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ENVIRONMENTAL TECTONICS CORP
Form 10-Q
January 12, 2004

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended November 28, 2003

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. 1-10655

ENVIRONMENTAL TECTONICS CORPORATION

(Exact name of registrant as specified in its charter)

Pennsylvania

23-1714256

(State or other jurisdiction
of incorporation or organization)

(IRS Employer
Identification No.)

COUNTY LINE INDUSTRIAL PARK
SOUTHAMPTON, PENNSYLVANIA 18966

(Address of principal executive offices)
(Zip Code)

(215) 355-9100

(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports
required to be filed by Section 13 or 15(d) of the Securities Exchange Act of
1934 during the 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 at least the past 90 days.

Yes x

No

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

Yes

No x

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The number of shares outstanding of the registrant's common stock as of December 31, 2003 is: 7,168,613.

PART I - FINANCIAL INFORMATION

Item 1. Financial Statements

Environmental Tectonics Corporation Consolidated Income Statements (unaudited)

(amounts in thousands, except share and per share information)

| | Thirteen Weeks Ended | | Thirty-nine |
|--|----------------------|----------------------|----------------------|
| | November 28, 2003 | November 22, 2002 | November 28, 2003 |
| Net Sales | \$ 7,115 | \$ 12,162 | \$ 17,997 |
| Cost of goods sold | 5,341 | 8,583 | 12,150 |
| | 1,774 | 3,579 | 5,847 |
| Gross profit | | | |
| Operating expenses: | | | |
| Selling and administrative | 2,330 | 2,437 | 6,246 |
| Research and development | 144 | 268 | 176 |
| | 2,474 | 2,705 | 6,422 |
| Operating (loss)/income | (700) | 874 | (575) |
| Other expenses/(income): | | | |
| Interest expense | 425 | 116 | 1,192 |
| Other, net | (138) | 174 | (51) |
| | 287 | 290 | 1,141 |
| (Loss)/income before income taxes | (987) | 584 | (1,716) |
| (Benefit from)/provision for income taxes | (280) | 154 | (451) |
| (Loss)/income before minority interest | (707) | 430 | (1,265) |
| Loss attributable to minority interest | (3) | (6) | (9) |
| Net (loss)/income | (704) | \$ 436 | \$ (1,256) |

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Per share information:

| | | | |
|--|-----------|-----------|------------|
| (Loss)/income available to common shareholders | \$ (704) | \$436 | \$ (1,256) |
| (Loss)/income per share: basic | \$ (0.10) | \$0.06 | \$ (0.18) |
| (Loss)/income per share: diluted | \$ (0.10) | \$0.06 | \$ (0.18) |
| Number of shares: basic | 7,168,000 | 7,153,000 | 7,168,000 |
| Number of shares: diluted | 7,168,000 | 7,481,000 | 7,168,000 |

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

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Environmental Tectonics Corporation
Consolidated Balance Sheets

| | |
|---|---|
| | November 28, 2003 ----- (unaudited) (amounts in thousand informati |
| Assets | |
| Current assets: | |
| Cash and cash equivalents | \$ 1,171 |
| Cash equivalents restricted for letters of credit | 569 |
| Accounts receivable, net | 20,284 |
| Costs and estimated earnings in excess of billings on uncompleted long-term contracts | 5,516 |
| Inventories | 9,134 |
| Deferred tax asset | 689 |
| Prepaid expenses and other current assets | 2,297 |
| Total current assets | 39,660 |
| Property, plant and equipment, at cost, net of accumulated depreciation of \$10,468 at November 28, 2003 and \$9,976 at February 28, 2003 | 4,850 |
| Software development costs, net of accumulated amortization of \$7,321 at November 28, 2003 and \$6,819 at February 28, 2003 | 3,048 |
| Goodwill and intangibles | 477 |
| Other assets, net | 479 |
| Total assets | \$ 48,514 ===== |
| Liabilities and Stockholders' Equity | |
| Liabilities | |
| Current liabilities: | |
| Current portion of long-term debt | \$ 281 |
| Accounts payable - trade | 2,363 |

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| | | |
|--|----------------------|-----------|
| Billings in excess of costs and estimated earnings on uncompleted long-term contracts | | 1,098 |
| Customer deposits | | 3,419 |
| Accrued liabilities | | 2,439 |
| | | ----- |
| Total current liabilities | | 9,600 |
| | | ----- |
| Long-term debt, less current portion: | | |
| Credit facility payable to banks | | 1,200 |
| Long-term bonds, net | | 4,370 |
| Subordinated debt | | 7,593 |
| Other | | 3 |
| | | ----- |
| | | 13,166 |
| | | ----- |
| Deferred income taxes | | 1,022 |
| | | ----- |
| Total liabilities | | 23,788 |
| | | ----- |
| Minority interest | | 39 |
| | | |
| | Stockholders' Equity | |
| Common stock; \$.05 par value; 20,000,000 shares authorized; 7,168,239 and 7,157,239 issued and outstanding at November 28, 2003 and February 28, 2003, respectively | | 359 |
| Capital contributed in excess of par value of common stock | | 9,381 |
| Accumulated other comprehensive loss | | (184) |
| Retained earnings | | 15,131 |
| | | ----- |
| Total stockholders' equity | | 24,687 |
| | | ----- |
| Total liabilities and stockholders' equity | | \$ 48,514 |
| | | ===== |

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

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Environmental Tectonics Corporation Consolidated Statements of Cash Flows (unaudited)

| | Thirty-nine Weeks Ended November 28, 2002 | November 2003 |
|--|---|------------------|
| | ----- | ----- |
| | (amounts in thousands) | |
| Cash flows from operating activities: | | |
| Net (loss)/income | \$ (1,256) | \$ 1,7 |
| Adjustments to reconcile net (loss)/income to net cash (used in)/provided by operating activities: | | |

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| | | |
|--|----------|--------|
| Depreciation and amortization | 1,009 | 1,1 |
| Non-cash interest expense | 443 | |
| Provision for losses on accounts receivable and inventories | (198) | 8 |
| Minority interest | (9) | (|
| Changes in operating assets and liabilities: | | |
| Accounts receivable | (4,025) | 1,8 |
| Costs and estimated earnings in excess of billings on uncompleted long-term contracts | (75) | 3,5 |
| Inventories | (861) | (2,5 |
| Prepaid expenses and other assets | (1,150) | (|
| Other assets | -- | |
| Accounts payable | 585 | (1,5 |
| Billings in excess of costs and estimated earnings on uncompleted long-term contracts | (365) | 3 |
| Customer deposits | 419 | 1,2 |
| Accrued income taxes | -- | (6 |
| Other accrued liabilities | 884 | 2 |
| | ----- | ----- |
| Net cash (used in)/provided by operating activities | (4,599) | 6,1 |
| | ----- | ----- |
| Cash flows from investing activities: | | |
| Acquisition of equipment | (271) | (2 |
| Capitalized software development costs | (973) | (3 |
| | ----- | ----- |
| Net cash used in investing activities | (1,244) | (5 |
| | ----- | ----- |
| Cash flows from financing activities: | | |
| Borrowings under credit facility | 1,200 | 24,0 |
| Payments under credit facility | (600) | (25,4 |
| Repayment of long-term bonds | (275) | (2 |
| Cash equivalents restricted for letters of credit | 2,620 | (5,2 |
| Proceeds from issuance of common stock / warrants | 51 | |
| Deferred finance charges/other | (272) | |
| | ----- | ----- |
| Net cash provided by/(used in) financing activities | 2,724 | (6,8 |
| | ----- | ----- |
| Effect of exchange rate changes on cash | (15) | 1 |
| | ----- | ----- |
| Net decrease in cash and cash equivalents | (3,134) | (1,1 |
| Cash and cash equivalents at beginning of period | 4,305 | 2,2 |
| | ----- | ----- |
| Cash and cash equivalents at end of period | \$ 1,171 | \$ 1,0 |
| | ===== | ===== |
| Supplemental schedule of cash flow information: | | |
| Interest paid | 582 | 3 |
| Income taxes paid | 64 | 1,5 |
| | | |
| Supplemental information on noncash operating and investing activities: | | |
| ===== | | |
| During the thirty-nine weeks ended November 28,2003, the Company reclassified \$353 from inventory to capitalized software. | | |
| | | |
| During the thirty-nine weeks ended November 22, 2002, the Company reclassified \$226 from inventory to property, plant and equipment and \$624 | | |

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from inventory to capitalized software.

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

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Environmental Tectonics Corporation
Notes to Consolidated Financial Statements
(amounts in dollars, except where noted and share and per share information)

1. Basis of Presentation

The accompanying consolidated financial statements include the accounts of Environmental Tectonics Corporation ("ETC" or the "Company"), Entertainment Technology Corporation, ETC International Corporation and ETC-Delaware, its wholly-owned subsidiaries, ETC Europe, its 99% owned subsidiary and ETC-PZL Aerospace Industries, Ltd. ("ETC-PZL"), its 95% owned subsidiary.

