

Edgar Filing: ENVIRONMENTAL TECTONICS CORP - Form 10-Q

ENVIRONMENTAL TECTONICS CORP  
Form 10-Q  
January 10, 2005

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 26, 2004

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       No        
    ---              ---

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

Yes            No   
    ---              ---

The number of shares outstanding of the registrant's common stock as of  
December 31, 2004 is: 7,640,686.

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## PART I - FINANCIAL INFORMATION

### ITEM 1. FINANCIAL STATEMENTS

Environmental Tectonics Corporation  
Consolidated Statements of Operations  
(unaudited)

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

	Thirteen Weeks Ended		Thirty-
	November 26, 2004	November 28, 2003	November 26, 2004
Net sales	\$7,751	\$7,115	\$20,449
Cost of goods sold	6,114	5,341	16,797
Gross profit	1,637	1,774	3,652
Operating expenses:			
Selling and administrative	4,224	2,330	9,775
Research and development	170	144	671
	4,394	2,474	10,446
Operating loss	(2,757)	(700)	(6,794)
Other expenses:			
Interest expense, net	440	425	1,171
Other, net	57	(138)	182
	497	287	1,353
Loss before income taxes	(3,254)	(987)	(8,147)
Benefit from income taxes	(4)	(280)	(1,453)
Loss before minority interest	(3,250)	(707)	(6,694)
Loss attributable to minority interest	(1)	(3)	-
Net loss	\$(3,249)	\$(704)	\$(6,694)
Per share information:			
Loss applicable to common shareholders	\$(3,249)	\$(704)	\$(6,694)
Loss per share: basic	\$(0.43)	\$(0.10)	\$(0.88)
Loss per share: diluted	\$(0.43)	\$(0.10)	\$(0.88)
Number of shares: basic	7,641,000	7,168,000	7,604,000
Number of shares: diluted	7,641,000	7,168,000	7,604,000

The accompanying notes are an integral part of the consolidated

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financial statements.

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Environmental Tectonics Corporation  
Consolidated Balance Sheets

	November 26, 2004 unaudited
	----- (amounts in thousand informati
Assets	
Current assets:	
Cash and cash equivalents	\$ 5,832
Cash equivalents restricted for letters of credit	2,850
Accounts receivable, net	9,044
Costs and estimated earnings in excess of billings on uncompleted long-term contracts	3,015
Inventories	7,412
Deferred tax asset	1,337
Prepaid expenses and other current assets	2,111
	-----
Total current assets	31,601
	-----
Property, plant and equipment, at cost, net of accumulated depreciation of \$11,263 at November 26, 2004 and \$10,651 at February 27, 2004	5,509
Software development costs, net of accumulated amortization of \$8,125 at November 26, 2004 and \$7,494 at February 27, 2004	3,524
Goodwill and intangibles	477
Other assets, net	612
	-----
Total assets	\$ 41,723 =====
Liabilities and Stockholders' Equity	
Liabilities	
Current liabilities:	
Current portion of long-term debt	\$ 452
Accounts payable - trade	3,767
Billings in excess of costs and estimated earnings on uncompleted long-term contracts	961
Customer deposits	1,163
Accrued liabilities	1,774
	-----
Total current liabilities	8,117
	-----
Long-term debt, less current portion:	
Credit facility payable to banks	-
Long-term bonds, net	4,095
Subordinated debt	7,905
Capital leases/Other	374
	-----
	12,374

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Deferred income taxes	1,502
Total liabilities	21,993
Minority interest	46
Stockholders' Equity	
Common stock; \$.05 par value; 20,000,000 shares authorized; 7,640,686 and 7,176,552 issued and outstanding at November 26, 2004 and February 27, 2004, respectively	381
Capital contributed in excess of par value of common stock	10,728
Accumulated other comprehensive loss	(325)
Retained earnings	8,900
Total stockholders' equity	19,684
Total liabilities and stockholders' equity	\$ 41,723

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 26, 2004
	(amounts in thousands)
Cash flows from operating activities:	
Net loss	\$(6,694)
Adjustments to reconcile net loss to net cash provided by/(used in) operating activities:	
Depreciation and amortization	1,405
Non-cash interest expense	239
Provision for losses on accounts receivable and inventories	172
Minority interest	1
Changes in operating assets and liabilities:	
Accounts receivable	10,168
Costs and estimated earnings in excess of billings on uncompleted long-term contracts	2,318
Inventories	1,687
Prepaid expenses and other assets	(68)
Accounts payable	1,336
Billings in excess of costs and estimated earnings on uncompleted long-term contracts	16
Customer deposits	(2,494)
Other accrued liabilities	(814)
Net cash provided by/(used in) operating activities	7,272

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	-----
Cash flows from investing activities:	
Acquisition of equipment	(122)
Capitalized software development costs	(1,066)
	-----
Net cash used in investing activities	(1,188)
	-----
Cash flows from financing activities:	
Borrowings under credit facility	-
Payments under credit facility	(30)
Repayment of long-term bonds	(275)
Cash equivalents restricted	(2,066)
Proceeds from issuance of common stock / warrants	1,320
Deferred finance charges	(571)
	-----
Net cash (used in)/provided by financing activities	(1,622)
	-----
Effect of exchange rate changes on cash	4
	-----
Net increase/(decrease) in cash and cash equivalents	4,466
Cash and cash equivalents at beginning of period	1,366
	-----
Cash and cash equivalents at end of period	\$5,832
	=====
Supplemental schedule of cash flow information:	
Interest paid	670
Income taxes paid	5

Supplemental information on noncash operating and investing activities:  
 During the thirty-nine weeks ended November 26, 2004, the Company reclassified \$593 from inventory to fixed assets.

During the thirty-nine weeks ended November 28, 2003 the Company reclassified \$353 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 ("EnTCo"), ETC International Corporation and ETC-Delaware, its wholly-owned subsidiaries, ETC Europe, its 99% owned

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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 27, 2004. Certain reclassifications have been made to the fiscal 2004 financial statements to conform with the fiscal 2005 presentation.

As a result of the Company's recent financial performance, PNC, the Company's main bank, has taken certain actions to substantially reduce the Company's operating facility. The facility is currently limited to the issuance of international letters of credit and the Company can no longer borrow cash under the facility. PNC has required the Company to keep \$2.8 million in a restricted cash account as collateral and has indicated that additional changes may be required to our Bank Agreement including increasing the amount of cash collateral. Given the Company's inability to borrow cash from its bank, the Company may need to obtain additional sources of capital in order to continue growing and operating the business. The reader is referred to the discussions in Footnote 7, Long Term Debt, and the Liquidity and Capital Resources Section of the Management's Discussion and Analysis of Results of Operations and Financial Condition later in this Form 10-Q.

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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 26, 2004			Thirteen Wee
	Loss (Numerator)	Shares (Denominator)	Per Share Amount	Loss (Numerator)
		(amounts in thousands, except share and per share i		
Basic EPS				
Net loss applicable to common stockholders	\$(3,249)	7,641,000	\$(0.43)	\$(704)
Effect of dilutive securities				
Options		-		
Warrants		-		

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Diluted EPS

Net loss applicable to common stockholders plus assumed conversions	\$ (3,249)	7,641,000	\$ (0.43)	\$ (704)
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Thirty-nine Weeks Ended November 26, 2004

Thirty-nine We

Loss (Numerator)	Shares (Denominator)	Per Share Amount	Loss (Numerator)
---------------------	-------------------------	---------------------	---------------------

(amounts in thousands, except share and per share i

Basic EPS

Net loss applicable to common stockholders	\$ (6,694)	7,604,000	\$ (0.88)	\$ (1,256)
---	------------	-----------	-----------	------------

Effect of dilutive  
securities

Options	-
Warrants	-

Diluted EPS

Net loss applicable to common stockholders plus assumed conversions	\$ (6,694)	7,604,000	\$ (0.88)	\$ (1,256)
---	------------	-----------	-----------	------------

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At November 26, 2004, there were stock options to purchase the Company's common stock totaling 299,779 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 1,652,893 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 165,289 shares would be issued, bringing the total shares to be issued to 1,818,182. Additionally, at November 26, 2004, there were outstanding warrants to purchase the Company's stock totaling 1,003,048 shares. None of these shares have been included in the computation of diluted earnings per share as the effect would be anti-dilutive.

