voluntary resignation, or 3) employee’s death, the Company is obligated to provide a severance benefit equal to six months of the employee’s salary, and, at its option, an additional six months at 50% to 100% of the employee’s salary. These agreements are renewable for one year at the Company’s option.

The Company has not renewed employment agreements with the Chairman, Chief Executive Officer and President and Chief Financial Officer which expired on December 21, 2005.

# ENGLOBAL CORPORATION AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

### NOTE 19 – COMMITMENTS AND CONTINGENCIES (Continued)

#### Litigation

From time to time, the Company and its subsidiaries become parties to various legal proceedings arising in the ordinary course of normal business activities. While we cannot predict the outcome of these proceedings, in our opinion and based on reports of counsel any liability arising from such matters, individually or in the aggregate, are not expected to have a material affect upon the consolidated financial position or operations of the Company, after giving effect of recorded reserves.

#### Insurance

The Company carries a broad range of insurance coverage, including general and business automobile liability, commercial property, professional errors and omissions, workers' compensation insurance and a general umbrella policy. The Company is not aware of any claims in excess of insurance recoveries. ENGlobal is partially self-funded for health insurance claims. Provisions for expected future payments are accrued based on the Company's experience. Specific stop loss levels provide protection for the Company with \$125,000 per occurrence and approximately \$8.6 million in aggregate in each policy year being covered by a separate insurance policy.

### NOTE 20 – SUBSEQUENT EVENTS

On January 9, 2006, the Company through its wholly-owned subsidiary, ENGlobal Systems, Inc. ("ESI") acquired certain assets of Analyzer Technology International, Inc. ("ATI"), a Houston-based analyzer systems provider. ATI, which specializes in the design and fabrication of online process analyzer systems, will relocate its operation to ESI's Houston facility. Co-locating enables ESI's clients to perform a more efficient factory acceptable test by temporarily connecting both control and analyzer systems onsite prior to delivery. The addition of ATI will provide ESI with a greater presence in the process analyzer sector, especially in Middle Eastern petrochemical facilities.

### NOTE 21 – QUARTERLY FINANCIAL INFORMATION (UNAUDITED)

All quarterly periods and the annual data have been restated to reflect the discontinued operations separate from continuing operations and reclassification of depreciation expense to direct costs.

	<b>For the Quarters Ended - 2005</b>											
	<u>March</u>		<u>June</u>		<u>September</u>		<u>December</u>					
	(in thousands, except per share amounts)											
Revenues per segment												
Engineering	\$	40,299	90.3%	\$	54,028	90.9%	\$	55,143	93.0%	\$	66,229	94.2%
Systems		4,330	9.7%		5,391	9.1%		4,123	7.0%		4,042	5.8%
Total	\$	<u>44,629</u>	100.0%	\$	<u>59,419</u>	100.0%	\$	<u>59,266</u>	100.0%	\$	<u>70,271</u>	100.0%
Gross profit per segment												
Engineering	\$	5,131	12.7%	\$	6,594	12.2%	\$	7,328	13.3%	\$	6,920	10.4%
Systems		567	13.1%		686	12.7%		510	12.4%		537	13.3%
Total	\$	<u>5,698</u>	12.8%	\$	<u>7,280</u>	12.3%	\$	<u>7,838</u>	13.2%	\$	<u>7,457</u>	10.6%
Net income	\$	<u>921</u>		\$	<u>1,520</u>		\$	<u>1,620</u>		\$	<u>721</u>	
Earnings per share – basic	\$	0.04		\$	0.06		\$	0.07		\$	0.03	
Earnings per share – diluted	\$	0.04		\$	0.06		\$	0.07		\$	0.03	



**ENGLOBAL CORPORATION AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**NOTE 21 – QUARTERLY FINANCIAL INFORMATION (UNAUDITED) (Continued)**