The accompanying consolidated financial statements have been prepared by ETC, without audit, pursuant to the rules and regulations of the Securities and Exchange Commission, and reflect all adjustments which, in the opinion of management, are necessary for a fair statement of the results for the interim periods presented. All such adjustments are of a normal recurring nature.

Certain information in footnote disclosures normally included in financial statements prepared in conformity with accounting principles generally accepted in the United States of America has been condensed or omitted pursuant to such rules and regulations and the financial results for the periods presented may not be indicative of the full year's results, although the Company believes the disclosures are adequate to make the information presented not misleading. These financial statements should be read in conjunction with the financial statements and the notes thereto included in the Company's Annual Report on Form 10-K for the year ended February 28, 2003. Certain reclassifications have been made to the fiscal 2003 financial statements to conform with the fiscal 2004 presentation.

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2. Earnings Per Share

Our calculation of earnings per share in accordance with SFAS No. 128, "Earnings Per Share", is as follows:

| | Thirteen Weeks Ended November 28, 2003 | | | Thirteen Wee |
|---|---|-------------------------|---------------------|-----------------------|
| | Loss (Numerator) | Shares (Denominator) | Per Share Amount | Income (Numerator) |
| | ----- | ----- | ----- | ----- |
| | (amounts in thousands, except share and per share i | | | |
| Basic EPS | | | | |
| Net (loss)/earnings available to common stockholders | \$ (704) | 7,168,000 | \$ (0.10) | \$436 |
| Effect of dilutive securities | | | | |
| Options | - | - | | |
| Warrants | - | - | | |
| Diluted EPS | | | | |
| Net (loss)/earnings available to common stockholders plus assumed conversions | \$ (704) | 7,168,000 | \$ (0.10) | \$436 |

| | Thirty-nine Weeks Ended November 28, 2003 | | | Thirty-nine Wee |
|--|---|-------------------------|---------------------|-----------------------|
| | Loss (Numerator) | Shares (Denominator) | Per Share Amount | Income (Numerator) |
| | ----- | ----- | ----- | ----- |
| | (amounts in thousands, except share and per share i | | | |
| Basic EPS | | | | |
| Net (loss)/earnings available to common stockholders | \$ (1,256) | 7,168,000 | \$ (0.18) | \$1,757 |
| Effect of dilutive securities | | | | |
| Options | - | - | | |
| Warrants | - | - | | |
| Diluted EPS | | | | |

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| | | | | |
|---------------------|------------|-----------|-----------|---------|
| Net (loss)/earnings | | | | |
| available to common | | | | |
| stockholders | | | | |
| plus assumed | | | | |
| conversions | \$ (1,256) | 7,168,000 | \$ (0.18) | \$1,757 |

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At November 28, 2003 there were stock options to purchase the Company's common stock totaling 412,000 shares which were not included in the computation of diluted earnings per share, as the effect of such would be anti-dilutive. Additionally, there was subordinated debt with a face value of \$10,000,000 which was convertible at an exercise price of \$6.05 per share, equating to 1,653,000 shares if fully converted to common shares. Upon each conversion of the Note, the holder would be entitled to receive a warrant to purchase additional shares of common stock equal to ten percent of the shares issued pursuant to such conversion. If the entire face value of the Note were to be converted into common shares, warrants for an additional 165,000 shares would be issued, bringing the total shares to be issued to 1,818,000. Additionally, at November 28, 2003, there were warrants to purchase the Company's stock totaling 1,241,000 shares. None of these shares were included in the computation of diluted earnings per share as the effect would be anti-dilutive.

At November 22, 2002, there were employee stock options to purchase the Company's stock totaling 329,000 shares which were not included in the computation of diluted earnings per share, as the effect of such options would be anti-dilutive.

3. Stock Options

The Company accounts for stock options under SFAS No. 123, "Accounting for Stock-Based Compensation," as amended by SFAS No. 148, which contains a fair value-based method for valuing stock-based compensation that entities may use, which measures compensation cost at the grant date based on the fair value of the award. Compensation is then recognized over the service period, which is usually the vesting period. Alternatively, SFAS No. 123 permits entities to continue accounting for employee stock options and similar equity instruments under Accounting Principles Board (APB) Opinion 25, "Accounting for Stock Issued to Employees." Entities that continue to account for stock options using APB Opinion 25 are required to make pro forma disclosures of net income and earnings per share, as if the fair value-based method of accounting defined in SFAS No. 123 had been applied.

At November 28, 2003, the Company had one stock-based employee compensation plan. The Company accounts for this plan under the recognition and measurement principles of APB Opinion 25, "Accounting for Stock Issued to Employees," and related interpretations. Stock-based employee compensation costs are not reflected in net income, as all options granted under the plan had an exercise price equal to the market value of the underlying common stock on the date of grant. The following table illustrates the effect on net income and earnings per share if the Company had applied the fair value recognition provisions of SFAS No. 123, to stock-based employee compensation (in thousands, except per share amounts).

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| | Thirteen Weeks E |
|--|-------------------|
| | November 28, 2003 |
| | ----- |
| Net (loss)/income, as reported | \$ (704) |
| Less: stock-based compensation costs determined under fair market value based methods for all awards | (10) ----- |
| Net (loss)/income, pro forma | \$ (714) |
| (Loss)/earnings per share of common stock-basic: | |
| As reported | \$ (0.10) |
| Pro forma | \$ (0.10) |
| (Loss)/earnings per share of common stock--diluted: | |
| As reported | \$ (0.10) |
| Pro forma | \$ (0.10) |

| | Thirty-nine Week |
|--|-------------------|
| | November 28, 2003 |
| | ----- |
| Net (loss)/income, as reported | \$ (1,256) |
| Less: stock-based compensation costs determined under fair market value based methods for all awards | (30) ----- |
| Net (loss)/income, pro forma | \$ (1,286) |
| (Loss)/earnings per share of common stock-basic: | |
| As reported | \$ (0.18) |
| Pro forma | \$ (0.18) |
| (Loss)/earnings per share of common stock--diluted: | |
| As reported | \$ (0.18) |
| Pro forma | \$ (0.18) |

There were no grants of stock options during the thirty-nine weeks ended November 28, 2003 or November 22, 2002.

4. Accounts Receivable

The components of accounts receivable are as follows:

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| | November 28, 2003 | F |
|---|----------------------|---|
| | ----- | |
| | (amounts in thou | |
| U.S. Government receivables billed and unbilled contract costs subject to negotiation | \$ 4,060 | |
| U.S. commercial receivables billed | 1,342 | |
| International receivables billed and unbilled contract costs subject to negotiation | 15,262 | |
| | ----- | |
| | 20,664 | |
| Less allowance for doubtful accounts | (380) | |
| | ----- | |
| | \$ 20,284 | |
| | ===== | |

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U.S. Government receivables billed and unbilled contract costs subject to negotiation:

Unbilled contract costs subject to negotiation as of November 28, 2003 and February 28, 2003, primarily represent claims made against the U.S. Government under a contract for a submarine rescue decompression chamber project. These costs totaling \$2,899,000 were recorded beginning in fiscal year 2002 and include \$1,691,000 recorded during fiscal year 2003 and \$833,000 during fiscal year 2004. In November 2003, the U.S. Government completed an audit of the claim, rejecting most of the items due to audit or engineering reasons. The Company was not provided a copy of the Government's Technical Report that questioned approximately half of the claim costs. The Company has submitted a written rebuttal to the draft report and has formally requested a copy of the Technical Report. The Company considers the recorded costs to be realizable due to the fact that they relate to customer caused delays, errors and changes in specifications and designs, disputed liquidated damages and other out of scope items. Additionally, the Company is currently preparing an update to the claim to incorporate additional spending related to the claim items. During the thirteen weeks ended November 28, 2003, this customer, citing failure to deliver product within contract terms, began assessing liquidated damages by offsetting progress payments due the Company under the contract. The Company disputes the basis for these liquidated damages, noting that applicable U.S. Government purchasing regulations allow for a waiver of these charges if the delay is beyond the control and not due to the fault or negligence of the Company. However, following accounting principles generally accepted in the United States of America, the Company has reduced contract values and corresponding revenue recognition for an estimated amount to cover a delay through the extended delivery period.

International receivables billed and unbilled contract costs subject to negotiation:

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International receivables billed includes \$700,000 at November 28, 2003 and February 28, 2003, respectively, related to a contract with the Royal Thai Air Force ("RTAF").