At November 28, 2003, there were stock options to purchase the Company's common stock totaling 412,064 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 1,652,893 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 165,289 shares would be issued, bringing the total shares to be issued to 1,818,182. Additionally, at November 28, 2003, there were outstanding warrants to purchase the Company's stock

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totaling 1,240,868 shares. None of these shares have been included in the computation of diluted earnings per share as the effect 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.

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At November 26, 2004, 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).

	Thirteen Weeks E	
	November 26, 2004	N
	-----	-----
Net loss,		
as reported	\$ (3,249)	
Less: stock-based compensation costs		
determined under fair market value based		
methods for all awards	(2)	
	-----	
Net loss, pro forma	\$ (3,251)	
Loss per share of common stock-basic:		
As reported	\$ (0.43)	
Pro forma	\$ (0.43)	
Loss per share of common stock-diluted:		
As reported	\$ (0.43)	
Pro forma	\$ (0.43)	
	Thirty-nine Week	
	November 26, 2004	N
	-----	-----



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Net loss, as reported	\$(6,694)
Less: stock-based compensation costs determined under fair market value based methods for all awards	(2) -----
Net loss, pro forma	\$(6,696)
Loss per share of common stock-basic:	
As reported	\$ (0.88)
Pro forma	\$ (0.88)
Loss per share of common stock-diluted:	
As reported	\$ (0.88)
Pro forma	\$ (0.88)

Stock options to purchase a total of 33,586 shares of the Company's common stock were granted during the thirteen weeks ended November 26, 2004.

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

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4. Accounts Receivable

The components of accounts receivable are as follows:

	November 26, 2004 unaudited -----
	(amounts in tho
U.S. Government receivables billed and unbilled contract costs subject to negotiation	\$ 3,167
U.S. commercial receivables billed	2,132
International receivables billed and unbilled contract costs subject to negotiation	4,145 -----
	9,444
Less allowance for doubtful accounts	(400) -----
	\$ 9,044 =====

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

Unbilled contract costs subject to negotiation as of November 26, 2004, and February 27, 2004, primarily represent claims made against the U.S. Government under a contract for a submarine rescue decompression chamber project. These costs totaling \$3,004,000 were recorded beginning in fiscal year 2002 and include \$833,000 recorded during fiscal year 2004 and \$105,000 recorded during fiscal year 2005. In November 2003, the U.S. Government completed an audit of the claim, rejecting most of the items due to audit or engineering

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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. On July 22, 2004, the U.S. Government's Contracting Officer issued a final decision on the claim, denying the claim in full. In response, the Company plans to file a complaint in the Court of Federal Claims in the near future.

This U. S. Government claim has followed the typical process of claim notification, preparation, submittal, government audit and review by the contracting officer. Historically, the Company's experience has indicated that most claims are initially denied in part or in full by the contracting officer (or no decision is forthcoming, which is then taken to be a deemed denial) which then forces the Company to seek relief in a court of law.

The Company considers the recorded costs to be realizable due to the fact that the costs relate to customer caused delays, errors and changes in specifications and designs, disputed liquidated damages and other out of scope items. In the first quarter of fiscal 2005, the Company submitted a supplement to the claim incorporating additional cost items. The U.S. Government, citing failure to deliver the product within contract terms, has assessed liquidated damages but has not offset or withheld any progress payments due to 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 of \$330,000 to cover a delay through the extended delivery period.

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International receivables billed and unbilled contract costs subject to negotiation:

International receivables billed include \$700,000 at November 26, 2004 and February 27, 2004, 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.

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

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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 (TAI). In December 2003 the Company and the RTAF both selected arbitrators to represent them in the dispute, although no date has yet been set for the arbitration proceedings. To choose the third (umpire) arbitrator, the RTAF, TAI and the Company will each nominate three candidates for a total of nine. The RTAF and the Company will then rank the candidates and the one receiving the highest rank will be asked to serve as the (umpire) arbitrator. It is expected that this approach will avoid any conflict of interest issues.

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 trainers that are the subject of the dispute and has sold a significant amount of additional equipment to the RTAF since this dispute began. Thus, we do not feel the initiation of legal action against the RTAF has affected our ability to obtain additional 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.

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Unbilled contract costs subject to negotiation represent a claim (\$2,600,000 recorded as of November 26, 2004) made against an international customer for a contract covering the period from 1997 to the present. 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 2005. 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. The Company is currently in discussions with this customer to finalize all open issues. At this point, the Company is unable to assess the ultimate impact of discussions or arbitration on current operations and financials.

Effective February 27, 2004, the Company reached an agreement totaling \$10.5 million with the same international customer on another claim, thus resolving all outstanding amounts related to that claim. These proceeds were received on March 16, 2004 (See also the Liquidity and Capital Resources section of the Management's Discussion and Analysis of Results of Operations and Financial Condition following).

Historically, the Company has had positive experience with regard to its contract claims in that recoveries have exceeded the carrying value of claims. However, there is no assurance that the Company will always have positive experience with regard to recoveries for its contract claims.

### 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 \$715,000 and \$564,000 at November 26, 2004 and February 27, 2004, respectively):

November 26,

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	2004 unaudited	February 27, 2004
	-----	-----
	(amounts in thousands)	
Raw materials	\$308	\$311
Work in process	5,461	7,803
Finished goods	1,643	1,729
	-----	-----
Total	\$7,412	\$9,843
	=====	=====

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6. Stockholders' Equity

The components of stockholders' equity at February 27, 2004 and November 26, 2004 were as follows:

	(amounts in thousands, except share in			
	Common Stock		Capital contributed	Accumulat
	Shares	Amount	in excess of par value of common stock	Other Co
	-----	-----	-----	-----
	Loss			
Balance at February 27, 2004	7,176,552	\$359	\$9,430	\$ (329)
Net loss for the thirty-nine weeks ended November 26, 2004	-	-	-	-
Foreign currency translation adjustment	-	-	-	-
Total comprehensive loss	-	-	-	4
Shares issued in connection with exercise of warrants	437,820	21	565	-
Value of warrants issued			571	
Shares issued under exercise of employee stock options and Director compensation	26,314	1	162	-
	-----	-----	-----	-----
Balance at November 26, 2004	7,640,686	\$381	\$10,728	\$ (325)
	=====	=====	=====	=====

7. Long Term Debt

The following table lists the long-term debt and other long-term obligations of the Company as of November 26, 2004.

PAYMENTS DUE BY PERIOD

Obligation	Total	Less than 1 Year	1-3 Years	4
-----	-----	-----	-----	-----
Current Portion of Long Term Debt	\$ 275	\$ 275	\$ -	-
Long-term Debt	-	-	-	-

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Capital Leases	551	177	374
Subordinated debt, net of unamortized discount of \$2,095	7,905	-	-
Long term bonds	4,095	-	825
	-----	-----	-----
Total Obligations	\$ 12,826	\$ 452	\$ 1,199
	=====	=====	=====
Expected Interest Expense	\$ 5,006	\$ 917	\$ 3,309

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 signed a Credit Agreement (the "Agreement") with PNC Bank, National Association ("PNC") and a Convertible Note and Warrant Purchase Agreement (the "Note") with H.F. Lenfest, an individual, in the aggregate amount of \$29,800,000. 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 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 Company used the net proceeds for working capital and general corporate purposes.

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On April 30, 2003, the Agreement was amended to include: (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 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.

During the first quarter of fiscal 2005, as a result of the Company's recent operating losses and its violation of certain financial covenants contained in the Agreement, PNC advised the Company that it was instituting certain changes to the revolving credit facility. The changes included reducing the facility to \$6,000,000 and requiring the Company to cash collateralize the full facility. These changes became effective on June 2, 2004.

On August 24, 2004, the Agreement was amended to substantially reduce the operating facility and eliminate the associated monthly borrowing base reporting requirements. The revolving facility was reduced from \$14,800,000 to \$5,000,000 and use of the facility was restricted to the issuance of letters of credit, which are frequently a requirement of international contracts. Under the amended Agreement, the Company could no longer borrow cash under the facility. The Company's long-term bonds were left intact. As additional collateral for the revised facility, PNC required the Company to keep \$2,500,000 in a restricted cash account. The annual fee for letters of credit was reduced from 1.75% to 1.0% per annum. Additionally, three of the financial covenants, the Leverage Ratio, the Fixed Charge Ratio and the requirement to report a net loss in any annual period were eliminated and the Tangible Net Worth requirement was reduced. All other terms and conditions of the revolving loan and the line of credit as set forth in the Agreement remained in effect.