	<b>For the Quarters Ended - 2004</b>							
	<u>March</u>		<u>June</u>		<u>September</u>		<u>December</u>	
	<b>(in thousands, except per share amounts)</b>							
Revenues per segment								
Engineering	\$ 28,463	91.8 %	\$ 31,470	91.8 %	\$ 32,796	88.0 %	\$ 40,901	88.3 %
Systems	<u>2,529</u>	8.2 %	<u>2,813</u>	8.2 %	<u>4,476</u>	12.0 %	<u>5,440</u>	11.7 %
Total	<u>\$ 30,992</u>	100.0 %	<u>\$ 34,283</u>	100.0 %	<u>\$ 37,272</u>	100.0 %	<u>\$ 46,341</u>	100.0 %
Gross profit per segment								
Engineering	\$ 3,805	13.4 %	\$ 3,925	12.5 %	\$ 3,899	11.9 %	\$ 4,394	10.7 %
Systems	<u>324</u>	12.8 %	<u>216</u>	7.7 %	<u>810</u>	18.1 %	<u>819</u>	15.1 %
Total	<u>\$ 4,129</u>	13.3 %	<u>\$ 4,141</u>	12.1 %	<u>\$ 4,709</u>	12.6 %	<u>\$ 5,213</u>	11.2 %
Net income	<u>\$ 471</u>		<u>\$ 421</u>		<u>\$ 755</u>		<u>\$ 717</u>	
Earnings per share – basic	\$ 0.02		\$ 0.02		\$ 0.03		\$ 0.03	
Earnings per share – diluted	\$ 0.02		\$ 0.02		\$ 0.03		\$ 0.03	

**REPORT OF  
INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM  
ON FINANCIAL STATEMENT SCHEDULE**

To the Board of Directors and Stockholders  
ENGlobal Corporation

We have audited, in accordance with auditing the standards of the Public Company Accounting Oversight Board (United States), the consolidated financial statements of ENGlobal Corporation and Subsidiaries included in this Form 10-K and have issued our report thereon dated March 17, 2006. Our audits were made for the purpose of forming an opinion on the basic financial statements taken as a whole. The financial statement schedule listed in Schedule II – Valuation and Qualifying Accounts is the responsibility of the Company’s management and is presented for the purpose of complying with the Securities and Exchange Commission’s rules and is not part of the basic financial statements. The financial statement schedule has been subjected to the auditing procedures applied to the audits of the basic financial statements and in our opinion, is fairly stated in all material respects with the financial data required to be set forth therein in relation to the basic financial statements taken as a whole.

*Hein & Associates LLP*

HEIN & ASSOCIATES LLP

Houston, Texas  
March 17, 2006

**Schedule II**

**ENGlobal Corporation**

**VALUATION AND QUALIFYING ACCOUNTS**

<b>Description</b>	<b>Balance - Beginning of Period</b>	<b>Additions</b>	<b>Deductions- Write offs</b>	<b>Balance - End of Period</b>
	<b>(in thousands)</b>			
Allowance for doubtful accounts				
For year ended December 31, 2005	\$ 476	\$ 53	\$ (26)	\$ 503
For year ended December 31, 2004	\$ 376	\$ 134	\$ (34)	\$ 476
For year ended December 31, 2003	\$ 282	\$ 282	\$ (188)	\$ 376

**ITEM 9. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE**

None.

**ITEM 9A. CONTROLS AND PROCEDURES**

- (a) Evaluation of Disclosure Controls and Procedures. We maintain disclosure controls and procedures designed to provide reasonable assurance that information required to be disclosed in the periodic reports we file with the SEC is recorded, processed, summarized and reported within the time periods specified in the rules and forms of the SEC. We carried out an evaluation as of December 31, 2005, under the supervision and the participation of our management, including our chief executive officer and chief financial officer, of the design and operation of the disclosure controls and procedures pursuant to Rules 13a-14 and 15d-14 under the Securities Exchange Act of 1934. Based upon that evaluation, our chief executive officer and chief financial officer concluded that our disclosure controls and procedures are effective in timely alerting them to material information relating to the Company that is required to be included in our periodic SEC filings.
  
- (b) Changes in Internal Controls over Financial Reporting. There have been no changes in internal control over financial reporting during the fiscal quarter ended December 31, 2005 that has materially affected, or is reasonably likely to affect, the registrant's internal control over financial reporting.

### **PART III**

#### **ITEM 10. DIRECTORS AND EXECUTIVE OFFICERS OF THE REGISTRANT**

The information under the captions *Election of Directors and Executive Officers Section 16(a) Beneficial Ownership Reporting Compliance* and *Corporate Code of Conduct*, in our definitive proxy statement for our 2006 annual meeting of stockholders to be filed with the SEC pursuant to Regulation 14A under the Exchange Act is incorporated herein by reference.