In October 1993, the Company was notified by the RTAF that the RTAF was terminating a \$4,600,000 simulator contract with the Company. Although the Company had performed in excess of 90% of the contract, the RTAF alleged a failure to completely perform. In connection with this termination, the RTAF made a call on a \$230,000 performance bond, as well as a draw on an approximately \$1,100,000 advance payment letter of credit. Work under this contract had stopped while under arbitration, but on October 1, 1996, the Thai Trade Arbitration Counsel rendered its decision under which the contract was reinstated in full and the Company was given a period of nine months to complete the remainder of the work. Except as noted in the award, the rights and obligations of the parties remained as stated in the original contract including the potential invoking of penalties or termination of the contract for delay. On December 22, 1997, the Company successfully performed acceptance testing and the unit passed with no discrepancy reports. Although the contract was not completed in the time allotted, the Company has requested an extension on the completion time due to various extenuating circumstances, including allowable "force majeure" events, one of which was a delay in obtaining an export license to ship parts required to complete the trainers. On August 30, 2001, the Company received a payment of \$230,000 representing the amount due on the performance bond.

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The open balance of \$700,000 due on the contract represents the total net exposure to the Company on this contract. On June 16, 2003, the Company's Thai attorneys filed for arbitration in Thailand seeking recovery of the open balance of \$700,000 due on this contract. On October 8, 2003, the Thai government filed their defense with the Thai Arbitration Institute. This document is currently being translated into English. In December 2003 the Company and the RTAF both picked arbitrators to represent them in the dispute, although no date has yet been set for the Arbitration proceedings. Since the circumstances that caused a delay are commonly considered "force majeure" events, and since the contract under question allows for consideration of "force majeure" events, the Company believes that the open balance related to this contract is collectible and will continue to treat this balance as collectible until a final unappealable legal decision is rendered by a competent Thai tribunal. The Company continues to enjoy a favorable relationship with the RTAF. It currently has both maintenance and upgrade contracts with the RTAF for the trainers that are the subject of the dispute and has sold a significant amount of additional equipment to the RTAF since this dispute began, so it is not anticipated that the initiation of legal action against the RTAF will have any material adverse impact on future sales to the RTAF. At this point, the Company is not able to determine what, if any, impact the extended completion period will ultimately have upon the receipt of final payment.

Unbilled contract costs subject to negotiation represent claims made or to be made against an international customer for two contracts covering 1997 to the present. Trade and claims receivables and resulting revenue aggregating \$10,269,000 have been recorded, including \$819,000 recorded in the current quarter. Claim costs have been incurred in connection with customer caused delays, errors in specifications and designs, other out-of-scope items and exchange losses and may not be received in full during fiscal 2004. In conformity with accounting principles generally accepted in the United States of America, revenue recorded by the Company from a claim does not exceed the incurred contract costs related to the claim. As a related item, during the third quarter of fiscal 2000, this international customer, citing failure to deliver product within contract terms, assessed liquidated damages totaling

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approximately \$1,600,000 on the two contracts. The Company disputes the basis for these liquidated damages and plans to contest them vigorously. However, following generally accepted accounting principles, the Company has reduced contract values and corresponding revenue recognition by approximately \$1,600,000.

On July 20, 2001, the Company was notified by the international customer that it was terminating the centrifuge contract, which was approximately 90% complete. The termination included a request for the refund of advance milestone payments made to date.

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The Company is currently mediating and arbitrating the disputes which have arisen under the two contracts in the United Kingdom but is unable to assess the ultimate impact of either the termination or the balance due on the contracts on its operations and financial condition.

With respect to the centrifuge contract, based on witness statements, expert reports and other facts, the Company believes that it has a reasonable basis to refute the concerns of the U.K. Ministry of Defense. The Company has installed seven centrifuges in the last 15 years at various locations throughout the world and the Company is unaware of any accidents or injuries caused by the operation of these centrifuges. The Company does not plan to reduce the carrying value of the trade and claims receivables until all unresolved matters have been properly adjudicated in the arbitration proceedings.

5. Inventories

Inventories are valued at the lower of cost or market using the first in, first out (FIFO) method and consist of the following (net of reserves of \$514,000 and \$646,000 at November 28, 2003 and February 28, 2003, respectively):

| | November 28, 2003 | February 28, 2003 |
|-----------------|------------------------|----------------------|
| | ----- | ----- |
| | (amounts in thousands) | |
| Raw materials | \$ 336 | \$ 322 |
| Work in Process | 6,667 | 5,629 |
| Finished Goods | 2,131 | 2,543 |
| | ----- | ----- |
| Total | \$9,134 | \$8,494 |
| | ===== | ===== |

6. Stockholders' Equity

The components of stockholders' equity at February 28, 2003 and November 28, 2003 were as follows:

| (amounts in thousands, except share in | | | |
|--|--------------|------------|-------------|
| | Common Stock | Additional | Accumulated |
| | | Paid in | Other Comp. |
| Shares | Amount | Capital | Loss |

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| | | | | |
|--|-----------|-------|---------|---------|
| Balance at February 28, 2003 | 7,157,239 | \$358 | \$9,331 | \$(169) |
| Net loss for the thirty-nine weeks ended November 28, 2003 | - | - | - | - |
| Foreign currency translation adjustment | - | - | - | (15) |
| Total comprehensive loss | - | - | - | (15) |
| Shares issued in connection with employee stock option plans | 11,000 | 1 | 50 | - |
| Balance at November 28, 2003 | 7,168,239 | \$359 | \$9,381 | \$(184) |

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7. Long Term Debt

The following table lists the long-term debt and other long-term obligations of the Company as of November 28, 2003.

| Obligation | Payments due by Period | | | |
|---|------------------------|------------------|-----------|-----------|
| | Total | Less than 1 Year | 1-3 Years | 4-5 Years |
| Current Portion of Long Term Debt | \$ 275 | \$ 275 | \$ - | \$ - |
| Long-term Debt | 1,200 | - | 1,200 | - |
| Capital Leases | 9 | 6 | 3 | - |
| Subordinated debt, net of unamortized discount of \$2,477 | 7,593 | - | - | - |
| Long term bonds | 4,370 | - | 825 | 550 |
| Total Obligations | \$ 13,447 | \$ 281 | \$ 2,028 | \$ 550 |

At November 28, 2003, the Company was in violation of three of its financial covenants in connection with its Bank Credit Agreement and two of its covenants in connection with its Convertible Note and Warrant Purchase Agreement. These violations occurred as a result of the second and third quarter fiscal 2004 net losses. As of the date of this Quarterly Report on Form 10-Q, the Company has obtained waivers for these covenant violations from both the Bank and the Note holder.

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8. Business Segment Presentation:

The Company primarily manufactures under contract various types of high-technology equipment that it has designed and developed. The Company considers its business activities to be divided into two segments: Aircrew Training Systems (ATS) and the Industrial Group. The ATS business segment produces devices which create and monitor the physiological effects of motion, including spatial disorientation and centrifugal forces for the medical, training, research and entertainment markets. The Industrial Group produces chambers that create environments that are used for sterilization, research, and medical applications. The following segment information reflects the accrual basis of accounting:

| | ATS --- | Industrial Group ----- (amounts in thousands) | To -- |
|--|------------|--|----------|
| Thirteen weeks ended November 28, 2003 | | | |
| Net Sales | \$ 4,029 | \$ 3,086 | \$ 7 |
| Interest Expense | 343 | 84 | |
| Depreciation and Amortization | 282 | 246 | |
| Operating loss | (286) | (153) | |
| Income Tax Benefit | 179 | 67 | |
| Goodwill and Intangibles | 477 | -- | |
| Identifiable Assets | 30,491 | 7,491 | 37 |
| Expenditures For Segment Assets | 55 | 9 | |
| Thirteen weeks ended November 22, 2002 | | | |
| Net Sales | \$ 10,137 | \$ 2,025 | \$ 12 |
| Interest Expense | 87 | 29 | |
| Depreciation and Amortization | 330 | 98 | |
| Operating Income/(Loss) | 1,730 | (489) | 1 |
| Income Tax Provision/(Benefit) | 427 | (135) | |
| Goodwill and Intangibles | 477 | -- | |
| Identifiable Assets | 26,350 | 7,579 | 33 |
| Expenditures For Segment Assets | 82 | 21 | |
| Reconciliation to consolidated amounts | | | |
| | 2003 | 2002 | |
| Segment Assets | \$ 38,459 | \$ 34,406 | |
| Corporate Assets | 10,055 | 13,948 | |
| | ----- | ----- | |
| Total Assets | \$ 48,514 | \$ 48,354 | |
| | ===== | ===== | |
| Segment operating (loss)/income | \$ (439) | \$ 1,241 | |
| Less interest expense | (427) | (116) | |
| Less income taxes benefit/(expense) | 246 | (292) | |
| | ----- | ----- | |
| Total (loss)/profit for segments | (620) | 833 | |
| Corporate home office expenses | (261) | (367) | |
| Interest and other expenses | 140 | (174) | |
| Income tax benefit | 34 | 138 | |
| Minority interest | 3 | 6 | |