Under the August 24, 2004, amendment the EXIM Bank credit facility was reduced from \$1,010,000 to \$995,000, with all other terms and conditions

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remaining unchanged. Availability under the EXIM facility is determined based on a borrowing base consisting of a portion of the Company's receivables and inventory.

As a condition of amending the Agreement, Mr. Lenfest, holder of the Company's subordinated debt, agreed to issue to PNC on the Company's behalf a limited guarantee to secure up to \$5,000,000 in principal amount of any letters of credit issued under the amended facility. In consideration for issuing this guarantee, Mr. Lenfest will receive a fee of 0.75% per annum of the average amount of letters of credit outstanding, payable on a quarterly basis, and received a warrant to purchase 200,000 shares of stock under the same terms and conditions as his existing warrant for 803,048 shares (see the Liquidity and Capital Resources section following in this report).

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On October 18, 2004, the Agreement was again modified. This amendment required the Company to deposit in a restricted cash account an additional amount of \$285,000 to cover the next scheduled payment of principal and interest due April 1, 2005 on the Company's long-term bonds. The Tangible Net Worth covenant requirement was reduced to a) \$14,500,000 for the periods ended November 26, 2004 and February 25, 2005 and b) on the last day of any fiscal quarter ending after February 25, 2005, to be at least equal to the actual Tangible Net Worth on February 25, 2005. Additionally, the fee for the PNC Letter of Credit, which backs the Company's long-term bonds, was increased from 2.0% to 2.5% annually.

Under the October 18, 2004 amendment to the Agreement, the Company must maintain a minimum Tangible Net Worth. At November 26, 2004, the Company's Tangible Net Worth dropped below this minimum and thus was in violation of this financial covenant. The Company has obtained a waiver from PNC for this violation.

Additionally, under the Note, which covers the Company's subordinated debt, the Company must meet certain financial covenants including a Leverage Ratio, a Fixed Charge Ratio and a Tangible Net Worth Ratio. At November 26, 2004 the Company failed to meet any of these financial covenants but has obtained a waiver from its subordinated lender. This waiver applies to the period through November 30, 2005. Except as specified, the waiver does not constitute a modification or alteration of any other terms or conditions in the Note, or a release of any of the lender's rights or remedies, all of which are reserved, nor does it release the Company or any guarantor from any of its duties, obligations, covenants or agreements including the consequences of any Event of Default, except as specified.

Going forward, PNC has alerted the Company that additional changes may be required to the Agreement and that an increase in the cash collateral account may be required. Specific terms and conditions for any additional modifications had not been finalized as of the filing date of this report. Based on the annual forecast and the indicated actions described above, the Company does not believe it is probable that it will fail future covenant tests.

Given the Company's inability to borrow cash under the amended Agreement, the Company may need to obtain additional sources of capital in order to continue growing and operating our business. This capital may be difficult to obtain and the cost of this additional capital is likely to be relatively high. However, we believe that we will be able to locate such additional capital and that these actions by PNC will not have a long-term material adverse effect on our business.

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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)
THIRTEEN WEEKS ENDED NOVEMBER 26, 2004		
Net Sales	\$3,368	\$4,383
Interest Expense	305	135
Depreciation and Amortization	174	302
Operating loss	(2,257)	(299)
Income Tax Benefit	4	-
Goodwill and Intangibles	477	-
Identifiable Assets	15,103	7,892
Expenditures For Segment Assets	601	41
THIRTEEN WEEKS ENDED NOVEMBER 28, 2003		
Net Sales	\$4,029	\$3,086
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
Expenditures For Segment Assets	55	9
Reconciliation to consolidated amounts		
	2004	2003
Segment Assets	\$22,995	\$ 38,459
Corporate Assets	18,728	10,055
	-----	-----
Total Assets	\$41,723	\$ 48,514
	=====	=====
Segment operating loss	\$ (2,556)	\$ (439)
Less interest expense	(440)	(427)
Less income tax benefit	4	246
	-----	-----
Total loss for segments	(2,992)	(620)
Corporate home office expenses	(201)	(261)
Interest and other expenses	(56)	140
Income tax benefit	-	34
Minority interest	-	3
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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.

Approximately 41% of sales totaling \$3,189,000 in the thirteen weeks ended November 26, 2004 were made to two international customers and one domestic customer in the ATS segment. 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 16% of sales totaling \$3,343,000 in the thirty-nine weeks ended November 26, 2004 were made to 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 and one international customer in the sterilizer and ATS segments respectively.

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Included in the segment information for the thirteen weeks ended November 26, 2004 are export sales of \$3,276,000. Of this amount, there are sales to or relating to governments or commercial accounts in Malaysia (\$1,203,000) and Italy (\$525,000). Sales to the U.S. Government and its agencies were \$1,157,000 for the period.

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 thirty-nine weeks ended November 26, 2004 are export sales of \$9,554,000. Of this amount, there are sales to or relating to commercial accounts in Malaysia (\$3,343,000). Sales to the U.S. Government and its agencies aggregated \$2,225,000 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 or government 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.

### 9. Recent Accounting Pronouncements

#### ACCOUNTING FOR SHARE-BASED PAYMENTS

In December 2004, the Financial Accounting Standards Board (FASB) issued FASB Statement No. 123 (revised 2004), Share-Based Payments. This statement replaces FASB Statement No. 123, Accounting for Stock-Based Compensation, and supersedes APB Opinion No. 25, Accounting for Stock Issued to Employees. This statement requires companies to recognize in financial statements the compensation cost relating to share-based transactions including share options, restricted share plans, performance-based awards, share appreciation rights and employee share purchase plans. The cost of these arrangements will be measured based on the fair value of the equity or liability instruments issued. Public companies will be required to apply Statement 123(R) as of the first interim or annual reporting period that begins after June 15, 2005. The Company is not able at this time to determine what impact, if any, adoption of Statement 123(R) will have on the results of operations.

#### ACCOUNTING FOR INVENTORY COSTS

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In November 2004, the FASB issued FASB Statement 151, Inventory Costs, an amendment of ARB No. 43, Chapter 4. While retaining the general principle that inventories are presumed to be stated at cost, Statement 151 amends ARB No. 43 to clarify that:

- o abnormal amounts of idle facilities, freight, handling costs, and spoilage should be recognized as charges of the current period.
- o allocation of fixed production overheads to inventories should be based on the normal capacity of the production facilities.

The Statement defines normal capacity as the production expected to be achieved over a number of periods or seasons under normal circumstances, taking into account the loss of capacity resulting from planned maintenance.

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Statement 151 is effective for inventory costs incurred during fiscal years beginning after June 15, 2005 and should be applied prospectively. Early application is permitted. The Company is not able at this time to determine what impact, if any, adoption of statement 151 will have on the results of operations.

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. 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

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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 27, 2004, 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.

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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

We are 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.

The following factors had an adverse impact on our performance for the fiscal quarter and the thirty-nine weeks ended November 26, 2004:

- o Unfavorable global economic and political conditions;

Our new sales bookings continued to be hampered by unfavorable global economic and political conditions. Many new projects continue to face budget constraints and other governmental delays by our customers throughout the world. Additionally, sentiment against purchasing American-made goods has heightened since September 11, 2001. Proposal activity in some of our businesses, most notably in the ATS and environmental areas, remains strong: the probability of being awarded some significant potential projects has recently increased: we have booked some large projects in the ATS area in fiscal 2005; however, we have not been able to materially increase the backlog and our resulting sales volume. Thus, we still remain cautious about the volume of new contracts that we may be awarded in the near term.