#### **ITEM 11. EXECUTIVE COMPENSATION**

The information under the captions *Executive Compensation, Director Compensation, Compensation Committee, Report of the Compensation Committee on Executive Compensation and Comparative Stock Performance Graph* contained in our definitive proxy statement for our 2006 annual meeting of stockholders to be filed with the SEC pursuant to Regulation 14A under the Exchange Act is incorporated herein by reference.

#### **ITEM 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT AND RELATED STOCKHOLDER MATTERS**

The information under the caption *Security Ownership of Certain Beneficial Owners and Management* contained in our definitive proxy statement for our 2006 annual meeting of stockholders to be filed with the SEC pursuant to Regulation 14A under the Exchange Act is incorporated herein by reference.

#### **ITEM 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS**

The information under the caption *Certain Relationships and Related Transactions* contained our definitive proxy statement for our 2006 annual meeting of stockholders to be filed with the SEC pursuant to Regulation 14A under the Exchange Act is incorporated herein by reference.

#### **ITEM 14. PRINCIPAL ACCOUNTING FEES AND SERVICES**

The information under the caption *Principal Accounting Fees and Services* in our definitive proxy statement for our 2006 annual meeting of stockholders to be filed with the SEC pursuant to Regulation 14A under the Exchange Act is incorporated herein by reference.

**PART IV**

**ITEM 15. EXHIBITS, FINANCIAL STATEMENTS SCHEDULES**

**(a)(1) *Financial Statements***

The consolidated financial statements filed as part of this Form 10-K are listed and indexed in Part II, Item 8, on page 38.

**(a)(2) *Schedules***

All schedules have been omitted since the information required by the schedule is not applicable, or is not present in amounts sufficient to require submission of the schedule, or because the information required is included in the consolidated financial statements and notes thereto.

**(a)(3) *Exhibits***

## EXHIBIT INDEX

Exhibit No.	Description	Form or Schedule	Incorporated by Reference to:		
			Exhibit No.	Filing Date with SEC	SEC File Number
2.1	Agreement and Plan of Merger by and between Industrial Data Systems Corporation, IDS Engineering Management, LC, PEI Acquisition, Inc. and Petrocon Engineering, Inc.	10-QSB	2.23	8/14/01	001-14217
2.2	First Amendment of the Agreement and Plan of Merger	S-4/A	2.24	11/6/01	333-68288
2.3	Letter Agreement of the Agreement and Plan of Merger	S-4/A	2.25	11/6/01	333-68288
3.1	Restated Articles of Incorporation of ENGlobal Corporation	10-Q	3.1	11/14/02	001-14217
3.2	Amended and Restated Bylaws of Registrant	S-3	4.4	10/31/05	333-129336
4.1	Specimen common stock certificate	S-3	4.1	10/31/05	333-129336
4.2	Registration Rights Agreement, dated as of September 29, 2005, by and among ENGlobal Corporation and Certain Investors named therein	S-3	4.2	10/31/05	333-129336
4.3	Securities Purchase Agreement, dated September 29, 2005, by and between Tontine Capital Partners, L.P. and Registrant	S-3	4.5	10/31/05	333-129336
4.4	Form of Subscription Agreement by and among Registrant, Michael L. Burrow, Alliance 2000, Ltd. and certain subscribers	S-3	4.6	10/31/05	333-129336
10.1	Option Pool Agreement between Industrial Data Systems Corporation and Alliance 2000, Ltd. Dated December 21, 2001	10-KSB	10.48	4/1/2002	001-14217
10.2	Guaranty and Suretyship Agreement between Industrial Data Systems Corporation and Corporate Property Associates 4 dated April 26, 2002	10-Q	10.64	8/12/02	001-14217
10.3	ENGlobal Corporation Incentive Bonus Plan dated June 12, 2002	10-Q	10.65	8/12/02	001-14217
10.4	1998 Incentive Plan	S-8	10.49	8/24/05	333-127803
10.5	Amendment No. 1 to 1998 Incentive Plan	S-8	10.65A	6/9/03	333 - 105966
10.6	Amendment No. 2 to the 1998 Incentive Plan	S-8	10.65A	6/9/03	333 - 105966
10.7	Amendment No. 3 to the 1998 Incentive Plan	S-8	10.52	8/24/05	333-127803
10.8	Form of ENGlobal Corporation (f/k/a Industrial Data Systems Corporation) Non-qualified Stock Option Agreement Granted Outside of 1998 Incentive Plan	S-8	10.80	8/24/05	333-127803
10.9	Lease Agreement between Petrocon Engineering, Inc. and Phelan Investments on July 25, 2002	10-Q	10.66	11/14/02	001-14217
10.10	Second Amendment of the Second Amended and Restated Loan and Security Agreement as of July 31,	10-Q	10.67	11/14/02	001-14217