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| | | |
|-------------------|----------------------------|--------------------------|
| Net (loss)/income | ----- \$ (704) ===== | ----- \$ 436 ===== |
|-------------------|----------------------------|--------------------------|

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| | ATS --- | Industrial Group ----- (amounts in thousands) | To --- |
|---|---------------------|--|-----------|
| Thirty-nine weeks ended November 28, 2003 | | | |
| Net Sales | \$ 9,690 | \$ 8,307 | \$ 17 |
| Interest Expense | 937 | 257 | 1 |
| Depreciation and Amortization | 731 | 722 | 1 |
| Operating Income | (51) | 363 | |
| Income Tax (Benefit)/Provision | (304) | 154 | |
| Goodwill and Intangibles | 477 | -- | |
| Identifiable Assets | 30,491 | 7,491 | 37 |
| Expenditures For Segment Assets | 215 | 56 | |
| Thirty-nine weeks ended November 22, 2002 | | | |
| Net Sales | \$ 27,255 | \$ 7,155 | \$ 34 |
| Interest Expense | 319 | 63 | |
| Depreciation and Amortization | 788 | 272 | 1 |
| Operating Income/(Loss) | 4,735 | (764) | 3 |
| Income Tax Provision/(Benefit) | 1,192 | (219) | |
| Goodwill and Intangibles | 477 | -- | |
| Identifiable Assets | 26,350 | 7,579 | 33 |
| Expenditures For Segment Assets | 174 | 38 | |
| Reconciliation to consolidated amounts | 2003 | 2002 | |
| Segment Assets | \$ 38,459 | \$ 34,406 | |
| Corporate Assets | 10,055 | 13,948 | |
| | ----- | ----- | |
| Total Assets | \$ 48,514 ===== | \$ 48,354 ===== | |
| Segment operating income | \$ 312 | \$ 3,971 | |
| Less interest expense | (1,194) | (382) | |
| Less income taxes benefit/(expense) | 150 | (973) | |
| | ----- | ----- | |
| Total (loss)/profit for segments | (732) | 2,616 | |
| Corporate home office expenses | (781) | (914) | |
| Interest and other expenses | (53) | (324) | |
| Income tax benefit | 301 | 342 | |
| Minority interest | 9 | 37 | |
| | ----- | ----- | |
| Net (loss)/income | \$ (1,256) ===== | \$ 1,757 ===== | |

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Segment operating income consists of net sales less applicable costs and expenses relating to these revenues. Unallocated general corporate expenses, letter of credit fees, interest expense and income taxes have been excluded from the determination of the total profit/loss for segments. Corporate home office expenses are primarily central administrative office expenses. Interest and other expenses include banking and letter of credit fees. Property, plant and equipment are not identified with specific business segments, as these are common resources shared by all segments.

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Approximately 23% of sales totaling \$1,611,000 in the thirteen weeks ended November 28, 2003 were made to two international customers in the ATS segment. Approximately 72% of sales totaling \$8,815,000 in the thirteen weeks ended November 22, 2002 were made to one domestic and one international customer in the ATS segment.

Approximately 30% of sales totaling \$5,318,000 in the thirty-nine weeks ended November 28, 2003 were made to one domestic customer and one international customer in the sterilizer and ATS segments respectively. Approximately 67% of sales totaling \$23,198,000 in the thirty-nine weeks ended November 22, 2002 were made to one domestic and one international customer in the ATS segment.

Included in the segment information for the thirteen weeks ended November 28, 2003 are export sales of \$4,382,000. Of this amount, there are sales to or relating to governments or commercial accounts in Venezuela (\$1,050,000), the United Kingdom (\$818,000), and Malaysia (\$793,000). Sales to the U.S. Government and its agencies were negligible for the period.

Included in the segment information for the thirteen weeks ended November 22, 2002 are export sales of \$8,113,000. A significant portion of this amount consisted of sales to a government account in Malaysia of \$6,345,000. In addition, sales to the U.S. Government and its agencies aggregated \$1,150,000 for the period.

Included in the segment information for the thirty-nine weeks ended November 28, 2003 are export sales of \$10,019,000. Of this amount, there are sales to or relating to commercial accounts in Malaysia (\$2,887,000) and Venezuela (\$1,050,000). Sales to the U.S. Government and its agencies aggregated \$624,000 for the period.

Included in the segment information for the thirty-nine weeks ended November 22, 2002 are export sales of \$12,150,000. Of this amount, there are sales to or relating to commercial or government accounts in Malaysia of \$6,345,000 and China of \$2,301,000. In addition, sales to the U.S. Government and its agencies aggregated \$2,585,000 for the period.

9. Recent Accounting Pronouncements

Rescission of FASB Statements No. 4, 44, and 64, Amendment of FASB No. 13, and Technical Corrections:

In April 2002, the Financial Accounting Standards Board (FASB) issued SFAS No. 145, "Rescission of FASB statements No. 4, 44, and 64, Amendment of FASB No. 13, and Technical Corrections." SFAS No. 145 changes the accounting principles governing extraordinary items by clarifying, and to some extent, modifying, the existing definition and criteria, specifying disclosure for

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extraordinary items and specifying disclosure requirements for other unusual or infrequently occurring events and transactions that are not extraordinary items. SFAS No. 145 is effective for financial statements issued for fiscal years beginning after June 15, 2002, with early adoption encouraged. The adoption of SFAS No. 145 did not have a significant impact on the financial condition or results of operations of the Company.

Accounting for Costs Associated with Exit or Disposal Activities:

In June 2002, the FASB issued SFAS No. 146, "Accounting for Costs Associated with Exit or Disposal Activities." This statement provides financial accounting and reporting guidance for costs associated with exit or disposal activities and nullifies Emerging Issues Task Force (EITF) Issue 94-3, "Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity including Certain Costs Incurred in a Restructuring." SFAS No. 146 is effective for exit or disposal activities initiated after December 31, 2002. The adoption of the statement did not have a significant impact on the financial condition or results of operations of the Company.

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In November 2002, FASB Interpretation 45, Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others (FIN 45), was issued. FIN 45 requires a guarantor entity, at the inception of a guarantee covered by the measurement provisions of the interpretation, to record a liability for the fair value of the obligation undertaken in issuing the guarantee. The Company previously did not record a liability when guaranteeing obligations unless it became probable that the Company would have to perform under the guarantee. FIN 45 applies prospectively to guarantees the Company issues or modifies subsequent to December 31, 2002, but has certain disclosure requirements effective for interim and annual periods ending after December 15, 2002. The Company has not historically issued guarantees and does not anticipate FIN 45 will have a material effect on its fiscal 2004 consolidated financial statements.

In January 2003, the FASB issued FASB Interpretation 46 (FIN 46), Consolidation of Variable Interest Entities. FIN 46 clarifies the application of Accounting Research Bulletin 51, Consolidated Financial Statements, for certain entities that do not have sufficient equity at risk for the entity to finance its activities without additional subordinated financial support from other parties or in which equity investors do not have the characteristics of a controlling financial interest ("variable interest entities"). Variable interest entities within the scope of FIN 46 will be required to be consolidated by their primary beneficiary. The primary beneficiary of a variable interest entity is determined to be the party that absorbs a majority of the entity's expected losses, receives a majority of its expected returns, or both. FIN 46 applies immediately to variable interest entities created after January 31, 2003, and to variable interest entities in which an enterprise acquires an interest after that date. It applies in the first fiscal year or interim period beginning after June 15, 2003, to variable interest entities in which an enterprise holds a variable interest that it acquired before February 1, 2003. The adoption of FIN 46 did not have a material effect on the Company's consolidated financial position, results of operations, or cash flows.

On May 15, 2003, the FASB issued SFAS No. 150, Accounting for Certain Financial Instruments with Characteristics of Both Liabilities and Equity. SFAS No. 150 establishes standards for how an issuer classifies and measures certain financial instruments with characteristics of both liabilities and equity. It requires that an issuer classify a financial instrument that is within its scope as a liability (or an asset in some circumstances). Many of those instruments were previously classified as equity.

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SFAS No. 150 affects the issuer's accounting for three types of freestanding financial instruments:

- o mandatorily redeemable shares, which the issuing company is obligated to buy back in exchange for cash or other assets;
- o instruments that do or may require the issuer to buy back some of its shares in exchange for cash or other assets, including put options and forward purchase contracts; and
- o obligations that can be settled with shares, the monetary value of which is fixed, tied solely or predominantly to a variable such as a market index, or varies inversely with the value of the issuers' shares.

SFAS No. 150 does not apply to features embedded in a financial instrument that is not a derivative in its entirety.

Most of the guidance in SFAS No. 150 is effective for all financial instruments entered into or modified after May 31, 2003, and otherwise is effective at the beginning of the first interim period beginning after June 15, 2003. The adoption of SFAS No. 150 did not have a material effect on the Company's consolidated financial position, results of operations or cash flows.