- o Technical and other issues which delayed completion of some projects;

Many of our products, especially in the ATS and environmental lines, incorporate new state-of-the-art or unproven technologies. Occasionally, given the engineering effort to design, develop and test these technologies and the difficult logistics of installation and acceptance requirements in foreign locations, we experience delays in the final completion and receipt of final payment for a project. This can have a negative impact on revenue recognition, gross margin performance, and cash flow from operations, especially if additional spending is required or if customer induced delays occur. Historically, we have charged the cost of new product technologies to individual contracts and occasionally only a portion of these costs is covered by customer payments. Although some significant long-standing contracts have been closed in fiscal 2005, additional contracts have continued to experience various delays, and these delays are expected to have a continued negative impact on our gross margins. This situation is applicable to many of our product lines and tends to add an element of unpredictability to our financial performance.

- o Limited borrowing availability and higher costs of capital.

Cash collections have been very strong in fiscal 2005 primarily due to the receipt of \$10.5 million in March 2004 under a settlement agreement of an international claim, and there are currently some sizable open customer receivables. However, given our inability to borrow cash from PNC under the August 24, 2004, amendment to the Bank Agreement, the requirement to restrict the use of \$2.8 million of cash, and the potential that PNC will require additional cash to be deposited in a restricted account as collateral, we may need to obtain additional sources of capital in order to grow our business. We currently have a relatively high average cost of capital and this continues to have a negative impact on our financial results. New capital may be difficult to obtain and the cost of this additional capital is likely to be relatively high.

- o Higher cost of litigation and contract claims activity.

A significant portion of our selling and administrative spending is related to costs associated with litigation and our ongoing contract claims activities. Two litigation matters, an international contract claim and the legal suit against Walt Disney World Company, were in the discovery phase in the fiscal quarter ended November 26, 2004 and required extensive outside legal effort. Although some decrease in the rate of expenditure is expected in future periods, these matters are expected to continue to require material legal expenditures for the foreseeable future. The Company plans to utilize collections from other outstanding claims and cash from operations to pay for these costs.

Our goal is to be the premier supplier of low-cost, high-performance and technologically advanced simulation equipment in the markets we serve. To that end, we face various challenges in order to make fiscal 2005 a successful year. In order to overcome the factors adversely impacting our performance and to meet this goal, we need to take the following actions. (The reader is referred to the Management's Discussion and Analysis of Financial Condition and Results of Operations included in the Company's Annual Report on Form 10-K for the fiscal year ended February 27, 2004.)

- o Sell through all of the products we technologically enhanced in fiscal 2004.

- o Stimulate interest in the U.S. Government Armed Forces to purchase Advanced Tactical Flight Simulation (ATFS) technology. This effort may require the use of scarce operating funds to manufacture a prototype device for demonstration purposes.
- o Allocate the resources and find the funding to continue to evolve ATFS.
- o Re-engineer the products in our ATS and environmental lines to remain competitive.
- o Complete some large international projects which have negative margins and continue to monopolize our limited installation

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personnel.

- o Continue to reduce the environmental business operating losses by utilizing the skills of additional personnel acquired from a former competitor.
- o Expand the entertainment line by repeat sales and the introduction of story line enhancements.
- o Settle at least one major claim.
- o Balance overhead and selling and administrative spending levels to be more in line with the current level of sales volume.
- o Rejuvenate the sales force and sales booking level.
- o Prioritize and focus our product development.
- o Tightly manage our cash to compensate for the reduced booking level and inability to borrow from our bank.
- o Minimize the financial cost of implementing the new requirements under the Sarbanes-Oxley Act of 2002 and related regulations.

Our failure to complete some or all of these steps may have a material adverse effect on both our cash availability and our future operating results.

We recognize revenue when it is realized or realizable and earned. We consider revenue realized or realizable and earned when there exists persuasive evidence of an arrangement, the product has been shipped or the services have been provided to the customer, the sales price is fixed or determinable and collectability is reasonably assured. In addition to the aforementioned general policy, the following are the specific revenue recognition policies we utilize:

Revenue on long-term contracts that require us to design, develop or manufacture a product or modify an existing unit is recognized using the percentage-of-completion method. Percentage of completion is measured based on the ratio of costs incurred to date compared to the total estimated costs. This

percentage is multiplied by the total estimated revenue under a contract to calculate the amount of revenue recognized in an accounting period. Total estimated costs are based on several factors, including estimated labor hours to complete certain tasks and the estimated cost of purchased items at future dates. Revenue recognized in excess of amounts billed to customers on uncompleted long-term contracts under the percentage of completion method is reflected as an asset. Amounts billed to customers in excess of revenue recognized on uncompleted long-term contracts under the percentage of completion method 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 we learn the facts that require us 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 which

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may need to be adjusted from quarter to quarter which would impact revenue and margins on a cumulative basis.

Effective with the beginning of fiscal year 2005, we changed the parameters for application of the percentage of completion method of revenue recognition. The minimum contract value has been raised to include all contracts over \$250,000 and the minimum completion period has been shortened to six months for a contract to apply for this method. The criteria in prior years was contracts over \$100,000 in value with a completion period of one year or more. This change applies to contracts entered into or started after February 27, 2004. Given the nature and mix of contracts booked in recent years, we believe adjusting the criteria in this way will allow for a more representative reporting of the production flow and earnings process. We are unable to quantify the impact this change would have had on prior years' operating results.

Revenue for contracts under \$250,000, or to be completed in less than six months, 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 or as-needed repair services is recognized on the date that the product is shipped to the customer or that the services are completed. Revenue on contracts under \$250,000, or to be completed in less than six months, and where post-shipment services (such as installation and customer acceptance) are required, is recognized following customer acceptance. Contracted maintenance services are provided under separate maintenance contracts with our customers. Revenue for contracted maintenance contracts is recognized ratably over the life of the contract with related material costs expensed as incurred.

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In accordance with accounting principles generally accepted in the United States of America, recognizing revenue on contract claims and disputes related to 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 we can reliably estimate the amount of additional contract revenue which may be received. However, revenue recorded on a contract claim cannot exceed the incurred contract costs related to that claim. Claims involve significant judgments and estimates and are subject to negotiation, arbitration and audit by the customer or governmental agency.

We have operating subsidiaries in the United Kingdom and Poland, maintain regional offices in the Middle East, and Asia, and use 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. We consider our business activities to be divided into two segments: Aircrew Training Systems (ATS) and the Industrial Group.

### 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 of America. 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

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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 our Annual Report on Form 10-K for the fiscal year ended February 27, 2004, which was filed with the Securities and Exchange Commission on May 27, 2004.

### Revenue Recognition on Long-Term Contracts

When the performance of a contract requires a customer to pay the Company more than \$250,000 and will extend beyond a six-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 us.

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We account for some of our largest contracts, including our contracts with the U.S. Government and foreign governments, using the percentage-of-completion method. If we do not accurately estimate the total cost to be incurred on this type of contract, or if we are unsuccessful in the ultimate collection of any associated contract claims, our actual gross margins may be significantly less than our estimates or losses may need to be recognized in future periods. Any resulting reductions in margins or contract losses could be material to our results of operations and financial position.

### Accounts Receivable

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

### RESULTS OF OPERATIONS

THIRTEEN WEEKS ENDED NOVEMBER 26, 2004 COMPARED TO THIRTEEN WEEKS ENDED NOVEMBER 28, 2003.

We have historically experienced significant variability in our quarterly revenue, earnings and other operating results, and our performance may fluctuate significantly in the future.

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SUMMARY TABLE OF RESULTS

	FY 05 Q3	FY 04 Q3	\$ VARIANCE	% VARIANCE
			( )=UNFAVORABLE	
SALES				
DOMESTIC	\$ 3,318	\$ 2,775	\$ 543	19.6%
US GOV'T	1,157	(42)	1,199	N/A
INT'L	3,276	4,382	(1,106)	(25.2)
TOTAL SALES	7,751	7,115	636	8.9
GROSS PROFIT	1,637	1,774	(137)	(7.7)
SG&A EXPENSES	4,224	2,330	(1,894)	(81.3)
R&D EXPENSES	170	144	(26)	(18.1)
INTEREST EXP.	440	425	(15)	(3.5)
OTHER EXP.,NET	57	(138)	(195)	(241.3)
INCOME TAXES	(4)	(280)	(276)	(98.6)
MINORITY INTEREST	(1)	(3)	(2)	(66.7)
NET LOSS	\$ (3,249)	\$ (704)	\$ (2,545)	(361.5%)
NET LOSS PER SHARE				
(DILUTED)	\$ (0.43)	\$ (0.10)	(0.33)	(330.0%)

Net Loss.

