

SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D.C. 20549

FORM 10-Q

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d)  
OF THE SECURITIES EXCHANGE ACT OF 1934  
**For the quarterly period ended September 25, 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 number: 1-6081

**COMFORCE Corporation**  
(Exact name of registrant as specified in its charter)

Delaware  
(State or other jurisdiction of  
incorporation or organization)

36-2262248  
(IRS Employer Identification No.)

415 Crossways Park Drive, P.O. Box 9006, Woodbury, New York 11797  
(Address of principal executive offices) (Zip Code)

Registrant's telephone number, including area code: (516) 437-3300

Not Applicable  
Former name, former address and former fiscal year, if changed since last report

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

Yes  No

Indicate by check mark whether the registrant is an accelerated filer(as defined in Rule 12b-2 of the Exchange Act).

Yes No

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

Yes No

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

Class  
Common stock, \$.01 par value

Outstanding at November 1, 2005  
17,009,526 shares

# COMFORCE Corporation

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## PART I - FINANCIAL INFORMATION

### ITEM 1. FINANCIAL STATEMENTS

#### COMFORCE CORPORATION AND SUBSIDIARIES CONDENSED CONSOLIDATED BALANCE SHEETS (in thousands, except share and per share amounts)

	September 25, 2005 (unaudited)	December 26, 2004
<b>Assets</b>		
Current assets:		
Cash and cash equivalents	\$ 4,949	\$ 15,233
Accounts receivable, net	94,486	70,322
Funding and service fees receivable, net	15,529	21,822
Prepaid expenses and other current assets	4,009	3,488
Deferred income taxes, net	2,404	2,404
Total current assets	121,377	113,269
Deferred income taxes, net	1,281	1,281
Property and equipment, net	5,478	6,293
Intangible assets, net	50	81
Goodwill, net	32,073	32,073
Deferred financing costs, net	1,017	1,464
Other assets	168	188
Total assets	\$ 161,444	\$ 154,649
<b>Liabilities and Stockholders' Deficit</b>		
Current liabilities:		
Accounts payable	\$ 2,722	\$ 4,325
Accrued expenses	71,741	62,926
Total current liabilities	74,463	67,251
Long-term debt (including related party debt)	110,958	117,227
Other liabilities	--	6
Total liabilities	185,421	184,484
Commitments and contingencies		
Stockholders' deficit:		
Common stock, \$.01 par value; 100,000,000 shares authorized; 17,009,522 and 16,689,496 shares issued and outstanding at September 25, 2005 and December 26, 2004, respectively	170	167
Convertible preferred stock, \$.01 par value:		
Series 2003A, 6,500 shares authorized; 6,148 shares issued and outstanding at September 25, 2005 and December 26, 2004, with an aggregate liquidation preference of \$7,351 at September 25, 2005	4,304	4,304
Series 2003B, 3,500 shares authorized; 513 shares issued and outstanding at September 25, 2005 and December 26, 2004, with an aggregate liquidation preference of \$590 at September 25, 2005	513	513
Series 2004A, 15,000 shares authorized; 6,737 shares issued and outstanding at September 25, 2005 and December 26, 2004, with an aggregate liquidation preference of \$7,147 at September 25, 2005	10,264	10,264
Additional paid-in capital	47,703	47,193
Accumulated other comprehensive income	126	153
Accumulated deficit	(87,057)	(92,429)
Total stockholders' deficit	(23,977)	(29,835)
Total liabilities and stockholders' deficit	\$ 161,444	\$ 154,649

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

COMFORCE CORPORATION AND SUBSIDIARIES  
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS  
(in thousands except per share amounts)  
(unaudited)

	Three Months Ended		Nine months Ended	
	September 25, 2005	September 26, 2004	September 25, 2005	September 26, 2004
Net sales of services	\$ 139,066	\$ 123,392	\$ 397,669	\$ 348,391
Costs and expenses:				
Cost of services	118,438	105,854	340,357	296,718
Selling, general and administrative expenses	15,452	13,179	44,260	39,390
Depreciation and amortization	948	1,002	2,672	3,028
Total costs and expenses	<u>134,838</u>	<u>120,035</u>	<u>387,289</u>	<u>339,136</u>
Operating income	<u>4,228</u>	<u>3,357</u>	<u>10,380</u>	<u>9,255</u>
Other income (expense):				
Interest expense	(2,783)	(2,983)	(8,346)	(9,153)
(Loss) gain on debt extinguishment	(37)	8	(290)	1,979
Other income, net	160	104	153	47
	<u>(2,660)</u>	<u>(2,871)</u>	<u>(8,483)</u>	<u>(7,127)</u>
Income from continuing operations before income taxes	1,568	486	1,897	2,128
(Benefit) provision for income taxes	<u>(3,545)</u>	<u>354</u>	<u>(3,374)</u>	<u>1,127</u>
Income from continuing operations	<u>5,113</u>	<u>132</u>	<u>5,271</u>	<u>1,001</u>
Income (loss) from discontinued operations, net of tax benefit of \$16 in 2004	--	--	101	(17)
Net income	<u>\$ 5,113</u>	<u>\$ 132</u>	<u>\$ 5,372</u>	<u>\$ 984</u>
Dividends on preferred stock	<u>254</u>	<u>125</u>	<u>754</u>	<u>375</u>
Net income available to common stockholders	<u>\$ 4,859</u>	<u>\$ 7</u>	<u>\$ 4,618</u>	<u>\$ 609</u>
Basic income (loss) per common share:				
Income from continuing operations	\$ 0.29	\$ 0.00	\$ 0.27	\$ 0.04
Income (loss) from discontinued operations	--	--	0.00	(0.00)
Net income	<u>\$ 0.29</u>	<u>\$ 0.00</u>	<u>\$ 0.27</u>	<u>\$ 0.04</u>
Diluted income (loss) per common share:				
Income from continuing operations	\$ 0.17	\$ 0.00	\$ 0.18	\$ 0.04
Income (loss) from discontinued operations	--	--	0.00	(0.00)
Net income	<u>\$ 0.17</u>	<u>\$ 0.00</u>	<u>\$ 0.18</u>	<u>\$ 0.04</u>
Weighted average common shares outstanding, basic	<u>16,917</u>	<u>16,684</u>	<u>16,862</u>	<u>16,671</u>
Weighted average common shares outstanding, diluted	<u>30,130</u>	<u>17,294</u>	<u>29,766</u>	<u>18,077</u>

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

COMFORCE CORPORATION AND SUBSIDIARIES  
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS  
(in thousands)  
(unaudited)

	Nine months ended	
	September 25, 2005	September 26, 2004
Cash flows from operating activities:		
Net income	\$ 5,372	\$ 984
(Income) loss from discontinued operations	(101)	17
	\$ 5,271	\$ 1,001
Adjustments to reconcile net income to net cash (used in) provided by operating activities:		
Depreciation and amortization of property and equipment	2,641	2,988
Amortization of intangible assets	31	40
Amortization of deferred financing fees	399	426
Net recoveries of bad debts	(182)	--
Interest expense paid through issuance of convertible notes	52	297
Loss (gain) on repurchase of Senior Notes	290	(1,979)
Equity-based consulting expense	30	--
Tax benefit from stock option exercises	211	--
Changes in assets and liabilities, net of effects of dispositions of businesses:		
Accounts, funding and service fees receivable	(17,716)	(16,439)
Prepaid expenses and other current assets	(796)	(820)
Accounts payable and accrued expenses	7,309	15,695
Income tax receivable	171	44
Net cash (used in) provided by continuing operations	(2,289)	1,253
Net cash used in discontinued operations	--	(421)
Net cash (used in) provided by operating activities	(2,289)	832
Cash flows from investing activities:		
Purchases of property and equipment	(1,826)	(1,162)
Proceeds from sale of niche telecom operations, net of cash transferred	225	2,420
Net cash (used in) provided by investing activities	(1,601)	1,258
Cash flows from financing activities:		
Net borrowings under line of credit agreements	5,279	8,860
Repurchase of Senior Notes	(11,767)	(12,559)
Debt financing costs	(68)	(24)
Proceeds from exercise of stock options	265	38
Net repayments under capital lease obligations	(103)	(223)
Net cash used in financing activities	(6,394)	(3,908)
Net decrease in cash and cash equivalents	(10,284)	(1,818)
Cash and cash equivalents at beginning of period	15,233	7,598
Cash and cash equivalents at end of period	\$ 4,949	\$ 5,780
Supplemental disclosures:		
Cash paid for:		
Interest	\$ 5,854	\$ 5,353
Income taxes	892	846