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Item 2. Management's Discussion and Analysis of Results of Operations and Financial Condition (amounts in dollars, except where noted and share and per share amounts)

Forward Looking Statements

This Quarterly Report on Form 10-Q includes forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. These forward-looking statements are based on the Company's current expectations and projections about future events. These forward-looking statements are subject to known and unknown risks, uncertainties and assumptions about the Company and its subsidiaries that may cause actual results, levels of activity, performance or achievements to be materially different from any future results, levels of activity, performance or achievements expressed or implied by these forward-looking statements.

These forward-looking statements include statements with respect to the Company's vision, mission, strategies, goals, beliefs, plans, objectives, expectations, anticipations, estimates, intentions, financial condition, results of operations, future performance and business of the Company, including but not limited to, (i) projections of revenue, costs of raw materials, income or loss, earnings or loss per share, capital expenditures, growth prospects, dividends, capital structure, other financial items and the effects of currency fluctuations, (ii) statements of plans and objectives of the Company or its management or Board of Directors, including the introduction of new products, or estimates or predictions of actions of customers, suppliers, competitors or regulatory authorities, (iii) statements of future economic performance, (iv) statements of assumptions and other statements about the Company or its business, and (v) statements preceded by, followed by or that include the words "may", "could", "should", "looking forward", "would", "believe", "expect", "anticipate", "estimate", "intend", "plan", or the negative of such terms or similar expressions. These forward-looking statements involve risks and uncertainties which are subject to change based on various important factors.

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Some of these risks and uncertainties, in whole or in part, are beyond the Company's control. Factors that might cause or contribute to such a material difference include, but are not limited to, those discussed in the Company's Annual Report on Form 10-K for the fiscal year ended February 28, 2003, in the section entitled "Risks Particular to Our Business." Shareholders are urged to review these risks carefully prior to making an investment in the Company's common stock.

The Company cautions that the foregoing list of important factors is not exclusive. The Company does not undertake to update any forward-looking statement, whether written or oral, that may be made from time to time by or on behalf of the Company.

Overview

The Company is principally engaged in the design, manufacture and sale of software driven products used to create and monitor the physiological effects of motion on humans and equipment and to control, modify, simulate and measure environmental conditions. These products include aircrew training systems, entertainment products, sterilizers, environmental and hyperbaric chambers and other products that involve similar manufacturing techniques and engineering technologies.

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The Company recognizes revenue using three methods:

On long-term contracts, the percentage-of-completion method is applied based on costs incurred as a percentage of estimated total costs. This percentage is multiplied by the total estimated revenue under a contract to calculate the amount of revenue recognized in an accounting period. Revenue recognized on uncompleted long-term contracts in excess of amounts billed to customers is reflected as an asset. Amounts billed to customers in excess of revenue recognized on uncompleted long-term contracts are reflected as a liability. When it is estimated that a contract will result in a loss, the entire amount of the loss is accrued. The effect of revisions in cost and profit estimates for long-term contracts is reflected in the accounting period in which the Company learns the facts which require it to revise the cost and profit estimates. Contract progress billings are based upon contract provisions for customer advance payments, contract costs incurred, and completion of specified contract milestones. Contracts may provide for customer retainage of a portion of amounts billed until contract completion. Retainage is generally due within one year of completion of the contract. Revenue recognition under the percentage-of-completion method involves significant estimates.

Revenue for contracts under \$100,000, or to be completed in less than one year, and where there are no post-shipment services included in the contract, is recognized on the date that the finished product is shipped to the customer.

Revenue derived from the sale of parts and services is also recognized on the date that the finished product is shipped to the customer. Revenue on contracts under \$100,000, or to be completed in less than one year, and where post-shipment services (such as installation and customer acceptance) are required, is recognized following customer acceptance. Revenue for service contracts is recognized ratably over the life of the contract with related material costs expensed as incurred.

In accordance with accounting principles generally accepted in the United States, recognizing revenue on contract claims and disputes related to

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customer caused delays, errors in specifications and designs, and other unanticipated causes, and for amounts in excess of contract value, is generally appropriate if it is probable that the claim will result in additional contract revenue and if the Company can reliably estimate the amount of additional contract revenue the Company may receive. However, revenue recorded on a contract claim cannot exceed the incurred contract costs related to that claim. Claims are subject to negotiation, arbitration and audit by the customer or governmental agency.

The Company has operating subsidiaries in the United Kingdom and Poland, maintains regional offices in the Middle East, Asia and Canada, and uses the services of approximately 100 independent sales organizations and agents throughout the world. ETC International Corporation is a holding company established for federal income tax purposes and is not an operating subsidiary. The Company considers its business activities to be divided into two segments: Aircrew Training Systems (ATS) and Industrial Group.

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Critical Accounting Policies

The discussion and analysis of the Company's financial condition and results of operation are based upon the Company's consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States. The preparation of these financial statements requires the Company to make estimates and judgments that affect the reported amount of assets and liabilities, revenues and expenses, and related disclosure of contingent assets and liabilities at the date of the Company's financial statements. Actual results may differ from these estimates under different assumptions or conditions.

Critical accounting policies are defined as those that reflect significant judgments and uncertainties, and potentially result in materially different results under different assumptions and conditions. The Company believes that its critical accounting policies include those described below. For a detailed discussion on the application of these and other accounting policies, see Note 1 to the Consolidated Financial Statements, Summary of Significant Accounting Policies in the Company's Annual Report on Form 10-K for the fiscal year ended February 28, 2003, which we filed with the Securities and Exchange Commission on May 29, 2003.

Revenue Recognition on Long-Term Contracts

When the performance of a contract requires a customer to pay the Company more than \$100,000 and will extend beyond a 12-month period, revenue and related costs are recognized on the percentage-of-completion method of accounting. Profits expected to be realized on such contracts are recognized based on total estimated sales for the contract compared to total estimated costs at completion of the contract. These estimates are reviewed periodically throughout the lives of the contracts, and adjustments to profits resulting from any revisions are made cumulative to the date of the change. Estimated losses on long-term contracts are recorded in the period in which the losses become known to the Company.

The Company accounts for some of its largest contracts, including its contracts with the U.S. Government and foreign governments, using the percentage-of-completion method. If the Company does not accurately estimate the total cost to be incurred on this type of contract, or if the Company is unsuccessful in the ultimate collection of associated contract claims, the estimated gross margins may be significantly impacted or losses may need to be

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recognized in future periods. Any resulting reductions in margins or contract losses could be material to the Company's results of operations and financial position.

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Accounts Receivable

The Company performs ongoing credit evaluations of its customers and adjusts credit limits based on payment history and the customer's current credit worthiness. The Company continuously monitors collections and payments from its customers and maintains a provision for estimated credit losses based on historical experience and any specific customer collection issues that have been identified. While the Company's credit losses have historically been within its expectations and the provisions established, the Company cannot guarantee that it will continue to experience the same credit loss rates that it has in the past. Additionally, as a result of the concentration of international receivables, the Company cannot predict the effect, if any, which geopolitical risk and uncertainty will have on the ultimate collection of its international receivables.

Results of Operations

Thirteen weeks ended November 28, 2003 compared to thirteen weeks ended November 22, 2002.

Net Income.

The Company had a net loss of \$704,000, or (\$0.10) per share (diluted), during the third quarter of fiscal 2004 versus a net income of \$436,000, or \$0.06 per share (diluted), for the third quarter of fiscal 2003, representing a decrease of \$1,140,000 or 261.5%. This decrease was due to a significant decrease in sales and gross profit margin partially offset by reduced selling, general and administrative and research and development expenses and an income tax benefit.

Sales.

Sales for the third quarter of fiscal 2004 were \$7,115,000 as compared to \$12,162,000 for the third quarter of fiscal 2003, a decrease of \$5,047,000 or 41.5%. The primary contributors to the sales decrease were reduced revenues for international ATS (down \$3,731,000) as the prior year quarter included a significant amount of start-up revenue for a centrifuge project in Malaysia, and reduced sales of entertainment products (down \$2,389,000) due to the completion of a major entertainment project. Providing partial offsets were increased domestic sterilizer sales, which benefited from a new Ethylene Oxide ("ETO") sterilizer project and increased domestic and international environmental sales from various projects.

Domestic Sales.

Overall, domestic sales in the third quarter of fiscal 2004 were \$2,775,000 as compared to \$2,899,000 in the third quarter of fiscal 2003, a decrease of \$124,000 or 4.3%, as a significant reduction in entertainment sales was only partially offset by increases across the board in all businesses with the strongest performance in sterilizers and environmental. Domestic sales represented 39.0% of the Company's total sales in the third quarter of fiscal 2004, up from 23.8% for the third quarter of fiscal 2003. Sales to the U.S. Government in the third quarter of fiscal 2004 were negligible as compared to \$1,150,000 in the third quarter of fiscal 2003, and represented 0.0% of total sales in the third quarter of fiscal 2004 versus 9.5% for the third quarter of

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fiscal 2003.