The Company had a net loss of \$(3,249,000), or (\$0.43) per share (diluted), during the third quarter of fiscal 2005 versus a net loss of \$(704,000), or (\$0.10) per share (diluted), for the third quarter of fiscal 2004, representing a decrease of \$2,545,000 or 361.5%. This increase in net loss was primarily due to a significant increase in litigation expenses associated with the Company's international contract claims and other litigation and a lower income tax benefit.

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Sales.

Sales for the third quarter of fiscal 2005 were \$7,751,000 as compared



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to \$7,115,000 for the third quarter of fiscal 2004, an increase of \$636,000 or 8.9%. Sales increases were evidenced in the environmental, hyperbaric and entertainment lines. Environmental benefited from higher international sales primarily in Italy. Hyperbaric, which evidenced the most significant increase (domestic hyperbaric sales were up \$940,000), benefited from the production on two large multi-man hyperbaric chambers. Entertainment benefited from work on Wild Earth units being produced for the Philadelphia Zoo.

We have historically experienced significant variability in our sales performance. This reflects the existing sales backlog, product and the nature of contract (size and performance time) mix, the manufacturing cycle and amount of time to effect installation and customer acceptance, and certain factors not in our control such as customer delays and the time required to obtain U.S. Government export licenses. One or a few contract sales may account for a substantial percentage of our quarterly revenue.

### Domestic Sales.

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Overall, domestic sales in the third quarter of fiscal 2005 were \$3,318,000 as compared to \$2,775,000 in the third quarter of fiscal 2004, an increase of \$543,000 or 19.6%, reflecting increases in hyperbaric, service, and entertainment sales. Hyperbaric and entertainment sales benefited from the aforementioned activity while service benefited from work on domestic sterilizers. Domestic sales represented 42.8% of the Company's total sales in the third quarter of fiscal 2005, up from 39.0% for the third quarter of fiscal 2004. Sales to the U.S. Government in the third quarter of fiscal 2005 were \$1,157,000 as compared to a negligible amount in the third quarter of fiscal 2004, and represented 14.9% of total sales in the third quarter of fiscal 2005 versus a negligible amount for the third quarter of fiscal 2004.

### International Sales.

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International sales for the third quarter of fiscal 2005 were \$3,276,000 as compared to \$4,382,000 in the third quarter of fiscal 2004, a decrease of \$1,106,000 or 25.2%, and represented 42.3% of total sales as compared to 61.6% in the third quarter of fiscal 2004. Throughout our history, most of the sales for ATS have been made to international customers. In the third quarter of fiscal 2005 international sales totaling at least ten percent of total international sales were made to Malaysia (\$1,203,000) and Italy (\$525,000). In the third quarter of fiscal 2004 international sales totaling at least ten percent of total international sales were made to government or commercial accounts in Venezuela (\$1,050,000), the United Kingdom (\$818,000), and Malaysia (\$793,000). 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.

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### Gross Profit.

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Gross profit for the third quarter of fiscal 2005 was \$1,637,000 as compared to \$1,774,000 in the third quarter of fiscal 2004, a decrease of \$137,000 or 7.7%. This decrease resulted from a 3.8 percentage point decrease in the gross profit rate as a percent of sales partially offset by an increase in sales. The quarter-to-quarter reduction reflected reduced manufacturing performance in all groups except hyperbaric (on favorable costing for the aforementioned large chamber contracts) and ATS which benefited from a large

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multi-product contract sold through the U.S. Government. On the negative side, sterilizers suffered from the completion in the prior period of a large multi-unit contract at higher margins while the environmental group continued to suffer cost overruns both domestically and internationally. This group has recently revised its proposal and project management procedures in an effort to improve margins. Historically we have charged the cost of new product technologies to individual contracts and occasionally only a portion of these costs are covered by customer payments, resulting in negative gross manufacturing margins.

We have historically experienced significant fluctuations in gross profit margins and, consequently, our operating results, and we expect such fluctuations to continue. Gross margins are routinely affected by selling prices, the engineering cost of product enhancements, the amount of new product development required to meet contract specifications, the mix of materials, labor content and engineering effort in manufacturing costs, labor difficulties in field work including installation and customer acceptance, our ability to negotiate change orders for additional work scope, and the impact of claims settlements. We face a continuous challenge to reduce costs and improve gross margins while implementing innovative new technologies.

### Selling and Administrative Expenses.

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Selling and administrative expenses for the third quarter of fiscal 2005 were \$4,224,000 as compared to \$2,330,000 in the third quarter of fiscal 2004, an increase of \$1,894,000 or 81.3% primarily reflecting significantly higher costs associated with litigation and the Company's ongoing contract claims activities. Two litigation matters, an international contract claim and the legal suit against Walt Disney World Company, etc., were in the discovery phase in the fiscal quarter ended November 26, 2004 and required extensive outside legal effort. The Company is currently in discussions with the international customer to finalize all open issues. Although some decrease in the rate of expenditure is expected in future periods, these matters are expected to continue to require material legal expenditures for the foreseeable future.

A significant portion of our selling and administrative spending is related to three activities: i. legal and contract claims costs, ii. outside sales agent and sales personnel commissions on booked contracts and iii. additional accounting, legal and stockholder's costs required to comply with applicable statutes, rules and regulations as a public company. We have recently instituted a series of cost cutting measures and plan to continue to review all spending categories.

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### Research and Development Expenses.

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Research and development expenses, which are charged to operations as incurred, were \$170,000 for the third quarter of fiscal 2005 as compared to \$144,000 for the third quarter of fiscal 2004, reflecting an increase of \$26,000 or 18.1%. Most of the increase resulted from a delay in obtaining local government grant funding for spending in our Turkish subsidiary for two projects currently in progress. We are currently evaluating the level of spending required to support this operation.

Most of our research efforts, which were and continue to be a significant cost of our business, are included in cost of sales for applied research for specific contracts, as well as research for feasibility and

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technology updates. Most of our products require a significant amount of continued development effort to implement new applications, design product extensions, and integrate new technology into existing products.

### Interest Expense.

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Interest expense for the third quarter of fiscal 2005 was \$440,000 versus \$425,000 for the third quarter of fiscal 2004. Interest expense includes interest on our debt, amortization of debt discount resulting from the beneficial conversion option of our subordinated debt and associated warrants issued with the debt, amortization expense associated with the recent issuance of additional warrants, and amortization of deferred financing costs for our February 2003 refinancing.

### Other Income/Expense, Net

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Other income/expense, net, consisted of an expense of \$57,000 for the third quarter of fiscal 2005 versus income of \$138,000 for the third quarter of fiscal 2004, an increase of \$195,000 or 241.3%. The increase resulted from the positive net impact in the prior period of \$283,000 from an insurance reimbursement.

### Provision for Income Taxes.

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During the current fiscal period, the Company applied for refunds for tax loss carry-backs from the fiscal 2004 operating losses and received refunds totaling approximately \$900,000 from the Internal Revenue Service and the Commonwealth of Pennsylvania. During the first two quarters of fiscal 2005, the Company recognized approximately \$1.4 million as income tax receivables reflecting the two quarter's operating losses, approximately \$800,000 of which will be filed as refunds applied to income earned in prior years. During the current fiscal quarter, the Company did not record any additional deferred tax asset related to the current period loss, although it is possible income will be generated in future periods which could be used to offset these third quarter losses. The consolidated rate for the third quarter of fiscal 2004 reflected an estimated rate of 28.4%, reflecting additional research and development tax credits.

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## RESULTS OF OPERATIONS

THIRTY-NINE WEEKS ENDED NOVEMBER 26, 2004 COMPARED TO THIRTY-NINE WEEKS ENDED NOVEMBER 28, 2003.

We have historically experienced significant variability in our revenue, earnings and other operating results, and our performance may fluctuate significantly in the future.