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

COMFORCE CORPORATION AND SUBSIDIARIES  
NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

**1. GENERAL**

COMFORCE Corporation (“COMFORCE” or the “Company”) is a provider of specialty staffing, consulting and outsourcing services primarily to Fortune 1000 companies and other large employers for their healthcare support, technical and engineering, information technology, telecommunications and other staffing services. The Company’s outsourced enterprise staffing management services enable its customers to consolidate, automate and manage staffing, compliance and oversight processes for their contingent workforce, including independent contractors, temporary workers, consultants, freelancers and, in some cases, returning retirees. The Company also offers services for the selection, procurement, management and tracking of the contingent workforce.

The accompanying unaudited interim condensed consolidated financial statements of COMFORCE and its subsidiaries, including COMFORCE Operating, Inc. (“COI”) (collectively, the “Company”) have been prepared pursuant to the rules and regulations of the Securities and Exchange Commission. Certain information and note disclosures normally included in annual financial statements have been condensed or omitted pursuant to those rules and regulations. In the opinion of management, all adjustments, consisting of normal recurring adjustments considered necessary for a fair presentation, have been included. Although management believes that the disclosures made are adequate to ensure that the information presented is not misleading, these financial statements should be read in conjunction with the consolidated financial statements and notes thereto included in the Company’s Annual Report on Form 10-K for the fiscal year ended December 26, 2004. The results for the three and nine month periods ended September 25, 2005 are not necessarily indicative of the results of operations for the entire year.

**2. ESTIMATES**

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Some of the significant estimates involved are the collectibility of receivables, the fair value of goodwill, the recoverability of long-lived assets and deferred tax assets, accrued workers compensation liabilities and the assessment of litigation and contingencies. Actual results could differ from those estimates.

**3. STOCK COMPENSATION PLANS**

The Company applies APB Opinion 25 and related interpretations in accounting for stock options; accordingly, no compensation cost has been recognized in the statements of operations for any options granted to employees, officers or directors since the exercise price of options was equal to or greater than the market value of the common stock on the date of grant. Had compensation cost been determined based upon the fair value of the stock options at grant date, consistent with the method in Statement No. 123, *Accounting for Stock-Based Compensation* (“SFAS 123”), the Company’s net income and net income per share would have been the pro forma amounts indicated below (in thousands):

	Three Months Ended		Nine months Ended	
	September 25, 2005	September 26, 2004	September 25, 2005	September 26, 2004
Net income available to common stockholders, as reported	\$ 4,859	\$ 7	\$ 4,618	\$ 609
Deduct: Total stock-based employee compensation expense determined under the fair value based method, net of related tax effects	--	7	502	21
Pro forma net income	<u>\$ 4,859</u>	<u>\$ --</u>	<u>\$ 4,116</u>	<u>\$ 588</u>
Income per share:				
Basic - as reported	\$ 0.29	\$ 0.00	\$ 0.27	\$ 0.04
Basic - pro forma	\$ 0.29	\$ 0.00	\$ 0.24	\$ 0.04
Diluted - as reported	\$ 0.17	\$ 0.00	\$ 0.18	\$ 0.04
Diluted - pro forma	\$ 0.17	\$ 0.00	\$ 0.17	\$ 0.03

#### 4. DEBT

Long-term debt at September 25, 2005 and December 26, 2004 consisted of (in thousands):

	September 25, 2005	December 26, 2004
12% Senior Notes, due December 1, 2007	\$ 52,810	\$ 64,410
8% Subordinated Convertible Note, due 2009	1,351	1,299
Revolving line of credit, due June 24, 2007, with interest payable at prime plus 0.5% and/or LIBOR plus 2.0% with a weighted average rate of 5.88% at September 25, 2005 and 4.93% at December 26, 2004	56,797	51,518
Total long-term debt	<u>\$ 110,958</u>	<u>\$ 117,227</u>

Required principal payments of long-term debt are as follows (in thousands):

2007	\$ 109,607
2009	1,351
Total	<u>\$ 110,958</u>

*PNC Credit Facility:* COMFORCE, COI and various of their operating subsidiaries, as co-borrowers and guarantors, entered into an \$85.0 million Revolving Credit and Security Agreement (the "PNC Credit Facility") with PNC Bank, National Association, as a lender and administrative agent ("PNC") and other financial institutions participating as lenders to provide for a revolving line of credit with available borrowings based, generally, on 85.0% of the Company's accounts receivable aged 90 days or less, subject to specified limitations and exceptions. The Company entered into the PNC Credit Facility in June 2003 and it has been subject to various amendments. At September 25, 2005, the Company had remaining availability, as defined in the agreement, under the PNC Credit Facility of \$20.3 million.

On May 13, 2005, the PNC Credit Facility was amended to lower the interest rates calculated in reference to LIBOR. As amended, borrowings under the PNC Credit Facility bear interest, at the Company's option, at a per annum rate equal to either (1) the greater of the federal funds rate plus 0.5% or the base commercial lending rate of PNC as announced from time to time, or (2) LIBOR plus a specified margin, determined as follows:

<u>Fixed charge coverage ratio*</u>	<u>Margin (%)</u>
greater than 1.50:1.00	1.75
greater than 1.30:1.00 to 1.50:1.00	2.00
greater than 1.05:1.00 to 1.30:1.00	2.25
equal to or less than 1.05:1.00	2.50

\*as defined in the PNC Credit Facility

The PNC Credit Facility also provides for a commitment fee of 0.375% of the unused portion of the facility. The obligations under the PNC Credit Facility are collateralized by a pledge of the capital stock of certain key operating subsidiaries of the Company and by security interests in substantially all of the assets of the Company. The May 13, 2005 amendment also reduced the lenders' audits of the Company's collateral at the Company's expense from three to two per calendar year, subject to specified exceptions. The PNC Credit Facility contains various financial and other covenants and conditions, including, but not limited to, a prohibition on paying cash dividends and limitations on engaging in affiliate transactions, making acquisitions and incurring additional indebtedness. The maturity date of the PNC Credit Facility is June 24, 2007. The Company was in compliance with all financial covenants under the PNC Credit Facility at September 25, 2005.

The PNC Credit Facility was previously amended in September 2004 to increase the Company's flexibility to draw funds to repurchase its 12% Senior Notes due December 1, 2007 (the "Senior Notes"). As amended, the Company is permitted to repurchase or prepay Senior Notes so long as the remaining availability under the PNC Credit Facility, as defined in the agreement, is at least \$7.5 million for the specified measurement period. In addition, the annual \$15.0 million limit on repurchases of Senior Notes was modified to permit the carryover from any prior calendar year of any unused portion of this amount, so long as the other criteria for borrowing are then satisfied.

As of September 25, 2005, the Company had outstanding \$5.4 million of standby letters of credit under the PNC Credit Facility.