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International Sales.

International sales for the third quarter of fiscal 2004 were \$4,382,000 as compared to \$8,113,000 in the third quarter of fiscal 2003, a decrease of \$3,731,000 or 46.0%, and represented 61.0% of total sales, as compared to 66.7% in the third quarter of fiscal 2003. Throughout the Company's history, most of the sales for Aircrew Training Systems have been made to international customers. In the thirteen weeks ended November 28, 2003, international sales totaling at least ten percent of total international sales were made to Venezuela (\$1,050,000), the United Kingdom (\$818,000), and Malaysia (\$793,000). In the thirteen weeks ended November 22, 2002, international sales totaling at least ten percent of total international sales were made to Malaysia (\$6,345,000). Fluctuations in sales to international countries from year to year primarily reflect revenue recognition on the level and stage of development and production on multi-year long-term contracts.

Gross Profit.

Gross profit for the third quarter of fiscal 2004 was \$1,774,000 as compared to \$3,579,000 in the third quarter of fiscal 2003, a decrease of \$1,805,000 or 50.4%. This decrease reflected the decrease in sales coupled with a 4.5 percentage point decrease in the gross profit rate as a percent of sales. The reduced gross profit rate as a percent of sales reflected reductions primarily in entertainment, simulation and ATS sales coupled with a higher mix of lower margin environmental sales.

Selling and Administrative Expenses.

Selling and administrative expenses for the third quarter of fiscal 2004 were \$2,330,000 as compared to \$2,437,000 in the third quarter of fiscal 2003, a decrease of \$107,000 or 4.4% primarily reflecting decreased advertising, trade show and legal costs.

Research and Development Expenses.

Research and development expenses, which are charged to operations as incurred, were \$144,000 for the third quarter of fiscal 2004 as compared to \$268,000 for the third quarter of fiscal 2003, reflecting a decrease of \$124,000 or 46.3%. The reduction primarily reflected reduced activity in the Company's Turkish subsidiary. Most of the Company's research efforts, which were and continue to be a significant cost of its business, are included in cost of sales for applied research for specific contracts, as well as research for feasibility and technology updates.

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Interest Expense.

Interest expense for the third quarter of fiscal 2004 was \$425,000 as compared to \$116,000 for the third quarter of fiscal 2003, representing an increase of \$309,000 or 266.4%. This increase reflected interest charges at a higher effective interest rate for the Company's subordinated debt borrowed in February 2003 (including amortization of debt discounts arising out of the beneficial conversion option and associated warrants issued) and amortization of

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deferred financing costs for the Company's February 2003 refinancing.

Other Income/Expense, Net

Other income/expense, net, was income of \$138,000 for the third quarter of fiscal 2004 versus a net expense of \$174,000 for the third quarter of fiscal 2003, a decrease of \$312,000 or 179.3%. The current period reflected the positive net impact of \$283,000 for an insurance reimbursement partially offset by international letter of credit and domestic bank charges.

Provision for Income Taxes.

The Company's tax benefit for the third quarter of fiscal 2004 reflected an estimated 30% rate domestically and a consolidated estimated rate of 28.4%. The lower than statutory effective tax rate domestically reflects the ongoing effect of offsetting research and development tax credits. The international rate reflects a recalculation in ETC Europe, a subsidiary of the Company, of the estimated tax loss carry-forward which will be used to offset any current year tax liability. The consolidated rate for the third quarter of fiscal 2003 reflected an estimated rate of 26.3%, reflecting additional research and development tax credits.

Results of Operations

Thirty-nine weeks ended November 28, 2003 compared to thirty-nine weeks ended November 22, 2002.

Net Income.

The Company had a net loss of \$1,256,000, or (\$0.18) per share (diluted), during the thirty-nine weeks ended November 28, 2003, versus net income of \$1,757,000, or \$.23 per share (diluted), for the thirty-nine weeks ended November 22, 2002, representing a decrease of \$3,013,000 or 171.5%. This decrease was due to a significant decrease in sales and gross profit margin partially offset by reduced selling, general and administrative and research and development expenses and an income tax benefit.

Sales.

Sales in the thirty-nine weeks ended November 28, 2003 were \$17,997,000 as compared to \$34,410,000 for the thirty-nine weeks ended November 22, 2002, a decrease of \$16,413,000 or 47.7%. The primary contributor to the sales decrease was reduced revenues for domestic entertainment (down \$16,595,000) due to the completion of a major entertainment project. The Company also experienced reduced international revenues for environmental and ATS sales. The prior period included a significant amount of sales in environmental for projects in China and start-up revenue in ATS for a centrifuge project in Malaysia. Providing partial offsets were increased domestic sterilizer sales (up \$3,222,000), which benefited from a new ETO sterilizer project, and increased domestic simulation sales for various projects.

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Domestic Sales.

Overall, domestic sales in the thirty-nine weeks ended November 28, 2003, were \$7,355,000 as compared to \$19,675,000 for the thirty-nine weeks ended November 22, 2002, a decrease of \$12,320,000 or 62.6%. This decrease was primarily due to the decrease in entertainment sales. Domestic sales represented 40.9% of the Company's total sales in the thirty-nine weeks ended November 28,

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2003, down from 57.2% for the thirty-nine weeks ended November 22, 2002. Sales to the U.S. Government in the thirty-nine weeks ended November 28, 2003 were \$624,000 as compared to \$2,585,000 for the thirty-nine weeks ended November 22, 2002, a decrease of \$1,961,000, 75.9%, and represented 3.5% of total sales in the thirty-nine weeks ended November 28, 2003 versus 7.5% for the thirty-nine weeks ended November 22, 2002.

International Sales.

International sales in the thirty-nine weeks ended November 28, 2003 were \$10,019,000 as compared to \$12,150,000 for the thirty-nine weeks ended November 22, 2002, a decrease of \$2,131,000 or 17.5%, and represented 55.6% of total sales in the period ended November 28, 2003, as compared to 35.3% for the thirty-nine weeks ended November 22, 2002. Throughout the Company's history, most of the sales for Aircrew Training Systems have been made to international customers. In the thirty-nine weeks ended November 28, 2003, international sales totaling at least ten percent of total international sales were made to government or commercial accounts in Malaysia (\$2,887,000) and Venezuela (\$1,050,000). In the thirty-nine weeks ended November 22, 2002, international sales totaling at least ten percent of total international sales were made to commercial or governmental accounts in Malaysia (\$6,345,000) and China (\$2,301,000). Fluctuations in sales to international countries from year to year primarily reflect revenue recognition on the level and stage of development and production on multi-year long-term contracts.

Gross Profit.

Gross profit in the thirty-nine weeks ended November 28, 2003 was \$5,847,000 as compared to \$10,425,000 for the thirty-nine weeks ended November 22, 2002, a decrease of \$4,578,000 or 43.9%. This decrease reflected the decrease in sales which was only partially offset by a 2.2 percentage point increase in the gross profit rate as a percent of sales. Increased gross profit rates as a percent of sales were evidenced in domestic sterilizer and simulation and international ATS sales.

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Selling and Administrative Expenses.

Selling and administrative expenses in the thirty-nine weeks ended November 28, 2003 were \$6,246,000 as compared to \$6,881,000 for the thirty-nine weeks ended November 22, 2002, a decrease of \$635,000 or 9.2% as compared to the first half of fiscal 2003, primarily reflecting a reimbursement in the first quarter of fiscal 2004 of prior period legal and claim expenses associated with an arbitration hearing in January 2003. Additional savings were evidenced in the Company's European subsidiary.

Research and Development Expenses.

Research and development expenses, which are charged to operations as incurred, were \$176,000 in the thirty-nine weeks ended November 28, 2003 as compared to \$487,000 for the thirty-nine weeks ended November 22, 2002, reflecting a decrease of \$311,000 or 63.9%. This decrease reflected government grants in our Turkish subsidiary under a government research award for work on our multi-axis centrifuge tactical flight simulator. Most of the Company's research efforts, which were and continue to be a significant cost of its business, are included in cost of sales for applied research for specific contracts, as well as research for feasibility and technology updates.

Interest Expense.

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Interest expense in the thirty-nine weeks ended November 28, 2003 was \$1,192,000 as compared to \$382,000 for the thirty-nine weeks ended November 22, 2002, representing an increase of \$810,000 or 212.0%. This increase reflected interest charges at a higher effective interest rate for the Company's subordinated debt borrowed in February 2003 (including amortization of debt discounts arising out of the beneficial conversion option and associated warrants issued) and amortization of deferred financing costs for the Company's February 2003 refinancing.