(\$000)

### SUMMARY TABLE OF RESULTS

	FIRST NINE MONTHS	FIRST NINE MONTHS	\$ VARIANCE	% VARIANCE
	FISCAL 2005	FISCAL 2004	( )=UNFAVORABLE	
<b>SALES</b>				
DOMESTIC	\$ 8,670	\$ 7,354	\$ 1,316	17.9%
US GOV'T	2,225	624	1,601	256.6

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INT'L	9,554	10,019	(465)	(4.6)
	-----	-----	-----	
TOTAL SALES	20,449	17,997	2,452	13.6
GROSS PROFIT	3,652	5,847	(2,195)	(37.5)
SG&A EXPENSES	9,775	6,246	(3,529)	(56.5)
R&D EXPENSES	671	176	(495)	(281.3)
INTEREST EXP.	1,171	1,192	21	1.8
OTHER EXP.,NET	182	(51)	(233)	(456.9)
INCOME TAXES	(1,453)	(451)	1,002	222.2
MINORITY INTEREST	-	(9)	(9)	N/A
	-----	-----	-----	
NET LOSS	\$ (6,694)	\$ (1,256)	\$ (5,438)	(433.0%)
	=====	=====	=====	=====
NET LOSS PER SHARE				
(DILUTED)	\$ (0.88)	\$ (0.18)	\$ (0.70)	(388.9%)
	=====	=====	=====	=====

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Net Loss.

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The Company had a net loss of \$(6,694,000), or (\$0.88) per share (diluted), during the thirty-nine weeks ended November 26, 2004 versus a net loss of \$(1,256,000), or (\$.18) per share (diluted), for the thirty-nine weeks ended November 28,2004 representing a decrease of \$5,438,000 or 433.0%. This increase in net loss was primarily due to a significantly reduced gross profit margin coupled with increases in legal costs associated with the Company's litigation and claims activity.

Sales.

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Sales in the thirty-nine weeks ended November 26, 2004 were \$20,449,000 as compared to \$17,997,000 for the thirty-nine weeks ended November 28, 2003, an increase of \$2,452,000 or 13.6%. Sales increases were evidenced in all business areas except sterilizers. Environmental benefited from additional activity both domestically for automotive testing equipment and internationally for a project in Italy and for HVAC applications in China. Hyperbaric benefited from the production of three large chambers. ATS benefited from the shipment of a Gyro for the Czech Republic and continued work on a pilot selection system purchased through the U.S. Government. Entertainment experienced significant period over period growth as new products were introduced to the market. Acting as a partial offset were significantly reduced sterilizer sales as the prior period included revenue for a large multi-unit order.

We have historically experienced significant variability in our sales performance. This reflects the existing sales bookings backlog, product and the nature of contract (size and performance time) mix, the manufacturing cycle and amount of time to effect installation and customer acceptance, and certain

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factors not in our control such as customer delays and the time required to obtain U.S. Government export licenses. One or a few contract sales may account for a substantial percentage of our quarterly revenue.

### Domestic Sales.

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Overall, domestic sales in the thirty-nine weeks ended November 26, 2004 were \$8,670,000 as compared to \$7,354,000 for the thirty-nine weeks ended November 28, 2003, an increase of \$1,316,000 or 17.9%. The increase in domestic sales resulted from significant growth in most product areas except sterilizers. Domestic sales represented 42.4% of our total sales in the thirty-nine weeks ended November 26, 2004, up slightly from 40.9% for the thirty-nine weeks ended November 28, 2004. Sales to the U.S. Government in the thirty-nine weeks ended November 26, 2004 were \$2,225,000 as compared to \$624,000 for the thirty-nine weeks November 28, 2004, an increase of \$1,601,000, 256.6%, and represented 10.9% of total sales in the thirty-nine weeks ended November 26, 2004 versus 3.5% for the thirty-nine weeks ended November 28, 2003.

### International Sales.

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International sales in the thirty-nine weeks ended November 26, 2004 were \$9,554,000 as compared to \$10,019,000 for the thirty-nine weeks ended November 28, 2003, an increase of \$465,000 or 4.6%, and represented 46.7% of total sales in the thirty-nine weeks ended November 26, 2004, as compared to

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55.7% for the thirty-nine weeks ended November 28, 2003. Throughout our history, most of the sales for ATS have been made to international customers. In the thirty-nine weeks ended November 26, 2004, international sales totaling at least ten percent of total international sales were made to government or commercial accounts in Malaysia (\$3,343,000). In the thirty-nine weeks ended November 28, 2003, international sales totaling at least ten percent of total international sales were made to commercial or governmental accounts in Malaysia (\$2,887,000) and Venezuela (\$1,050,000). 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.

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Gross profit in the thirty-nine weeks ended November 26, 2004 was \$3,652,000 as compared to \$5,847,000 for the thirty-nine weeks ended November 28, 2003, a decrease of \$2,195,000 or 37.5%. This decrease resulted from a 14.6 percentage point drop in the gross profit rate as a percent of sales partially offset by the aforementioned sales increase. The period-to-period decrease reflected gross profit rate reductions in all categories except environmental and hyperbaric areas. Sterilizers suffered from the completion in the prior period of a large multi-unit project. ATS margin decrease reflected the sale of a gyro to the Czech Republic at a cost above sales value and an addition to the budget for the Malaysia centrifuge project reflecting additional testing and an extended installation period due to customer delays. Historically, we have charged the cost of new product technologies to individual contracts and occasionally only a portion of these costs are covered by customer payments. The simulation group evidenced additional development costs to enhance and expand product functionality.

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We have historically experienced significant fluctuations in gross profit margins and, consequently, our operating results, and we expect such fluctuations to continue. Gross margins are routinely affected by selling prices, the amount of new product development required to meet contract specifications, the mix of materials, labor content and engineering effort in manufacturing costs, and labor difficulties in field work including installation and customer acceptance, and the impact of claims settlements.

### Selling and Administrative Expenses.

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Selling and administrative expenses in the thirty-nine weeks ended November 26, 2004, were \$9,775,000 as compared to \$6,246,000 for the thirty-nine weeks ended November 28, 2003, an increase of \$3,529,000 or 56.5%. During the thirty-nine weeks ended November 26, 2004, we incurred significant legal costs and claims expenses to support an international contract claim and the suit against Walt Disney World Company, each of which was in the discovery phase. Additionally, the first quarter of fiscal 2004 included a reimbursement of prior period legal and claim expenses associated with an arbitration hearing in January 2003. The Company is currently in discussions with the international customer to finalize all open issues. Although some decrease in the rate of expenditure is expected in future periods, these matters are expected to continue to require material legal expenditures for the foreseeable future.

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A significant portion of our selling and administrative spending is related to three activities: i. legal and contract claims costs, ii. outside agent and sales personnel commissions on booked contracts, and iii. additional accounting, legal and stockholder's costs required to comply with applicable statutes, rules and regulations as a public company. We have recently instituted a series of cost cutting measures and plans to continue to review all spending categories.

### Research and Development Expenses.

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Research and development expenses, which are charged to operations as incurred, were \$671,000 in the thirty-nine weeks ended November 26, 2004 as compared to \$176,000 for the thirty-nine weeks ended November 28, 2003, reflecting an increase of \$495,000 or 281.3%. Most of the increase in research and development expenses resulted from a delay in obtaining local government grant funding for spending in our Turkish subsidiary for two projects currently in progress. The Company is currently evaluating the level of spending required to support this operation.

Most of our research efforts, which were and continue to be a significant cost of our business, are included in cost of sales for applied research for specific contracts, as well as research for feasibility and technology updates. Most of our products require a significant amount of continued development effort to implement new applications, design product extensions, and integrate new technology into existing products.

### Interest Expense.

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Interest expense in the thirty-nine weeks ended November 26, 2004 was \$1,171,000 as compared to \$1,192,000 for the thirty-nine weeks ended November 28, 2003, representing a decrease of \$21,000 or 1.8%. The reduction in interest expense primarily reflected a temporary reduction in the interest rate for our subordinated debt borrowed in February 2003. Interest expense includes interest

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on our debt, amortization of debt discount resulting from the beneficial conversion option of our subordinated debt and associated warrants issued with the debt, amortization expense associated with the recent issuance of additional warrants, and amortization of deferred financing costs for our February 2003 refinancing.

### Other Income/Expense, Net

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Other income/expense, net, was a net expense of \$182,000 for the thirty-nine weeks ended November 26, 2004 versus income of \$51,000 for the thirty-nine weeks ended November 28, 2003, an increase of \$233,000 or 456.9%. The increase resulted from the positive net impact in the prior period of \$283,000 from an insurance reimbursement.