*Senior Notes:* The indenture governing the Senior Notes contains a number of significant restrictions and covenants that require the Company to ensure among other things that:

- the Company does not grant a security interest in its assets or incur indebtedness, except indebtedness incurred in accordance with the indenture, which permits indebtedness subordinated to and due later than the Senior Notes and that meets other conditions in the indenture, indebtedness on a parity with the Senior Notes meeting specified conditions in the indenture, renewals or replacements of any bank credit facility, capital lease obligations, securitization transactions, indebtedness within specified dollar limitations and other exceptions;
- the Company does not sell or dispose of its assets except in accordance with the covenants and conditions in the indenture, or issue shares of its capital stock except in accordance with the covenants and conditions in the indenture;
- the net proceeds from any permitted sale of the Company's capital stock or its assets are applied to repay any bank credit facility, or, if not required by the lender or such net proceeds are not reinvested in other assets, to redeem Senior Notes or applied for other specified proper purposes;
- the Company does not enter into transactions with affiliates other than in accordance with the indenture; and
- the Company does not invest in other businesses or engage in other business activities unless permitted under the indenture.

In February, March and September 2004, the Company repurchased an aggregate of \$14.8 million principal amount of its Senior Notes for \$12.6 million in transactions with unrelated parties. As a result of these repurchases during the first and third quarters of 2004, the Company recognized an aggregate gain on debt extinguishment of \$2.0 million in the first nine months of 2004, including a reduction of \$237,000 of deferred financing costs.

In April, May and September 2005, the Company repurchased an aggregate of \$11.6 million principal amount of its Senior Notes for \$11.8 million, utilizing available funds under the PNC Credit Facility. The Senior Notes were purchased from unrelated parties. As a result of these repurchases, the Company recognized an aggregate loss on debt extinguishment of \$290,000 in the first nine months of 2005, including a reduction of \$123,000 of deferred financing costs.

In October 2005, the Company repurchased \$1.0 million principal amount of its Senior Notes for \$1.0 million, utilizing available funds under the PNC Credit Facility. The Senior Notes were purchased from unrelated parties. As a result, the Company expects to recognize a loss on debt extinguishment related to this repurchase in the fourth quarter of 2005.

*Convertible Note:* The Company's 8.0% Subordinated Convertible Note due December 2, 2009 (the "Convertible Note") is convertible into common stock at \$1.70 per share.

On December 8, 2004, the Company issued 6,737 shares of its Series 2004A Convertible Preferred Stock in exchange for \$6,726,385 of its Convertible Note, plus accrued interest of \$10,463, in a transaction with the Fanning CPD Assets, LP (the "Fanning Partnership"). This exchange eliminated \$6.7 million of long-term debt while maintaining, under the terms of the 2004A Series Preferred Stock, the same common stock conversion rights as existed for the Convertible Note. As part of the transaction, the Convertible Note was restated at the principal amount of \$1,299,402, and the terms were modified to permit the Company to pay interest in cash or kind, at its election, for the balance of the term of the Convertible Note. Under the terms of the Convertible Note prior to this amendment, interest was to be payable only in cash beginning with the interest payment due on June 1, 2005. The debt service costs associated with the Convertible Notes have been satisfied through additions to principal through June 1, 2005 (the most recent semi-annual interest payment date). During 2004 and the nine months ended September 25, 2005, \$605,000 and \$52,000, respectively, of the Convertible Notes were issued at a conversion rate of \$1.70 per share of common stock for payment of interest, which resulted in a beneficial conversion feature of \$180,000 and \$6,000, respectively, that increased deferred financing costs and paid-in capital. The Convertible Note may be prepaid in whole or in part, provided that the market value of the Company's common stock exceeds \$2.13 for a specified period of time and, for any prepayment prior to December 1, 2005, a prepayment premium must be paid of 2%, which decreases to 1% on December 1, 2005 and is eliminated for any period after November 30, 2006. Upon notice of prepayment, the holder has 10 days to convert the Convertible Notes.

The Fanning Partnership is a limited partnership in which John C. Fanning, the Company's chairman and chief executive officer, holds the principal economic interest. Rosemary Maniscalco, a director of the Company, is the general partner of the Fanning Partnership, but has no pecuniary interest therein. The Company obtained the opinion of an independent investment banking firm that the terms of the exchange transaction with the Fanning Partnership were fair to the Company from a financial point of view, and the Company's independent directors approved the terms of the transaction.

## **5. INCOME PER SHARE**

Basic income per common share is computed by dividing net income available to common stockholders by the weighted average number of shares of common stock outstanding during each period. Diluted income per share is computed assuming the conversion of stock options and warrants with exercise prices less than the average market value of the Company's common stock during the period, and the conversion of convertible debt and preferred stock into common stock to the extent such conversion assumption is dilutive. The following represents a reconciliation of the numerators and denominators for basic and diluted income per share computations (in thousands):

	Three Months Ended		Nine Months Ended	
	September 25, 2005	September 26, 2004	September 25, 2005	September 26, 2004
Basic income per common share:				
Income from continuing operations	\$ 5,113	\$ 132	\$ 5,271	\$ 1,001
Dividends on preferred stock:				
Series 2003A	115	115	346	346
Series 2003B	10	10	29	29
Series 2004A	129	--	379	--
	<u>254</u>	<u>125</u>	<u>754</u>	<u>375</u>
Income available to common stockholders from continuing operations	\$ 4,859	\$ 7	\$ 4,517	\$ 626
Weighted average common shares outstanding	16,917	16,684	16,862	16,671
Basic income per common share from continuing operations	\$ 0.29	\$ 0.00	\$ 0.27	\$ 0.04
Diluted income per common share:				
Income available to common stockholders from continuing operations	\$ 4,859	\$ 7	\$ 4,517	\$ 626
Dividends on preferred stock :				
Series 2003A	115	--	346	--
Series 2003B	10	--	29	29
Series 2004A	129	--	379	--
	<u>254</u>	<u>--</u>	<u>754</u>	<u>29</u>
After tax equivalent of interest expense on 8% convertible notes	16	--	48	--
Income for purposes of computing diluted income per share from continuing operations	\$ 5,129	\$ 7	\$ 5,319	\$ 655
Weighted average common shares outstanding	16,917	16,684	16,862	16,671
Dilutive stock options	317	610	443	438
Assumed conversion of 8% subordinated convertible notes	800	--	769	--
Assumed conversion of Preferred Stock:				
Series 2003A	6,891	--	6,672	--
Series 2003B	1,075	--	1,039	968
Series 2004A	4,130	--	3,981	--
Weighted average common shares outstanding for purposes of computing diluted income per share	<u>30,130</u>	<u>17,294</u>	<u>29,766</u>	<u>18,077</u>

Diluted income per common share from continuing operations	<u>\$ 0.17</u>	<u>\$ 0.00</u>	<u>\$ 0.18</u>	<u>\$ 0.04</u>
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The following shares of common stock were excluded from the above calculations as their effect would have been anti-dilutive:

As of September 26, 2004, 4.7 million shares of common stock issuable upon conversion of Convertible Notes, including accrued interest, and 6.6 million shares issuable upon conversion of the Series 2003A Preferred Stock, including accrued, unpaid, undeclared dividends, were excluded from the computation of diluted income per share because their effect would be anti-dilutive.

Options and warrants to purchase 3.3 million and 2.0 million shares of common stock were outstanding as of September 25, 2005 and September 26, 2004, respectively, but were not included in the computation of diluted income per share because their effect would be anti-dilutive.

## 6. INDUSTRY SEGMENT INFORMATION

COMFORCE has determined that its reportable segments can be distinguished principally by the types of services offered to the Company's clients. The Company reports its results through three operating segments -- Human Capital Management Services, Staff Augmentation and Financial Outsourcing Services. The Human Capital Management Services segment primarily provides contingent workforce management services. The Staff Augmentation segment provides healthcare support, technical and engineering, information technology (IT), telecommunications and other staffing services. The Financial Outsourcing Services segment provides funding and back office support services to independent consulting and staffing companies.

The accounting policies of the segments are described in the "Summary of Significant Accounting Policies" in note 2 to the Company's consolidated financial statements for the fiscal year ended December 26, 2004. COMFORCE evaluates the performance of its segments and allocates resources to them based on operating contribution, which represents segment revenues less direct costs of operations, excluding the allocation of corporate general and administrative expenses. Assets of the operating segments reflect primarily net accounts receivable and goodwill associated with segment activities; all other assets are included as corporate assets. The Company does not evaluate or account for expenditures for long-lived assets on a segment basis.