Other Income/Expense, Net

Other income/expense, net, was income of \$51,000 for the thirty-nine weeks ended November 28, 2003 versus a net expense of \$324,000 for the thirty-nine weeks ended November 22, 2002, a decrease of \$375,000 or 115.7%. The current period reflected the positive net impact of \$283,000 for an insurance reimbursement partially offset by international letter of credit and domestic bank charges.

Provision for Income Taxes.

The Company's tax provision in the thirty-nine weeks ended November 28, 2003 reflected an estimated 30.0% rate domestically and a consolidated estimated rate of 26.3%. The lower than statutory effective tax rate domestically reflects the ongoing effect of offsetting research and development tax credits. The international rate reflects a recalculation in ETC Europe, a subsidiary of the Company, of the estimated tax loss carry-forward which will be used to offset any current year tax liability. The consolidated rate for the thirty-nine weeks ended November 22, 2002 reflected an estimated rate of 26.8% reflecting additional research and development tax credits.

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Liquidity and Capital Resources

During the thirty-nine weeks ended November 28, 2003, the Company used \$4,599,000 to support operating activities. This was primarily the result of the net loss coupled with an increase in accounts receivable, prepaid expenses and inventory. Acting as partial offsets were non-cash expenses and an increase in accrued liabilities, accounts payable and customer deposits. Generally speaking, the cash usage reflected significant period end billings on large international contracts and a build-up in inventory of costs for contracts that were not finished by the end of the period, partially offset by an increase in various liability accounts.

The Company's investing activities used \$1,244,000 during the thirty-nine weeks ended November 28, 2003, which consisted of purchases of capital equipment and capitalized software.

The Company's financing activities generated \$2,724,000 during the thirty-nine weeks ended November 28, 2003, consisting of a reduction in the Company's cash collateral restricted cash account and net borrowings on the Company's bank line. The cash collateral account serves as security for any of the Company's international letters of credit that are not covered under the Company's bank facility.

The Company has historically financed operations through a combination of cash generated from operations, and bank and other debt. On February 19, 2003, the Company completed a refinancing of its indebtedness with PNC Bank, National Association and H.F. Lenfest in the aggregate amount of \$29,800,000.

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The Company used a portion of the proceeds from the financing to satisfy its existing debt obligations to Wachovia Bank, the Company's former lender, and to permit PNC Bank to issue a letter of credit to support outstanding bonds issued by the Company in a previous financing transaction. The transaction resulted in net proceeds (after transaction expenses and payment of existing debt) to the Company of approximately \$3,600,000. The net proceeds have been used by the Company for working capital and general corporate purposes.

In accordance with the terms of an amendment dated April 30, 2003, the PNC Bank facility was increased and, as of the date of this Quarterly Report on Form 10-Q, includes: (i) a revolving credit facility in the maximum aggregate principal amount of \$14,800,000 to be used for the Company's working capital and general corporate purposes, including capital expenditures, with a sublimit for issuances of letters of credit in the maximum aggregate face amount of \$10,300,000, and (ii) a standby letter of credit in the face amount of \$4,750,000 as credit support for the Company's bonds. Additionally, on July 9, 2003, a second amendment to the bank agreement was executed which formed an additional \$1,010,000 credit facility for use in financing export contracts which qualify for an EXIM (the Export-Import Bank of the United States) Bank guarantee.

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The terms and conditions of the revolving loan and the line of credit are set forth in a Credit Agreement, as amended, between the Company and PNC Bank. Availability under both the main facility and the EXIM facility are determined each month based on a borrowing base consisting of a portion of the Company's receivables, inventory and costs and estimated earnings in excess of billings, net of billings in excess of costs and estimated earnings on uncompleted long-term contracts. As of November 28, 2003, availability under the \$14,800,000 revolving facility was \$7,626,000, of which the Company had utilized \$7,157,000, and availability under the EXIM facility was \$328,000, which was fully available.

The obligations of the Company to PNC Bank under the Credit Agreement are secured by a first priority lien on and senior security interest in all of the assets of the Company, including all real property owned by the Company.

At November 28, 2003, the Company was in violation of three of its financial covenants in its Bank Credit Agreement and two of its covenants in its Convertible Note and Warrant Purchase Agreement. These violations occurred as a result of the second and third quarter fiscal 2004 net losses. As of the date of this Quarterly Report on Form 10-Q, the Company has obtained waivers for these covenant violations from both the Bank and the Note holder. Notwithstanding the covenant violations at November 28, 2003, it is the opinion of management based on the current sales backlog, forecasted new contract bookings and claim arbitration discussions that it is not probable that the Company will have additional covenant violations going forward. However, should there be unforeseen delays in completing existing contracts, should the receipt of new contracts be delayed, or should arbitration discussions be delayed or extended, it is possible that additional covenant violations may occur.

In connection with the financing provided by Mr. Lenfest, the Company entered into a Convertible Note and Warrant Purchase Agreement with Mr. Lenfest, pursuant to which the Company issued to Mr. Lenfest (i) a senior subordinated convertible promissory note in the original principal amount of \$10,000,000 and (ii) warrants to purchase 803,048 shares of the Company's common stock. Upon the occurrence of certain events, the Company will be obligated to issue additional warrants to Mr. Lenfest. The note accrues interest at the rate of 10% per annum and matures on February 18, 2009. The note entitles Mr. Lenfest to convert all

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or a portion of the outstanding principal of plus accrued and unpaid interest on the note into shares of common stock at a conversion price of \$6.05 per share. The warrants may be exercised into shares of common stock at an exercise price equal to the lesser of \$4.00 per share or two-thirds of the average of the high and low sale prices of the common stock for the 25 consecutive trading days immediately preceding the date of exercise.

The obligations of the Company to Mr. Lenfest under the Convertible Note and Warrant Purchase Agreement are secured by a second priority lien on and security interest in all of the assets of the Company, junior in rights to the liens and security interests in favor of PNC Bank, including all real property owned by the Company.

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Prior to the consummation of the refinancing, ETC Asset Management, LLC, a shareholder of the Company and a holder of warrants to purchase 332,820 shares of the Company's common stock, consented to the transactions contemplated under the Credit Agreement and the financing provided by Mr. Lenfest, including the below market issuance of warrants to Mr. Lenfest. As a result of its consent, ETC Asset Management waived, solely in connection with such issuance, the anti-dilution rights contained in its warrant. In exchange for ETC Asset Management's consent, the Company issued to ETC Asset Management warrants to purchase an additional 105,000 shares of common stock. Except for the number of shares issuable upon exercise of the warrants, the new ETC Asset Management warrants have substantially the same terms as the warrants issued to Mr. Lenfest.

To fund its operations, the Company plans to utilize cash from operations, potential arbitration proceeds as well as additional cash available under the revolving and EXIM facilities as the borrowing base expands and international letters of credit expire. The Company believes that cash generated from operating activities as well as future availability under its credit agreement will be sufficient to meet its future obligations for the foreseeable future.

The following table presents our contractual cash flow commitments on long-term debt and operating leases.

| | Payments Due by Period (in thousands) | | | |
|---------------------------|---------------------------------------|-----------|-----------|-------|
| Total | Less Than 1 Year | 1-3 Years | 4-5 Years | Af |
| Long-term debt, including | | | | |
| current maturities | \$13,447 | \$281 | \$2,028 | \$550 |
| Operating leases | 343 | 168 | 175 | - |
| | ----- | ---- | ----- | ---- |
| Total | \$13,790 | \$449 | \$2,203 | \$550 |

Contract Claims

Historically, the Company has had positive experience with regard to its contract claims in that recoveries have exceeded the carrying value of claims. As of November 28, 2003, claims recorded against the U.S. Government totaled \$2,899,000 and claims recorded against an international customer totaled

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\$10,269,000.

Claim costs have been incurred in connection with customer caused delays, errors in specifications and designs, other out-of-scope items and exchange losses and may not be received in full during fiscal 2004. In conformity with accounting principles generally accepted in the United States, revenue recorded by the Company from a claim may not exceed the incurred contract costs related to the claim.

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In November 2003, the U.S. Government completed an audit of one of the company's claims, rejecting most of the items due to audit or engineering reasons. The Company was not provided a copy of the Government's Technical Report that questioned approximately half of the claim costs. The Company has submitted a written rebuttal to the draft report and has formally requested a copy of the Technical Report. The Company considers the recorded costs to be realizable due to the fact that they relate to customer caused delays, errors and changes in specifications and designs, disputed liquidated damages and other out of scope items. Additionally the Company is currently preparing an update to the claim to incorporate additional spending related to the claim items. During the 13 weeks ended November 28, 2003 this customer, citing failure to deliver product within contract terms, began assessing liquidated damages by offsetting progress payments due the Company under the contract. The Company disputes the basis for these liquidated damages, noting that applicable U.S. Government purchasing regulations allow for a waiver of these charges if the delay is beyond the control and not due to the fault or negligence of the Company. However, following accounting principles generally accepted in the United States, the Company has reduced contract values and corresponding revenue recognition for an estimated amount to cover a delay through the extended delivery period.