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### Provision for Income Taxes.

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During the current fiscal period, the Company applied for refunds for tax loss carry-backs from the fiscal 2004 operating losses and received refunds totaling approximately \$900,000 from the Internal Revenue Service and the Commonwealth of Pennsylvania. During the first two quarters of the current fiscal year, the company recognized approximately \$1.4 million as income tax receivables reflecting the two quarter's operating losses, approximately \$800,000 of which will be filed as refunds applied to income earned in prior years. During the current fiscal quarter, the Company did not record any additional deferred tax asset related to the current period loss, although it is possible income will be generated in future periods which could be used to offset these third quarter losses. The consolidated rate for the thirty-nine weeks ended November 28, 2003, reflected an estimated rate of 23.5% reflecting additional research and development tax credits.

### LIQUIDITY AND CAPITAL RESOURCES

Our cash flow is subject to significant fluctuations due to many factors. The timing of new orders and associated advance and milestone deposits; the complicated logistics of collecting payments from international customers under letters of credit; customer induced schedule changes which could delay shipments, final acceptance and release of final contract payments; the variability and availability of funding for foreign government defense purchases; changes in levels of customer capital spending; and international conflicts or economic crises. These and other factors not under our control may have a material impact on the timing and amount of cash generation or usage.

During the thirty-nine weeks ended November 26, 2004 we generated \$7,272,000 from operating activities. This was primarily the result of the collection in March 2004 of a \$10.5 million settlement on an international claim (Please refer to the Notes to the Consolidated Financial Statements, Note 4, "Accounts Receivable" for a discussion of claims.) coupled with non-cash expenses, a decrease in inventory and costs and estimated earnings in excess of billings on uncompleted long-term contracts and an increase in accounts payable. Acting as partial offsets were the net loss and decreases in customer deposits and other accrued liabilities. Generally speaking, the cash generation reflected significant claims collections and collections on contracts accounted for by the percentage of completion method.

Our investing activities used \$1,188,000 during the thirty-nine weeks ended November 26, 2004 which consisted of purchases of capital equipment and capitalized software.

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Our financing activities used \$1,622,000 during the thirty-nine weeks ended November 26, 2004 primarily reflecting an increase in our cash collateral restricted cash account. The cash collateral account serves as additional collateral for our bank facility. Providing a partial offset was proceeds from the issuance of common stock and warrants.

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We have historically financed operations through a combination of cash generated from operations, and bank and other debt. On February 19, 2003, we signed a Credit Agreement (the "Agreement") with PNC Bank, National Association ("PNC") and a Convertible Note and Warrant Purchase Agreement (the "Note") with H.F. Lenfest, an individual, in the aggregate amount of \$29,800,000. We used a portion of the proceeds from the financing to satisfy our existing debt obligations to Wachovia Bank, our former lender, and to permit PNC to issue a letter of credit to support outstanding bonds that we had issued 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. We used the net proceeds for working capital and general corporate purposes.

Our obligations to PNC under the Agreement are secured by a first priority lien on and senior security interest in all of our assets, including all real property that we own.

The Note issued to Mr. Lenfest included (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 our common stock. Upon the occurrence of certain events, we 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 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.

Our obligations to Mr. Lenfest under the Note are secured by a second priority lien on and security interest in all of our assets, junior in rights to the liens and security interests in favor of PNC, including all real property that we own.

Prior to the consummation of the February 2003 refinancing, Advanced Technology Asset Management, LLC, ("ATAM"), a shareholder and a holder of warrants to purchase 332,820 shares of our common stock, consented to the transactions contemplated under the Agreement and the financing provided by Mr. Lenfest, including the below market issuance of warrants to Mr. Lenfest. As a result of its consent, ATAM waived, solely in connection with the issuance of warrants to Mr. Lenfest, the anti-dilution rights contained in its warrant. In exchange for ATAM's consent, we issued to ATAM 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 ATAM warrants have substantially the same terms as the warrants issued to Mr. Lenfest. In March 2004 ATAM exercised all of its warrants and received a total of 437,820 shares of our common stock. We received proceeds of \$586,410 from the exercise of these warrants.



On April 30, 2003, the Agreement was amended to include: (i) a revolving credit facility in the maximum aggregate principal amount of \$14,800,000 to be used for our 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 our bonds. Additionally, on July 9, 2003, a second amendment to the 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.

During the first quarter of fiscal 2005, as a result of our recent operating losses and our violation of certain financial covenants contained in the Agreement, PNC advised us that it was instituting certain changes to the revolving credit facility. The changes included reducing the facility to \$6,000,000 and requiring us to cash collateralize the full facility. These changes became effective on June 2, 2004.

On August 24, 2004 the Agreement was amended to substantially reduce the operating facility and eliminate the associated monthly borrowing base reporting requirements. The revolving facility was reduced from \$14,800,000 to \$5,000,000 and use of the facility was restricted to the issuance of letters of credit, which are frequently a requirement of international contracts. We could no longer borrow cash under the facility. Our long-term bonds were left intact. As additional collateral for the revised facility, PNC required us to keep \$2,500,000 in a restricted cash account. The fee for letters of credit was reduced from 1.75% to 1.0% per annum. Additionally, three of the financial covenants, the Leverage Ratio, the Fixed Charge Ratio and the requirement not to report a net loss in any annual period were eliminated and the Tangible Net Worth requirement was reduced. All other terms and conditions of the revolving loan and the line of credit as set forth in the Agreement remained in effect.

Under the August 24, 2004 amendment, the EXIM Bank credit facility was reduced from \$1,010,000 to \$995,000, with all other terms and conditions remaining as per the Agreement. Availability under the EXIM facility is determined based on a borrowing base consisting of a portion of our receivables and inventory.

As a condition of amending the Agreement, Mr. Lenfest, holder of our subordinated debt, agreed to issue to PNC on our behalf a limited guarantee to secure up to \$5,000,000 in principal amount of any letters of credit issued under the amended revolving line of credit. In consideration for issuing this guarantee, Mr. Lenfest will receive a fee of 0.75% per annum of the average amount of letters of credit outstanding, payable on a quarterly basis, and received a warrant to purchase 200,000 shares of stock under the same terms and conditions as his existing warrant for 803,048 shares.

On October 18, 2004, the Agreement was again modified. This amendment required the company to deposit in a restricted cash account an additional amount of \$285,000 to cover the next scheduled payment of principal and interest due April 1, 2005 on the Company's long-term bonds. The tangible Net Worth covenant requirement was reduced to a. \$14,500,000 for the periods ending November 26, 2004 and February 25, 2005 and b. on the last day of any fiscal quarter ending after February 25, 2005, to be at least equal to the actual

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tangible Net Worth on February 25, 2005. Additionally, the fee for the PNC Letter of Credit which backs the Company's long-term bonds was increased from 2.0% to 2.5% annually.

Under the October 18, 2004 amendment to the Agreement, the Company must meet a minimum Tangible Net Worth. At November 26, 2004 the Company's Tangible Net Worth dropped below this minimum and thus was in violation of this financial covenant. The Company has obtained a waiver from PNC for this violation.

Additionally, under the Note, which covers our subordinated debt, we must meet certain financial covenants including a Leverage Ratio, a Fixed Charge Ratio, and a Tangible Net Worth Ratio. At November 26, 2004, we failed to meet any of these financial covenants but have obtained a waiver from our subordinated lender. This waiver applies to the period through November 30, 2005. Except as specified, the waiver does not constitute a modification or alteration of any other terms or conditions in the Note, or a release of any of the lender's rights or remedies, all of which are reserved, nor does it release us or any guarantor from any of its duties, obligations, covenants or agreements including the consequences of any Event of Default, except as specified.

Our bank has alerted us that additional changes may be required to the Agreement and that an increase in the cash collateral account may be required. Specific terms and conditions for any additional modifications had not been finalized as of the filing date of this report. Based on the annual forecast and the indicated actions described above, we do not believe it is probable that we will fail future covenant tests.