The table below presents information on the revenues and operating contribution for each segment for the three and nine months ended September 25, 2005 and September 26, 2004, and items which reconcile segment operating contribution to COMFORCE's reported income from continuing operations before income taxes (in thousands):

	Three Months Ended		Nine Months Ended	
	September 25, 2005	September 26, 2004	September 25, 2005	September 26, 2004
Net sales of services:				
Human Capital Management				
Services	\$ 79,430	\$ 70,097	\$ 228,756	\$ 193,429
Staff Augmentation	58,585	51,678	165,547	149,343
Financial Outsourcing Services	1,051	1,617	3,366	5,619
	<u>\$ 139,066</u>	<u>\$ 123,392</u>	<u>\$ 397,669</u>	<u>\$ 348,391</u>
Operating contribution:				
Human Capital Management				
Services	\$ 2,782	\$ 2,336	\$ 8,359	\$ 7,526
Staff Augmentation	5,512	4,365	14,283	11,923
Financial Outsourcing Services	754	1,393	2,643	4,395
	<u>9,048</u>	<u>8,094</u>	<u>25,285</u>	<u>23,844</u>
Consolidated expenses:				
Corporate general and				
administrative expenses	3,872	3,735	12,233	11,561
Depreciation and amortization	948	1,002	2,672	3,028
Interest and other, net	2,623	2,879	8,193	9,106
Loss (gain) on debt				
extinguishment	37	(8)	290	(1,979)
	<u>7,480</u>	<u>7,608</u>	<u>23,388</u>	<u>21,716</u>
Income from continuing				
operations before income taxes	<u>\$ 1,568</u>	<u>\$ 486</u>	<u>\$ 1,897</u>	<u>\$ 2,128</u>
	September 25, 2005	December 26, 2004		
Total assets:				
Staff Augmentation	\$ 63,001	\$ 59,399		
Human Capital Management				
Services	63,558	42,996		
Financial Outsourcing Services	15,529	21,822		
Corporate	19,356	30,432		
	<u>\$ 161,444</u>	<u>\$ 154,649</u>		

## 7. NEW ACCOUNTING STANDARDS

In December 2004, the Financial Accounting Standards Board (the "FASB") issued SFAS No. 123(R), *Share Based Payment ("SFAS 123(R))*. This statement replaces SFAS No. 123, *Accounting for Stock Based Compensation* and supercedes APB No. 25, *Accounting for Stock Issued to Employees*. SFAS 123(R) requires all stock based compensation to be recognized as an expense in the financial statements and that such cost be measured according to the grant date fair value of the stock options or other equity instruments. SFAS 123(R) will be effective for annual periods beginning after June 15, 2005. While the Company currently provides the pro forma disclosures required by SFAS No. 148, *Accounting for Stock Based Compensation - Transition and Disclosure*, on a quarterly basis it is currently evaluating the impact this statement will have on its consolidated financial statements.

In June 2005, the FASB issued SFAS No. 154, *Accounting Changes and Error Corrections, a replacement of APB Opinion No. 20, Accounting Changes, and Statement No. 3, Reporting Accounting Changes in Interim Financial Statements ("SFAS 154")*. SFAS 154 changes the requirements for the accounting for, and reporting of, a change in accounting principle. Previously, most voluntary changes in accounting principles were required to be recognized by way of a cumulative effect adjustment within net income during the period of the change. SFAS 154 requires retrospective application to prior periods' financial statements, unless it is impracticable to determine either the period-specific effects or the cumulative effect of the change. SFAS 154 is effective for accounting changes

made in fiscal years beginning after December 15, 2005; however, the Statement does not change the transition provisions of any existing accounting pronouncements. The Company does not believe that the adoption of SFAS 154 will have a material effect on its consolidated financial position, results of operations or cash flows.

## 8. RECLASSIFICATIONS

Certain reclassifications have been made to conform prior period amounts to the current period presentation.

## 9. COMPREHENSIVE INCOME

The components of comprehensive income are as follows (in thousands):

	Three months ended		Nine months ended	
	September 25, 2005	September 26, 2004	September 25, 2005	September 26, 2004
Net income	\$ 5,113	\$ 132	\$ 5,372	\$ 984
Foreign currency translation adjustment	(29)	53	(27)	27
Total comprehensive income	\$ 5,084	\$ 185	\$ 5,345	\$ 1,011

## 10. LITIGATION AND CONTINGENCIES

As previously reported by the Company's periodic reports, one of the Company's significant Staff Augmentation customers (with revenues from the contract with this customer representing approximately 6% of consolidated revenues for fiscal 2004 and approximately 3.3% of revenues for the first nine months of fiscal 2005) is evaluating whether the use of contingent labor is consistent with its business model. This customer subsequently advised the Company that it would significantly reduce its utilization of contract labor, including the Company's employees, beginning in the fourth quarter of 2004 and continuing through the end of the first quarter 2005. However, the proposed reductions have not been fully implemented as of the end of the third fiscal quarter of 2005, and management of the Company does not currently believe that any further significant reductions in staffing under this arrangement will be made at least through the first quarter of 2006.

In addition, in accordance with the terms of the contract, this customer is auditing the payments made under the contract with the Company for 2003. Management does not believe any adjustment to the Company's fees under this contract is warranted.

The Company is currently undergoing audits for certain state and local tax returns. The results of these audits are not estimable at this time.

In July 2005, the Company's subsidiary, COMFORCE Technical Services, Inc. ("CTS") was served with an amended complaint in the suit titled *Reyes V. East Bay Municipal Utility District, et al*, filed in the Superior Court of California, Alameda County, in connection with a gasoline pipeline explosion in November 2004 that killed five workers and injured four others. As stated in the complaint, as part of a construction project to lay a water transmission line, a backhoe operator employed by a construction contractor (unaffiliated with CTS) struck and breached a gasoline pipeline, resulting in the explosion. The complaint names various persons involved in the construction project as defendants, including CTS. The complaint alleges, among other things, that CTS was negligent in failing to properly mark the location of the pipeline. The complaint does not specify monetary damages.

CTS was subsequently named as defendant in four other lawsuits concerning this accident in the Superior Court of California: *Knox v. Mountain Cascade et al*, *Farley v. Mountain Cascade et al*, *Arias v. Kinder Morgan et*

*al, and Angeles v. Kinder Morgan, et al.* These actions have since been consolidated with the *Reyes* case in a single coordinated action styled as the *Gas Pipeline Explosion Cases* in the Superior Court of California, Contra Costa County.

CTS denies any responsibility for this accident. CTS has requested that its insurance carriers defend it in these actions. Management of CTS (and the Company) cannot estimate the amount of damages, if any, to which CTS may be liable. Following an investigation of the accident, Cal-OSHA issued citations to four of the contractors on the project, but declined to issue any citations against CTS.

The Company is a party to routine contract and employment-related litigation matters arising in the ordinary course of its business. Except as described above, there are no other pending matters, individually or in the aggregate, if adversely determined, which are believed by management to be material to the business or financial condition of the Company. The Company maintains general liability insurance, property insurance, automobile insurance, fidelity insurance, errors and omissions insurance, professional and medical malpractice insurance, fiduciary insurance and directors' and officers' liability insurance. The Company is generally self-insured with respect to workers compensation, but maintains excess workers compensation coverage to limit its maximum exposure to such claims.

The terms of certain customer service agreements provide that the Company will indemnify its customers regarding various employment matters, including Fair Labor Standards Act and co-employment liabilities. Such indemnification provisions are accounted for in accordance with FASB issued Statement No. 5, *Accounting for Contingencies*. For the three and nine months ended September 25, 2005, there have not been any significant claims under such indemnification provisions.