Exhibit No.	Description	Form or Schedule	Incorporated by Reference to:		
			Exhibit No.	Filing Date with SEC	SEC File Number
	2002 between IDS Engineering and Subsidiaries and Fleet Capital Corporation				
10.11	Amendment of the Intercreditor Agreement between Fleet Capital Corporation, Equus II Incorporated and ENGlobal Corporation dated July 31, 2002	10-Q	10.68	11/14/02	001-14217
10.12	Fifth Amendment of Lease Agreement between IDS and 600 C.C. Business Park Ltd.	10-Q	10.69	11/14/02	001-14217
10.13	Lease Agreement between PEI Investments and Petrocon Engineering, Inc. dated July 1, 2002	10-Q	10.70	5/13/03	001-14217
10.14	Lease Agreement between Petro-Chem Engineering and ENGlobal Engineering, Inc. dated June 4, 2003	10-Q	10.72	8/14/03	001-14217
10.15	Contract between BASF and ENGlobal Engineering, Inc. dated June 9, 2003	10-Q	10.73	8/14/03	001-14217
10.16	Sublease Agreements between Family Connect, Inc., a tenant of CitiPlex Towers Building and IDS Engineering dated February 2, 2003	10-Q	10.74	11/14/03	001-14217
10.17	Lease Agreement between Oral Roberts University and IDS Engineering, dba ENGlobal Engineering, Inc. dated October 20, 2003	10-Q	10.75	11/14/03	001-14217
10.18	Sixth Amendment of the Second Amended and Restated Loan and Security Agreement as of June 30, 2003 between ENGlobal Corporation and Subsidiaries and Fleet Capital Corporation	10-Q	10.76	11/14/03	001-14217
10.19	Second Amendment of the ENGlobal Engineering, Inc. 401(k) Plan dated January 1, 2004 (formerly called the "Petrocon Engineering, Inc. 401(k) Plan")	10-K	10.77	3/30/04	001-14217
10.20	ENGlobal Corporation Employee Stock Purchase Plan dated March 2, 2004	S-8	10.1	3/12/04	333-113554
10.21	Lease Agreement between ENGlobal Design Group, Inc. and TC Meridian Tower LP dated January 24, 2004	10-K	10.79	3/30/04	001-14217
10.22	Credit Agreement by and between Comerica Bank and ENGlobal Corporation and its subsidiaries dated July 27, 2004	8-K	10.1	8/9/04	001-14217
10.23	Security Agreement by and between Comerica Bank and ENGlobal Corporation and its subsidiaries dated July 27, 2004	8-K	10.2	8/9/04	001-14217
10.24	Master Revolving Note by and between Comerica Bank and ENGlobal Corporation and its subsidiaries dated July 27, 2004	8-K	10.3	8/9/04	001-14217
10.25	Termination Agreement by and among ENGlobal Corporation, Equus II Incorporated, Alliance 2000, Ltd., Significant PEI Shareholders, Michael L. Burrow, as shareholder representative for the Significant PEI	8-K	99.1	10/1/04	001-14217



Incorporated by Reference to:

Exhibit No.	<u>Description</u>	<u>Form or Schedule</u>	<u>Exhibit No.</u>	<u>Filing Date with SEC</u>	<u>SEC File Number</u>
	Shareholders, and Johnny J. Williams, Esq., as Escrow Agent, dated September 28, 2004				
10.26	ENGlobal Corporation Key Manager Incentive Plan dated December 16, 2004	8-K	10.1	12/21/04	001-14217
10.27	ENGlobal Corporation Executive Level Incentive Plan dated December 16, 2004	8-K	10.1	12/21/04	001-14217
10.28	Third Amendment of the ENGlobal Engineering, Inc. 401(k) Plan (formerly called the "Petrocon Engineering, Inc. 401(k) Plan") dated March 9, 2005 and effective January 1, 2005.	10-K	10.48	3/30/05	001-14217
*11.1	Statement Regarding Computation of Per Share Earnings is included as Note 2 to the Notes to Consolidated Financial Statements.				
14.1	ENGlobal Corporation Code of Ethics for Chief Executive Officer and Senior Financial Officers dated March 25, 2004	10-K	99.5	3/30/04	001-14217
14.2	ENGlobal Corporation Code of Business Conduct and Ethics dated March 25, 2004	10-K	99.6	3/30/04	001-14217
*21.1	Subsidiaries of the Registrant				
*23.1	Consent of Hein & Associates LLP				
*31.1	Certification of Chief Executive Officer pursuant to Exchange Act Rules 13a-14 or 15d-14				
*31.2	Certification of Chief Financial Officer pursuant to Exchange Act Rules 13a-14 or 15d-14				
*32.1	Certification of Chief Executive Officer pursuant to Exchange Act Rules 13a-14(b) or 15d-14(b) and 18 U.S.C. Section 1350				
*32.2	Certification of Chief Financial Officer pursuant to Exchange Act Rules 13a-14(b) or 15d-14(b) and U.S.C. Section 1350				

\* Filed herewith

## SIGNATURES

In accordance with Section 13 or 15(d) of the Securities Exchange Act of 1934, the Registrant has caused this Annual Report on Form 10-K to be signed on its behalf by the undersigned, thereunto duly authorized.

ENGlobal CORPORATION

Dated: March 30, 2006

By: /s/ Michael L. Burrow  
Michael L. Burrow, P.E.,  
Chief Executive Officer, Director

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

By: /s/ Michael L. Burrow  
Michael L. Burrow, P.E.  
Chief Executive Officer, Director

By: /s/ William A. Coskey  
William A. Coskey, P.E.  
Chairman of the Board, Director

By: /s/ Robert W. Raiford  
Robert W. Raiford  
Chief Financial Officer, Treasurer

By: /s/ David W. Gent  
David W. Gent, P.E., Director

By: /s/ Randall B. Hale  
Randall B. Hale, Director

By: /s/ David C. Roussel  
David C. Roussel, Director

**EXHIBIT 21.1**  
**SUBSIDIARIES OF REGISTRANT**

ENGlobal Corporate Services, Inc.	Incorporated in the State of Texas
ENGlobal Engineering, Inc.	Incorporated in the State of Texas
ENGlobal Systems, Inc.	Incorporated in the State of Texas
ENGlobal Construction Resources, Inc.	Incorporated in the State of Texas
RPM Engineering, Inc. dba ENGlobal Engineering, Inc.	Incorporated in the State of Louisiana
ENGlobal Automation Group, Inc.	Incorporated in the State of Texas
ENGlobal Technical Services, Inc.	Incorporated in the State of Texas
ENGlobal Canada, ULC	Incorporated in Alberta, Canada

**EXHIBIT 23.1**

**INDEPENDENT REGISTERED PUBLIC ACCOUNTANTS'S CONSENT**

**The Board of Directors:**

We hereby consent to the incorporation by reference in the Registration Statements filed on Form S-8 and Form S-3 of our report dated March 17, 2006, relating to the financial statements of ENGlobal Corporation appearing in the Form 10-K for the year ended December 31, 2005.

*Hein & Associates LLP*

HEIN & ASSOCIATES LLP

Houston, Texas  
March 30, 2006

## EXHIBIT 31.1

### Certification by the Chief Executive Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002

I Michael L. Burrow, certify that:

1. I have reviewed this report on Form 10-K of ENGlobal Corporation;
2. Based on my knowledge, this report does not contain any untrue statements of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) for the registrant and have:
  - a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
  - b) [Reserved];
  - c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
  - d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
  - a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
  - b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: March 30, 2006

/s/ Michael L. Burrow  
Michael L. Burrow  
Chief Executive Officer

## EXHIBIT 31.2

### **Certification by the Chief Financial Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002**

I Robert W. Raiford, certify that:

1. I have reviewed this report on Form 10-K of ENGlobal Corporation;
2. Based on my knowledge, this report does not contain any untrue statements of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) for the registrant and have:
  - a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
  - b) [Reserved];
  - c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
  - d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
  - a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
  - b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: March 30, 2006

/s/ Robert W. Raiford  
Robert W. Raiford  
Chief Financial Officer

**EXHIBIT 32.1**

**Certification by the Chief Executive Officer Pursuant to 18 U. S. C. Section 1350,  
as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002**

Pursuant to 18 U. S. C. Section 1350, I, Michael L. Burrow, hereby certify that, to the best of my knowledge, the Annual Report on Form 10-K of ENGlobal Corporation for the fiscal year ended December 31, 2005 (the "Report") fully complies with the requirements of Section 13(a) or Section 15(d) of the Securities Exchange Act of 1934, and that the information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of ENGlobal Corporation.