Going forward, our significant cash requirements will relate to salaries and other operational expenses, continued spending for product enhancements and technology and the costs of litigating claims and lawsuits. To fund these items, we plan to utilize cash from operations and proceeds from potential arbitration proceeds and collections. However, given our inability to borrow cash under the amended Agreement, we may need to obtain additional sources of capital in order to continue growing and operating our business. This capital may be difficult to obtain and the cost of this additional capital is likely to be relatively high. However, we believe that we will be able to locate such additional capital and that these actions by our bank will not have a long-term material adverse effect on our business.

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The following table presents our contractual cash flow commitments on long-term debt and operating leases as of November 26, 2004.

	PAYMENTS DUE BY PERIOD (IN THOUSANDS)			
	TOTAL	LESS THAN 1 YEAR	1-3 YEARS	4-5 YEARS
	-----	-----	-----	-----
Long-term debt, including				
current maturities	\$12,826	\$452	\$1,199	\$8,455
Operating leases	686	147	83	83
	-----	-----	-----	-----
Total	\$13,512	\$599	\$1,282	\$8,538
	=====	=====	=====	=====

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Expected Interest Expense	\$ 5,006	\$917	\$3,309	\$ 409
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### Contract Claims

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Historically, we have had positive experience with our contract claims in that recoveries have exceeded the carrying value of claims. As of November 26, 2004, claims recorded against the U.S. Government totaled \$3,004,000 and claims recorded against an international customer totaled \$2,600,000.

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 2005. In conformity with accounting principles generally accepted in the United States of America, revenue that we record from a claim may not exceed the incurred contract costs related to the claim.

In November 2003, the U.S. Government completed an audit of the submarine rescue decompression chamber project claim, rejecting most of the items due to audit or engineering reasons. We were not provided a copy of the Government's Technical Report that questioned approximately half of the claim costs. We have submitted a written rebuttal to the draft report and have formally requested a copy of the Technical Report. On July 22, 2004 the U.S. Government's Contracting Officer issued a final decision on the claim, denying the claim in full. In response, we plan to file a complaint in the Court of Federal Claims in the near future.

This U. S. Government claim has followed the typical process of claim notification, preparation, submittal, government audit, and review by the contracting officer. Historically, most claims are initially denied in part or in full by the contracting officer (or no decision is forthcoming, which is then taken to be a deemed denial) which then forces us to seek relief in a court of law.

We consider 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. The U.S. Government, citing failure to deliver the product within contract terms, has assessed liquidated damages but has not offset or withheld any progress payments due to us under the contract. We dispute 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 our control and not due to our fault or negligence. However, following accounting principles generally accepted in the United States, we have reduced contract values and corresponding revenue recognition for an estimated amount of \$330,000 to cover a delay through the extended delivery period.

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With respect to the claims filed against an international customer, we are currently in the discovery phase of the arbitration process. We have filed our "Points of Claim" to which the customer has replied. Additionally, the customer has filed a counterclaim, which we answered, in the fiscal quarter ended August 27, 2004. The customer, citing failure to deliver product within contract terms, has assessed liquidated damages totaling approximately \$400,000 on the contract. We dispute the basis for these liquidated damages and are vigorously contesting them. However, following accounting principles generally accepted in the United States of America, we have reduced contract values and corresponding revenue recognition by approximately \$400,000. The Company is currently in discussions with this customer to finalize all open issues. At this

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time we are unable to assess the ultimate impact of any discussions or arbitration on current operations and financials.

The open balance of \$700,000 due on the contract represents the total net exposure to us on this contract. On June 16, 2003, we 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. In December 2003 we and the RTAF both picked arbitrators to represent each of us respectively in the dispute, although no date has yet been set for the Arbitration proceedings. To choose the third (umpire) arbitrator, the RTAF, TAI, and the Company will each nominate three candidates for a total of nine. The RTAF and the Company will then rank the candidates and the one receiving the highest rating will be asked to serve as the (umpire) arbitrator. It is felt this approach will avoid any conflict of interest issues.

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, we believe 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. We continue to enjoy a favorable relationship with the RTAF. We currently have both maintenance and upgrade contracts with the RTAF for trainers that are the subject of the dispute and have sold a significant amount of additional equipment to the RTAF since this dispute began, and the initiation of legal action against the RTAF has not affected our ability to obtain future contracts with the RTAF. At this point, we are not able to determine what, if any, impact the extended completion period will ultimately have upon the receipt of final payment under this contract.

Backlog

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Our sales backlog at November 26, 2004 and February 27, 2004, for work to be performed and revenue to be recognized under written agreements after such dates was approximately \$16,029,000 and \$16,914,000 respectively. In addition, our training, maintenance and upgrade contracts backlog at November 26, 2004, and February 27, 2004, for work to be performed and revenue to be recognized after that date under written agreements was approximately \$1,200,000 and \$2,637,000 respectively. Of the November 26, 2004 backlog, approximately \$9,716,000 was under contracts for ATS products including \$2,404,000 for Egypt and \$6,600,000 for a contract in the Company's Polish subsidiary for simulators for L-3 Communications.

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

We are exposed to various market risk, including changes in interest rates. Market risk is the potential loss arising from adverse changes in market rates and prices such as interest rates and foreign exchange rates. We do not enter into derivatives or other financial instruments for trading or speculative purposes. Also, we have not entered into financial instruments to manage and reduce the impact of interest rates and foreign currency exchange rates although we may enter into such transactions in the future. A portion of our indebtedness bears interest at rates that vary with the prime rate of interest. Accordingly, any applicable increases in the applicable prime rate of interest will reduce our earnings. With respect to currency risk, where we have a contract that is denominated in a foreign currency, we often establish local in-country bank accounts and fund in-country expenses in the local currency, thus creating a

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"natural" currency hedge for a portion of the contract.

### ITEM 4. CONTROLS AND PROCEDURES.

Under the supervision and with the participation of our management, including our chief executive officer and chief financial officer, we have evaluated the effectiveness of the design and operation of our disclosure controls and procedures as of November 26, 2004 (the "Evaluation Date"), and, based on this evaluation, our chief executive officer and chief financial officer have concluded that these controls and procedures were effective as of the Evaluation Date. There were no significant changes in our internal controls or in other factors that could significantly affect these controls during the fiscal quarter ended on 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 our internal controls and other procedures that are designed to ensure that information required to be disclosed by us in the reports that we file or submit 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 that we are required to disclose in the reports that we file under the Exchange Act is accumulated and communicated to our management, including our chief executive officer and chief financial officer, as appropriate to allow timely decisions regarding required disclosure.

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## 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 is ongoing and the Company is unable to predict the outcome of this matter.

In June 2003, Entertainment Technology Corporation ("EnTCo"), our wholly-owned subsidiary, 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 EnTCo 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 \$22 million plus punitive damages. EnTCo 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, the parties are engaged in the discovery process. The parties have exchanged self-executing disclosures and responses to interrogatories, have produced documents, and have conducted

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depositions. EnTCo 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 us. 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 our financial position if resolved unfavorably.

### ITEM 2. CHANGES IN SECURITIES AND USE OF PROCEEDS

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.

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### ITEM 4. SUBMISSION OF MATTERS TO VOTE OF SECURITY HOLDERS

At the Company's Annual Meeting of Stockholders held on September 20, 2004 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	Abstentions and		
	For	Withheld	Broker Non-votes
George K. Anderson	5,635,499	49,312	0
Howard W. Kelley	5,634,499	50,312	0
H.F. Lenfest	5,625,317	59,494	0
William F. Mitchell	5,635,437	49,374	0
Pete L. Stephens	5,634,499	50,312	0

### ITEM 5. OTHER INFORMATION

None.

### ITEM 6. EXHIBITS AND REPORTS ON FORM 8-K

#### (a) Exhibits:

Number	Item
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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)

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to Registrant's Form 10-K for the year ended February 25, 1994, and are incorporated herein by reference.

- 10.1 Amendment to Credit Agreement, dated as of October 18, 2004, between ETC and PNC Bank, National Association.
- 31.1 Certification dated January 10, 2005 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 10, 2005 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 10, 2005 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 20, 2004, the Company filed a Current Report on Form 8-K reporting its financial results for the second quarter of fiscal 2005.

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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 10, 2005

By: /s/ William F. Mitchell

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

Date: January 10, 2005

By: /s/ Duane D. Deaner

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