## **11. SALE OF NICHE TELECOM OPERATIONS**

Effective as of March 1, 2004, COMFORCE sold an 80% interest in two telecom subsidiaries in the Staff Augmentation segment and sold its remaining 20% minority interest in these companies by June 29, 2004. These subsidiaries operated in the customer premise equipment services niche of the telecom sector, a niche that was outside of the Company's core competency in telecom. The buyer, Spears Holding Company, Inc. ("Spears"), is controlled by an individual who was one of the principals of these companies when they were sold to COMFORCE in 1998. Revenues for the subsidiaries that were sold represented less than 3.5% of the Company's consolidated revenues in fiscal 2003. All cash proceeds received by the Company to date from this sale have been used to pay down bank debt. The total consideration was a combination of cash, short-term promissory notes and long-term promissory notes, as follows:

- In respect of the 80% interest, \$500,000 was received in cash at closing with \$1,150,000 evidenced by the buyer's short-term promissory notes providing for the payment of \$950,000 by March 31, 2004 and \$200,000 by April 30, 2004, which amounts were paid timely. The balance of the purchase price for the 80% interest is payable under the terms of the buyer's long-term promissory note due on March 1, 2009 in the principal amount of \$2,960,000, which provided for monthly payments of interest only in the first year, with principal and interest payable monthly in arrears thereafter, with interest computed at the prime rate plus 1.25% and principal amortizing on a seven-year schedule with a balloon payment of the remaining principal due at maturity.
- The Company sold an additional 8% interest on May 30, 2004 for \$304,000 in cash and an additional long-term promissory note due March 1, 2009 in the principal amount of \$296,000 under the same terms of the long-term promissory note received in exchange for the 80% interest above.
- The Company sold the remaining 12% interest on June 29, 2004 in exchange for \$644,000 in cash as well as an additional buyer's long-term promissory note due March 1, 2009 in the principal amount of \$444,000 under the same terms of the long-term note received in exchange for the 80% interest above.

These long-term notes in the total principal amount of \$3.7 million (\$3.6 million as of July 1, 2005), were valued at \$1.4 million by an independent valuation firm. The sale resulted in a gain of \$1,102,000, which represented

the excess of the net proceeds (cash and short-term notes of \$2,598,000 plus the fair value of the long-term notes of \$1,400,000, less transaction costs of \$144,000), over the net book value of the net assets of the business sold of \$2,752,000. The Company did not recognize a gain on this transaction until the cash payments it received exceeded its investment (\$2,896,000) in the business sold. The cash received under the sale agreement, including principal and interest on the notes, was recorded as a reduction of, and, during the second quarter of 2005, had eliminated the balance in net assets held for sale. The cash received in excess of net assets held for sale has been recorded as a gain from the sale of discontinued operations that resulted in income from discontinued operations for the nine months ended September 25, 2005 of \$101,000. Additional cash received by the Company in future periods, if any, will be recorded as an additional gain from the sale of discontinued operations up to the amount of the \$1,102,000 gain. If and when the entire gain has been recognized, additional cash receipts, if any, will be recorded as interest income within other income from continuing operations.

In accordance with SFAS 144, the results of operations from the sale of the Company's niche telecom operations have been recorded as discontinued operations. The net loss from discontinued operations was \$17,000 for the nine month period ended September 26, 2004.

On or about June 29, 2005 the Company received a copy of a notice to Spears from Spears' senior lender. The notice stated that defaults had occurred and were continuing under Spears' credit agreement with its senior lender. Spears subsequently failed to make the payments of principal and interest that became due and payable since July 1, 2005 under the long-term notes it issued to the Company as part of the consideration for the telecom businesses.

The long-term notes from Spears to the Company are subject to a subordination agreement between the Company, Spears and Spears' senior lender. Under that agreement, among other things, the Company cannot accept payments under the long-term notes from Spears if there is a default under the senior lender's credit agreement with Spears, subject to a 180-day standstill period after which the Company can take action to enforce its rights under these long-term notes. On July 5, 2005, the Company gave notice of the default under Spears' credit agreement with the senior lender, commencing the running of the 180-day standstill period. The Company also has the right to enforce a keep well agreement between the individual who controls Spears, and the senior lender and has brought an action to enforce that right. There can be no assurance that any of these actions will result in the cure of Spears' defaults to its senior lender or the Company, or any further payments to the Company.

## **12. SUBSEQUENT EVENTS**

As described in note 4, in October 2005, the Company repurchased an additional \$1.0 million principal amount of its Senior Notes.

## **ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**

The discussion set forth below supplements the information found in the unaudited condensed consolidated financial statements and related notes of COMFORCE Corporation ("COMFORCE") and its wholly-owned subsidiaries, including COMFORCE Operating, Inc. ("COI") (collectively, the "Company").

### **Overview and Recent Developments**

Staffing personnel placed by the Company are employees of the Company. The Company is responsible for employment related expenses for its employees, including workers compensation, unemployment compensation insurance, Medicare and Social Security taxes and general payroll expenses. The Company offers health, dental, 401(k), disability and life insurance to its eligible billable employees. Staffing and consulting companies, including the Company, typically pay their billable employees for their services before receiving payment from their customers, often resulting in significant outstanding receivables. To the extent the Company grows, these receivables will increase and there will be greater requirements for borrowing availability under its credit facility to fund current operations.

The Company reports its results through three operating segments -- Human Capital Management Services, Staff Augmentation and Financial Outsourcing Services. The Human Capital Management Services segment primarily provides consulting services for managing the contingent workforce. The Staff Augmentation segment provides healthcare support, technical and engineering, information technology (IT), telecommunications and other staffing services. The Financial Outsourcing Services segment provides funding and back office support services to independent consulting and staffing companies.

Management of the Company has observed improvement in the business environment for staffing companies beginning in the first quarter of 2003. Recent industry statistics have generally supported management's observations including, since the beginning of 2004, improvement in the rate of job creation in the United States; however management is unsure how long these trends will continue in the future.

As previously reported in its periodic reports, one of the Company's significant Staff Augmentation customers (with revenues from the contract with this customer representing approximately 6% of consolidated revenues for fiscal 2004 and approximately 3.3% of revenues for the first nine months of fiscal 2005) is evaluating whether the use of contingent labor is consistent with its business model. This customer subsequently advised the Company that it would significantly reduce its utilization of contract labor, including the Company's employees, beginning in the fourth quarter of 2004 and continuing through the end of the first quarter 2005. However, the proposed reductions have not been fully implemented as of the end of the third fiscal quarter of 2005, and management of the Company does not currently believe that any further significant reductions in staffing under this arrangement will be made at least through the first quarter of 2006.

In addition, in accordance with the terms of the contract, this customer is auditing the payments made under the contract with the Company for 2003. Management does not believe any adjustment to the Company's fees under this contract is warranted.

### **Critical Accounting Policies and Estimates**

As disclosed in the annual report on Form 10-K for the fiscal year ended December 26, 2004, the discussion and analysis of our financial condition and results of operations are based upon our consolidated financial statements, which have been prepared in conformity with accounting principles generally accepted in the United States. The preparation of these financial statements requires us to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenues and expenses reported in those financial statements. These judgments can be subjective and complex, and consequently actual results could differ from those estimates. Our most critical accounting policies relate to allowance for doubtful accounts, accrued workers compensation liability, goodwill impairment, and income taxes. Since December 26, 2004, there have been no changes in our critical accounting policies and no other significant changes to the methods used in the assumptions and estimates related to them.

### **Results of Operations**

#### ***Three Months ended September 25, 2005 compared to Three Months ended September 26, 2004***

Net sales of services for the three months ended September 25, 2005 were \$139.1 million, which represents a 12.7% increase from the \$123.4 million in net sales of services realized for the three months ended September 26, 2004. Net sales of services in the Human Capital Management Services segment increased by \$9.3 million or 13.3%, due to an increase in services provided to existing clients. Management believes such increase is reflective of a trend for companies to rely increasingly on providers of human capital management services, such as those provided by the Company's PrO Unlimited subsidiary. In the Staff Augmentation segment, the increase of \$6.9 million or 13.4% is principally attributable to services provided to information technology and telecom customers. Net sales of services were lower by \$565,000 or 35.0% in the Financial Outsourcing Services segment, principally due to a reduction in the number of customers.