With respect to the claims filed against an international customer, the Company is currently mediating and arbitrating the disputes that have arisen under two contracts with one of its international customers in the United Kingdom but is unable to assess the ultimate impact of either the termination or the arbitration on current operations and financial condition.

Based on witness statements, expert reports and other facts, the Company believes that it has a reasonable basis to refute the concerns of the U.K. Ministry of Defense. The Company has installed seven centrifuges in the last 15 years at various locations throughout the world and the Company is unaware of any accidents or injuries caused by the operation of these centrifuges. To the extent the Company is unsuccessful in further recovery of contract costs, such an event could have a material adverse effect on the Company's liquidity and results of operations. The Company does not plan to reduce the carrying value of the claim until all unresolved matters have been properly adjudicated in the arbitration proceedings.

The Company has an open receivable balance of \$700,000 due from the RTAF. This amount represents the total net exposure to the Company on this contract. On June 16, 2003, the Company's Thai attorneys filed for arbitration in Thailand seeking recovery of the open balance of \$700,000 due on the contract. On October 8, 2003, the Thai government filed their defense with the Thai Arbitration Institute. This document is currently being translated into English. In December 2003 the Company and the RTAF both picked arbitrators to represent them in the dispute, although no date has yet been set for the Arbitration proceedings. Since the circumstances that caused a delay are

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commonly considered "force majeure" events, and since the contract under question allows for consideration of "force majeure" events, the Company believes that the open balance related to this contract is collectible and will continue to treat this balance as collectible until a final unappealable legal decision is rendered by a competent Thai tribunal. The Company has enjoyed a favorable relationship with the RTAF. It currently has both maintenance and upgrade contracts with the RTAF for trainers that are the subject of the dispute and has sold a significant amount of additional equipment to the RTAF since this dispute began, and it is not anticipated that the initiation of legal action against the RTAF will have any material adverse impact on future contracts with the RTAF. At this point, the Company is not able to determine what, if any, impact the extended completion period will ultimately have upon the receipt of final payment under this contract.

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Backlog

The Company's sales backlog at November 28, 2003 and February 28, 2003, for work to be performed and revenue to be recognized under written agreements after such dates was approximately \$11,968,000 and \$21,454,000 respectively. In addition, the Company's training, maintenance and upgrade contracts backlog at November 28, 2003, and February 28, 2003, for work to be performed and revenue to be recognized after that date under written agreements was approximately \$3,582,000 and \$3,931,000 respectively. Of the November 28, 2003 backlog, approximately \$6,513,000 was under contracts for ATS products including \$3,785,000 for the Royal Malaysian Air Force.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

Not Applicable.

Item 4. Controls and Procedures.

Under the supervision and with the participation of the Company's management, including the Company's principal executive officer and principal financial officer, the Company has evaluated the effectiveness of the design and operation of the Company's disclosure controls and procedures as of November 28, 2003 (the "Evaluation Date"), and, based on their evaluation, the Company's principal executive officer and principal financial officer have concluded that these controls and procedures were effective as of the Evaluation Date. There were no significant changes in the Company's internal controls or in other factors that could significantly affect these controls subsequent to the Evaluation Date.

Disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended) are the Company's internal controls and other procedures that are designed to ensure that information required to be disclosed by the Company in the reports that it files or submits under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission's rules and forms. Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed by the Company in the reports that it files under the Exchange Act is accumulated and communicated to the Company's management, including the Company's principal executive officer and principal financial officer, as appropriate to allow timely decisions regarding required disclosure.

Part II - OTHER INFORMATION

Item 1. Legal Proceedings

In April 2003, Boenning & Scattergood, Inc. ("B&S") filed suit against the Company in the Court of Common Pleas in Philadelphia, Pennsylvania, seeking payment of \$901,843.46 for financing fees allegedly due to B&S pursuant to the terms of an agreement for investment banking services, which was entered into with a predecessor of B&S (the "B&S Agreement"). B&S alleges that it contacted the investors in the Company's February 2003 financing transaction and that it earned the claimed financing fees pursuant to the terms of the B&S Agreement. The Company has responded to the complaint and also filed a counterclaim for breach of contract and professional malpractice. The Company believes that it has valid defenses to each of the claims of B&S and intends to vigorously defend itself against these claims. At this time, however, discovery has just begun and the Company is unable to predict the outcome of this matter.

In June 2003, Associated Mezzanine Investors, LLC ("AMI") filed suit against the Company in the United States District Court for the Eastern District of Pennsylvania seeking payment of \$195,682.86 for costs, fees and expenses allegedly due to AMI pursuant to the terms of an agreement which the Company entered into with AMI (the "AMI Agreement"). AMI claims that it located suitable investors for the Company's February 2003 financing transaction and that it earned the claimed fees and is entitled to reimbursement of the claimed costs and expenses pursuant to the terms of the AMI Agreement. The Company has responded to the complaint. The Company believes that it has valid defenses to each of the claims of AMI and intends to vigorously defend itself against these claims. At this time, however, the Company is unable to predict the outcome of this matter.

In June 2003, Entertainment Technology Corporation, a wholly-owned subsidiary of the Company, filed suit against Walt Disney World Co. and other entities ("Disney") in the United States District Court for the Eastern District of Pennsylvania, alleging breach of contract for, among other things, failure to pay all amounts due under contract for the design and production of the amusement park ride "Mission: Space" located in Disney's Epcot Center. In response, in August 2003, Disney filed counterclaims against both Entertainment Technology Corporation and the Company (under a guarantee) for, among other things, alleged failures in performance and design in the contract. Disney is seeking damages in excess of \$150,000. Entertainment Technology Corporation and the Company believe that they have valid defenses to each of Disney's counterclaims and intend to vigorously defend against these counterclaims. At this time, however, discovery is still ongoing and Entertainment Technology Corporation and the Company are unable to predict the outcome of this matter.

Certain claims, suits and complaints arising in the ordinary course of business have been filed or are pending against the Company. In the opinion of management, all such matters are reserved for or are adequately covered by insurance or, if not so covered, are without merit or are of such kind, or involve such amounts as would not have a material adverse effect on the Company's financial position if resolved unfavorably.

Item 2. Changes in Securities and Use of Proceeds

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The constituent instruments defining the rights of the holders of any class of securities were not modified nor were the rights evidenced by any class of registered securities materially limited or qualified during the period covered by this report.

Item 3. Defaults Upon Senior Securities

None.

Item 4. Submission of Matters to Vote of Security Holders

At the Company's Annual Meeting of Stockholders held on September 11, 2003 the following proposal was adopted by the vote specified below. No other matters were submitted to a vote of security holders at the Annual Meeting.

Proposal One: To elect five directors to serve until successors have been elected and qualified.

| Nominee | For | Withheld | Abstentions and Broker Non-votes |
|---------------------|-----------|----------|-------------------------------------|
| | | | |
| George K. Anderson | 6,026,023 | 2,200 | 0 |
| Howard W. Kelley | 6,026,023 | 2,200 | 0 |
| H.F."Gerry"Lenfest | 6,026,023 | 2,200 | 0 |
| William F. Mitchell | 5,736,928 | 293,515 | 0 |
| Pete L. Stephens | 6,026,023 | 2,200 | 0 |

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Item 5. Other Information

None.

Item 6. Exhibits and Reports on Form 8-K

(a) Exhibits:

| Number | Item |
|--------|--|
| | |
| 3.1 | Registrant's Articles of Incorporation, as amended, were filed as Exhibit 3.1 to Registrant's Form 10-K for the year ended February 28, 1997 and are incorporated herein by reference. |
| 3.2 | Registrant's By-Laws, as amended, were filed as Exhibit 3 (ii) to Registrant's Form 10-K for the year ended February 25, 1994, and are incorporated herein by reference. |

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- 31.1 Certification dated January 12, 2004 pursuant to 18 U.S.C. Section 1350 as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 made by William F. Mitchell, Chief Executive Officer.
- 31.2 Certification dated January 12, 2004 pursuant to 18 U.S.C. Section 1350 as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 made by Duane D. Deaner, Chief Financial Officer.
- 32 Certification dated January 12, 2004 pursuant to 18 U.S.C. Section 1350 as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 made by William F. Mitchell, Chief Executive Officer, and Duane D. Deaner, Chief Financial Officer.

(b) Reports on Form 8-K

On October 15, 2003, the Company filed a Current Report on Form 8-K reporting its financial results for the second quarter of fiscal 2004.

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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.

ENVIRONMENTAL TECTONICS CORPORATION
(Registrant)

Date: January 12, 2004

By: /s/ William F. Mitchell

William F. Mitchell
President and Chief
Executive Officer
(Principal Executive Officer)

Date: January 12, 2004

By: /s/ Duane Deaner

Duane Deaner,
Chief Financial Officer
(Principal Financial and
Accounting Officer)