Date: March 30, 2006

/s/ Michael L. Burrow  
Michael L. Burrow  
Chief Executive Officer

This certification accompanies this Report on Form 10-K pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 and shall not, except to the extent required by such Act, be deemed filed by the Company for purposes of Section 18 of the Securities Exchange Act of 1934, as amended (the "Exchange Act"). Such certification will not be deemed to be incorporated by reference into any filing under the Securities Act of 1933, as amended, or the Exchange Act, except to the extent that the Company specifically incorporates it by reference.

**EXHIBIT 32.2**

**Certification by the Chief Executive Officer Pursuant to 18 U. S. C. Section 1350,  
as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002**

Pursuant to 18 U. S. C. Section 1350, I, Robert W. Raiford, hereby certify that, to the best of my knowledge, the Annual Report on Form 10-K of ENGlobal Corporation for the fiscal year ended December 31, 2005 (the "Report") fully complies with the requirements of Section 13(a) or Section 15(d) of the Securities Exchange Act of 1934, and that the information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of ENGlobal Corporation.

Date: March 30, 2006

/s/ Robert W. Raiford  
Robert W. Raiford  
Chief Financial Officer

This certification accompanies this Report on Form 10-K pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 and shall not, except to the extent required by such Act, be deemed filed by the Company for purposes of Section 18 of the Securities Exchange Act of 1934, as amended (the "Exchange Act"). Such certification will not be deemed to be incorporated by reference into any filing under the Securities Act of 1933, as amended, or the Exchange Act, except to the extent that the Company specifically incorporates it by reference.



**Board of Directors**

**William A. Coskey, P.E.**  
Chairman of the Board  
*ENGlobal Corporation*

**Michael L. Burrow, P.E.**  
President and Chief Executive Officer  
*ENGlobal Corporation*

**David W. Gent, P.E.**  
Senior Vice President  
*Bray International, Inc.*

**Randall B. Hale**  
Chairman of the Board  
*ConGlobal Industries, Inc.*

**David C. Roussel**  
Vice President  
*Randall & Dewey, Inc., a division of  
Jefferies & Company, Inc.*

**Securities Listing**

The common stock of ENGlobal Corporation is listed on the American Stock Exchange under the trading symbol ENG.

**Stock Transfer Agent**

Computershare Investor Services LLC  
Chicago, Illinois  
+312-588-4652—ENG stockholders dedicated line

**Investor Information**

ENGlobal Corporation  
Investor Relations Department  
654 North Sam Houston Parkway East  
Suite 400  
Houston, Texas 77060-5914  
+281-878-1043 IR Hotline  
ir@englobal.com  
www.englobal.com

**Officers**

**William A. Coskey, P.E.**  
Chairman of the Board

**Michael L. Burrow, P.E.**  
President and Chief Executive Officer

**Robert W. Raiford**  
Chief Financial Officer and Treasurer

**Michael M. Patton, P.E.**  
Senior Vice President—Business Development

**Natalie S. Hairston**  
Investor Relations Officer,  
Chief Governance Officer and Corporate Secretary

**Independent Accountants**

Hein & Associates LLP  
Houston, Texas

**Corporate Counsel**

Jenkins & Gilchrist, P.C.  
Austin, Texas

**Principal Corporate Office**

ENGlobal Corporation  
654 North Sam Houston Parkway East  
Suite 400  
Houston, Texas 77060-5914  
+281-878-1000  
+281-878-1011 Fax

Large Cover photo: Lloyd Hullinger and Dale Harris perform instrumentation test at the National Cooperative Refinery Association (NCRA) facility in McPherson, Kansas.

## SAFE HARBOR STATEMENT

The statements in this annual report that relate to the future are forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities and Exchange Act of 1934 and involve risks and uncertainties, and are based on assumptions that the Company believes are in good faith are reasonable but which may be materially different from actual results. Readers are encouraged to refer to the risk disclosures in the Company's reports on Form 10-K, 10-Q, and 8-K, as applicable.





**ENGlobal Corporation**

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