Cost of services for the three months ended September 25, 2005 was 85.2% of net sales of services as compared to cost of services of 85.8% of net sales of services for the three months ended September 26, 2004. The

cost of services as a percentage of net sales for the third quarter of fiscal 2005 decreased slightly from the third quarter of fiscal 2004 principally as a result of favorable workers compensation claims experience, partially offset by the higher growth in Human Capital Management Services which have a higher cost of services as a percentage of net sales of services and a reduction in the number of clients serviced under the Financial Outsourcing Services segment.

Selling, general and administrative expenses as a percentage of net sales of services were 11.1% for the three months ended September 25, 2005, compared to 10.7% for the three months ended September 26, 2004. The \$2.3 million increase in selling, general and administrative expenses is primarily due to an increase in personnel costs associated with the increase of net sales discussed above. In addition, start-up expenses related to the expansion of PrO Unlimited services in Europe and Asia contributed to the increase in selling, general and administrative expenses as a percentage of net sales during the third quarter of 2005.

Operating income for the three months ended September 25, 2005 was \$4.2 million as compared to operating income of \$3.4 million for the three months ended September 26, 2004. The Company's higher operating income for the 2005 period is principally due to an increase in net sales of services and decrease in cost of services, partially offset by an increase in selling, general and administrative expenses discussed above.

The Company's interest expense for the three months ended September 25, 2005 was principally attributable to interest recorded on the PNC Credit Facility, the Convertible Note and the Senior Notes. The interest expense of \$2.8 million for the third quarter of 2005 was lower as compared to the interest expense of \$3.0 million for the third quarter of 2004. This reduction was principally due to the exchange and repurchase of \$6.7 million of Convertible Notes and \$18.1 million of Senior Notes during 2004, and the repurchase of \$11.6 million of Senior Notes in the first nine months of 2005. These decreases were partially offset by increased interest expense on the Company's revolving line of credit due to higher average outstanding balances and interest rates in the third quarter of 2005. See "Financial Condition, Liquidity and Capital Resources" in this Item 2.

As a result of the Company's repurchase of Senior Notes during the third quarter of 2005, the Company recognized a loss on debt extinguishment of \$37,000, including a reduction of \$24,000 of deferred financing costs. The purpose of this transaction was to improve the Company's balance sheet through the elimination of higher interest rate debt.

In the third quarter ending September 25, 2005, the income tax provision includes a tax benefit of \$4.3 million from the resolution of certain federal and state income tax contingencies. Excluding this tax benefit, the income tax provision for the third quarter of 2005 was \$797,000 (a rate of 50.8%) on income from continuing operations before income taxes of \$1.6 million. The income tax provision for the third quarter of 2004 was \$354,000 (a rate of 72.8%) on income from continuing operations before income taxes of \$486,000. The difference between income taxes at the federal statutory income tax rate and the Company's tax provision, excluding the tax benefit associated with the resolution of certain tax contingencies, for the respective periods relates primarily to state income taxes and a disallowance for non-deductible expenses.

#### ***Nine months ended September 25, 2005 compared to Nine months ended September 26, 2004***

Net sales of services for the nine months ended September 25, 2005 were \$397.7 million, which represents a 14.1% increase from the \$348.4 million in net sales of services realized for the nine months ended September 26, 2004. Net sales of services in the Human Capital Management Services segment increased by \$35.3 million or 18.3%, due to an increase in services provided to existing clients. Management believes such increase is reflective of a trend for companies to rely increasingly on providers of human capital management services, such as those provided by the Company's PrO Unlimited subsidiary. In the Staff Augmentation segment, the increase of \$16.2 million, or 10.8%, is principally attributable to services provided to information technology, telecom and technical customers. Sales of services were lower by \$2.3 million, or 40.1% in the Financial Outsourcing Services segment, principally due to a reduction in the number of customers.

Cost of services for the nine months ended September 25, 2005 was 85.6% of net sales of services as compared to cost of services of 85.2% of net sales of services for the nine months ended September 26, 2004. The

cost of services as a percentage of net sales for the first nine months of fiscal 2005 increased from the first nine months of fiscal 2004 principally as a result of higher growth in Human Capital Management Services which have a higher cost of services as a percentage of net sales of services and a reduction in the number of clients serviced under the Financial Outsourcing Services segment, partially offset by a reduction in accrued workers compensation liabilities based upon favorable claims experience.

Selling, general and administrative expenses as a percentage of net sales of services were 11.1% for the nine months ended September 25, 2005, compared to 11.3% for the nine months ended September 26, 2004. The \$4.9 million increase in selling, general and administrative expenses is primarily due to an increase in personnel costs associated with the increase of net sales discussed above.

Operating income for the nine months ended September 25, 2005 was \$10.4 million as compared to operating income of \$9.3 million for the nine months ended September 26, 2004. The Company's higher operating income for the 2005 period is principally due to an increase in net sales of services discussed above.

The Company's interest expense for the nine months ended September 25, 2005 was principally attributable to interest recorded on the PNC Credit Facility, the Convertible Note and the Senior Notes. The interest expense of \$8.3 million for the first nine months of 2005 was lower as compared to the interest expense of \$9.2 million for the first nine months of 2004. This reduction was principally due to the exchange and repurchase of \$6.7 million of Convertible Notes and \$18.1 million of Senior Notes during 2004, and the repurchase of \$11.6 million of Senior Notes in the first nine months of 2005. These decreases were partially offset by increased interest expense on the Company's revolving line of credit due to higher average outstanding balances and interest rates in the first nine months of 2005. See "Financial Condition, Liquidity and Capital Resources" in this Item 2.

As a result of the Company's repurchase of Senior Notes in the first nine months of 2005, the Company recognized a loss on debt extinguishment of \$290,000, including a reduction of \$123,000 of deferred financing costs. The Company's repurchase of Senior Notes during the first nine months of 2004, resulted in a gain on debt extinguishment of \$2.0 million, including a reduction of \$237,000 of deferred financing costs. The purpose of these transactions was to improve the Company's balance sheet through the elimination of higher interest rate debt.

In the third quarter ending September 25, 2005, the income tax provision included a tax benefit of \$4.3 million from the resolution of certain federal and state income tax contingencies. Excluding this tax benefit, the income tax provision for the first nine months of 2005 was \$968,000 (a rate of 51.0%) on income from continuing operations before income taxes of \$1.9 million. The income tax provision for the first nine months of 2004 was \$1.1 million (a rate of 53.0%) on income from continuing operations before income taxes of \$2.1 million. The difference between income taxes at the federal statutory income tax rate and the Company's tax provision, excluding the tax benefit associated with the resolution of certain tax contingencies, for the respective periods relates primarily to state income taxes and a disallowance for non-deductible expenses.

In accordance with SFAS 144, the results of operations from the sale of the Company's niche telecom operations (as described in note 11 to the condensed consolidated financial statements) have been recorded as discontinued operations. The net income from discontinued operations was \$101,000 for the nine months ended September 25, 2005, which represented the gain from the sale of discontinued operations for the excess of the cash received from the sale through September 25, 2005 over the carrying value of the net assets sold, and the net loss from discontinued operations was (\$17,000) for the nine months ended September 26, 2004.

### **Financial Condition, Liquidity and Capital Resources**

The Company generally pays its billable employees weekly or bi-weekly for their services, and remits certain statutory payroll and related taxes as well as other fringe benefits. Invoices are generated to reflect these costs plus the Company's markup. These invoices are typically paid within 35 days. Increases in the Company's net sales of services, resulting from expansion of existing offices or establishment of new offices, will require additional cash resources.

*Off-Balance Sheet and Contractual Obligations:* During the nine months ended September 25, 2005, the Company had no off-balance sheet arrangements other than operating leases entered into in the normal course of business, as indicated in the table below. The following table represents contractual commitments associated with operating lease agreements and principal repayments on debt obligations (excluding interest):

	Payments due by fiscal year (in thousands)				
	2005	2006	2007	2008	Thereafter
Operating Leases	\$ 687	\$ 2,052	\$ 1,507	\$ 1,212	\$ 1,621
PNC Credit Facility--					
principal repayments	--	--	56,797	--	--
Senior Notes - principal					
repayments	--	--	52,810	--	--
Convertible Note - principal					
repayments	--	--	--	--	1,351
Total	\$ 687	\$ 2,052	\$ 111,114	\$ 1,212	\$ 2,972

The Company also had standby letters of credit outstanding at September 25, 2005 in the aggregate amount of \$5.4 million.

COMFORCE, COI and various of their operating subsidiaries, as co-borrowers and guarantors, entered into an \$85.0 million PNC Credit Facility with PNC, as a lender and administrative agent and other financial institutions participating as lenders to provide for a revolving line of credit with available borrowings based, generally, on 85.0% of the Company's accounts receivable aged 90 days or less, subject to specified limitations and exceptions. The Company entered into the PNC Credit Facility in June 2003 and it has been subject to various amendments. At September 25, 2005, the Company had remaining availability, as defined in the agreement, of \$20.3 million.

On May 13, 2005, the PNC Credit Facility was amended to lower the interest rates calculated in reference to LIBOR. As amended, borrowings under the PNC Credit Facility bear interest, at the Company's option, at a per annum rate equal to either (1) the greater of the federal funds rate plus 0.5% or the base commercial lending rate of PNC as announced from time to time, or (2) LIBOR plus a specified margin, determined as follows:

<i>Fixed charge coverage ratio*</i>	<i>Margin (%)</i>
greater than 1.50:1.00	1.75
greater than 1.30:1.00 to 1.50:1.00	2.00
greater than 1.05:1.00 to 1.30:1.00	2.25
equal to or less than 1.05:1.00	2.50

\*as defined in the PNC Credit Facility

The PNC Credit Facility also provides for a commitment fee of 0.375% of the unused portion of the facility. The obligations under the PNC Credit Facility are collateralized by a pledge of the capital stock of certain key operating subsidiaries of the Company and by security interests in substantially all of the assets of the Company. The May 13, 2005 amendment also reduced the lenders' audits of the Company's collateral at the Company's expense from three to two per calendar year, subject to specified exceptions. The PNC Credit Facility contains various financial and other covenants and conditions, including, but not limited to, a prohibition on paying cash dividends and limitations on engaging in affiliate transactions, making acquisitions and incurring additional indebtedness. The maturity date of the PNC Credit Facility is June 24, 2007. The Company was in compliance with all financial covenants under the PNC Credit Facility at September 25, 2005.

During the nine months ended September 25, 2005, the Company used \$2.3 million of cash in continuing operations. Cash and cash equivalents decreased \$10.3 million during the nine months ended September 25, 2005. The reduction of cash primarily resulted from a \$17.7 million increase in accounts receivable, \$1.8 million of capital expenditures and the repurchase of \$11.8 million of Senior Notes which was partially offset by an increase of \$5.3

million of cash from net borrowings under the PNC Credit Facility. The increase in accounts receivable resulted from the increase in net sales of services.

At September 25, 2005, the Company had outstanding \$56.8 million principal amount under the PNC Credit Facility bearing interest at a weighted average rate of 5.88% per annum. At such date, the Company had remaining availability of \$20.3 million, as defined in the agreement, under the PNC Credit Facility.

At September 25, 2005, the Company also had outstanding (i) \$52.8 million principal amount of Senior Notes bearing interest at 12% per annum and (ii) \$1.4 million principal amount of Convertible Notes bearing interest at 8% per annum.

Substantially all of the consolidated net assets of the Company are assets of COI and all of the net income that had been generated by the Company was attributable to the operations of COI. Except for permitted distributions, these assets and any cumulated net income are restricted as to their use by COMFORCE. The indenture governing the Senior Notes imposes restrictions on COI making specified payments, which are referred to as "restricted payments," including making distributions or paying dividends (referred to as upstreaming funds) to COMFORCE. Under the indenture, COI is not permitted to make cash distributions to COMFORCE other than to upstream \$2.0 million annually to pay public company expenses, and to upstream funds to the extent COI meets the restricted payments test under the indenture, the most significant component of which is based upon 50% of net income generated by COI since January 1, 1998 on a cumulative basis, less prior distributions made in reliance on this provision. In calculating net income for this purpose, under the terms of the indenture, the Company must apply generally accepted accounting principles as in effect at the time the indenture was entered into in 1997. Principally as a result of distributions made, and losses incurred by COI in prior years, COI can make no distributions to COMFORCE based upon the cumulative net income provisions of the indenture until COI generates additional net income of approximately \$11.1 million. However, COMFORCE has approximately \$1.7 million available at September 25, 2005 from proceeds it has generated from the sale of stock, principally upon the exercise of options and warrants. This \$1.7 million may be used by COMFORCE to pay interest and principal on the Convertible Notes or for other business purposes.

The Company has made significant progress in improving its capital structure through the elimination of long-term debt through the purchase or exchange of Senior Notes, Convertible Notes and other instruments. Since June 2000, the Company has reduced its public debt from \$138.8 million to \$51.8 million. As a result, COMFORCE has reduced its annualized interest expense by borrowing at the lower rates available under the PNC Credit Facility to effectuate repurchases of long-term debt and by exchanging preferred stock and lower interest rate Convertible Notes for public debt.

The Company's Series 2003A, 2003B and 2004A Preferred Stock provide for dividends of 7.5% per annum and, at September 25, 2005 there were cumulated, unpaid and undeclared dividends of \$1.2 million on the Series 2003A Preferred Stock, \$77,000 on the Series 2003B Preferred Stock and \$410,000 on the Series 2004A Preferred Stock.

Management of the Company believes that cash flow from operations and funds anticipated to be available under the PNC Credit Facility will be sufficient to service the Company's indebtedness and to meet currently anticipated working capital requirements through the end of 2005. Thereafter, if the Company experiences further growth in its businesses, it would then consider increasing the availability under the PNC Credit Facility or pursuing other financing alternatives. The Company was in compliance with all financial covenants under the PNC Credit Facility at September 25, 2005 and expects to remain in compliance for the next 12 months. In the event that the Company is unable to meet any of such covenants, it will request a modification (or waiver) of such covenants.

The Company is currently undergoing audits for certain state and local tax returns. The results of these audits are not estimable at this time.

### **Impact of Recently Issued Accounting Standards**

In December 2004, the FASB issued SFAS No. 123 (R), *Share Based Payment* ("SFAS 123(R)"). This

statement replaces SFAS No. 123, *Accounting for Stock Based Compensation* and supercedes APB No. 25, *Accounting for Stock Issued to Employees*. SFAS 123 (R) requires all stock based compensation to be recognized as an expense in the financial statements and that such cost be measured according to the grant date fair value of the stock options or other equity instruments. SFAS 123 (R) will be effective for annual periods beginning after June 15, 2005. While the Company currently provides the pro forma disclosures required by SFAS No. 148, *Accounting for Stock Based Compensation - Transition and Disclosure*, on a quarterly basis (see "Note 3 - Stock Compensation Plans"), it is currently evaluating the impact this statement will have on its consolidated financial statements.

In June 2005, the FASB issued SFAS No. 154, *Accounting Changes and Error Corrections, a replacement of APB Opinion No. 20, Accounting Changes, and Statement No. 3, Reporting Accounting Changes in Interim Financial Statements* ("SFAS 154"). SFAS 154 changes the requirements for the accounting for, and reporting of, a change in accounting principle. Previously, most voluntary changes in accounting principles were required to be recognized by way of a cumulative effect adjustment within net income during the period of the change. SFAS 154 requires retrospective application to prior periods' financial statements, unless it is impracticable to determine either the period-specific effects or the cumulative effect of the change. SFAS 154 is effective for accounting changes made in fiscal years beginning after December 15, 2005; however, the Statement does not change the transition provisions of any existing accounting pronouncements. The Company does not believe that the adoption of SFAS 154 will have a material effect on its consolidated financial position, results of operations or cash flows.

### **Seasonality**

The Company's quarterly operating results are affected primarily by the number of billing days in the quarter and the seasonality of its customers' businesses. Demand for technical and engineering services, IT and telecom staffing services has historically been lower during the second half of the fourth quarter through the following first quarter, and, generally, shows gradual improvement until the second half of the fourth quarter.

### **Forward Looking Statements**

Various statements made in this Report concerning the manner in which the Company intends to conduct its future operations, and potential trends that may impact future results of operations, are forward looking statements. The Company may be unable to realize its plans and objectives due to various important factors, including, but not limited to the following: the loss of key customers, weakness in job growth, a reduction in corporate or government spending, adverse economic conditions generally or in key industries served by the Company, or a reduction in the demand for outsourcing services generally which could heighten competition among staffing companies and negatively impact revenues and margins; the Company's significant leverage may leave it with a diminished ability to obtain additional financing for working capital or other capital expenditures, for retiring higher interest rate debt or for otherwise improving the Company's competitiveness and capital structure or expanding its operations; SFAS 142, which requires the Company to evaluate at least annually the recoverability of goodwill on its books, could cause the Company to write-off goodwill in future periods, which could have a material adverse impact on the Company's financial condition and results of operations; or, if COI fails to generate sufficient consolidated net income in future periods or to have other funds available to upstream to COMFORCE under the restricted payments test of the Senior Notes indenture.

Additional important factors that could cause the Company to be unable to realize its plans and objectives are described under "Risk Factors" in the Registration Statement on Form S-8 of the Company filed with the Securities and Exchange Commission on April 24, 2003 (Registration No. 333-104730). The disclosure under "Risk Factors" in the Registration Statement may be accessed through the Web site maintained by the Securities and Exchange Commission at "www.sec.gov." In addition, the Company will provide, without charge, a copy of such "Risk Factors" disclosure to each stockholder of the Company who requests such information. Requests for copies should be directed to the attention of Linda Annicelli, Vice President, Administration at COMFORCE Corporation, 415 Crossways Park Drive, P.O. Box 9006, Woodbury, New York 11797, telephone 516-437-3300.

### **ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

The information required by Item 3 has been disclosed in Item 7A of the Company's Annual Report on Form 10-K for the year ended December 26, 2004. There has been no material change in the disclosure regarding market risk.

### **ITEM 4. CONTROLS AND PROCEDURES**

The Company's management evaluated, with the participation of the chief executive officer and chief financial officer, the effectiveness of the Company's disclosure controls and procedures as of the end of the period covered by this Report. Based on that evaluation, the chief executive officer and chief financial officer have concluded that the Company's disclosure controls and procedures were effective as of the end of the period covered by this Report. There has been no change in the Company's internal controls over financial reporting that occurred during the quarter covered by this Report that has materially affected, or is reasonably likely to materially affect, the Company's internal controls over financial reporting.

## **PART II - OTHER INFORMATION**

### **ITEM 1. LEGAL PROCEEDINGS.**

Since the date of the filing of the Company's Annual Report on Form 10-K for the year ended December 26, 2004, there have been no material new legal proceedings involving the Company or any material developments to the proceedings described in such Form 10-K, except as described below.

In July 2005, the Company's subsidiary, COMFORCE Technical Services, Inc. ("CTS") was served with an amended complaint in the suit titled *Reyes V. East Bay Municipal Utility District, et al*, filed in the Superior Court of California, Alameda County, in connection with a gasoline pipeline explosion in November 2004 that killed five workers and injured four others. As part of a construction project to lay a water transmission line, a backhoe operator employed by a construction contractor unaffiliated with CTS struck and breached a gasoline pipeline, resulting in the explosion. The complaint names various persons involved in the construction project as defendants, including CTS. The complaint alleges, among other things, that CTS was negligent in failing to properly mark the location of the pipeline. The complaint does not specify monetary damages.

CTS was subsequently named as defendant in four other lawsuits concerning this accident in the Superior Court of California: *Knox v. Mountain Cascade et al*, *Farley v. Mountain Cascade et al*, *Arias v. Kinder Morgan et al*, and *Angeles v. Kinder Morgan, et al*. These actions have since been consolidated with the *Reyes* case in a single coordinated action styled as the *Gas Pipeline Explosion Cases* in the Superior Court of California, Contra Costa County.

CTS denies any responsibility for this accident. CTS has requested that its insurance carriers defend it in these actions. Management of CTS (and the Company) cannot estimate the amount of damages, if any, to which CTS may be liable. Following an investigation of the accident, Cal-OSHA issued citations to four of the contractors on the project, but declined to issue any citations against CTS.

**ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS.**

Not applicable.

**ITEM 3. DEFAULTS UPON SENIOR SECURITIES.**

Not applicable.

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

Not applicable.

**ITEM 5. OTHER INFORMATION.**

Not applicable.

**ITEM 6. EXHIBITS.**

- 31.1 Rule 13a-14(a) certification of chief executive officer in accordance with section 302 of the Sarbanes-Oxley Act of 2002.
- 31.2 Rule 13a-14(a) certification of chief financial officer in accordance with section 302 of the Sarbanes-Oxley Act of 2002.
- 32.1 Section 1350 certification of chief executive officer in accordance with section 906 of the Sarbanes-Oxley Act of 2002.
- 32.2 Section 1350 certification of chief financial officer in accordance with section 906 of the Sarbanes-Oxley Act of 2002.

**SIGNATURES**

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

COMFORCE Corporation

/s/ Harry V. Maccarrone  
Harry V. Maccarrone  
Executive Vice President and Chief Financial Officer

Date: November 3, 2005

**Rule 13a-14(a)  
CERTIFICATION**

I, John C. Fanning, Chairman and Chief Executive Officer of COMFORCE Corporation, hereby certify that:

1. I have reviewed this quarterly report on Form 10-Q of COMFORCE Corporation;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial 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(s) 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) 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
  - (c) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer(s) 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 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: November 3, 2005

/s/ John C. Fanning  
John C. Fanning,  
Chairman and Chief Executive Officer

**Rule 13a-14(a)  
CERTIFICATION**

I, Harry V. Maccarrone, Executive Vice President and Chief Financial Officer of COMFORCE Corporation, hereby certify that:

1. I have reviewed this quarterly report on Form 10-Q of COMFORCE Corporation;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial 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(s) 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) 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
  - (c) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer(s) 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 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: November 3, 2005

/s/ Harry V. Maccarrone  
Harry V. Maccarrone  
Executive Vice President and Chief Financial Officer

**Section 1350  
CERTIFICATION**

The undersigned officer hereby certifies that, to his knowledge, (1) the Quarterly Report on Form 10-Q of COMFORCE Corporation for the quarter ended September 25, 2005 as to which this Certification is an exhibit fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934 (15 U.S.C. 78m(a) or 78o(d)) and (2) the information contained in such Report fairly presents, in all material respects, the financial condition and results of operations of COMFORCE Corporation.

Signed November 3, 2005.

/s/ John C. Fanning  
John C. Fanning,  
Chairman and Chief Executive Officer

**Section 1350  
CERTIFICATION**

The undersigned officer hereby certifies that, to his knowledge, (1) the Quarterly Report on Form 10-Q of COMFORCE Corporation for the quarter ended September 25, 2005 as to which this Certification is an exhibit fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934 (15 U.S.C. 78m(a) or 78o(d)) and (2) the information contained in such Report fairly presents, in all material respects, the financial condition and results of operations of COMFORCE Corporation.

Signed November 3, 2005.

/s/ Harry V. Maccarrone  
Harry V. Maccarrone  
Executive Vice President and Chief Financial Officer