ENVIRONMENTAL TECTONICS CORP
Form 10-Q
October 14, 2003

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

FORM 10-Q

(Mark One)

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

For the quarterly period ended August 29, 2003

OR

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

For the transition period from _______ to _______

Commission File No. 1-10655

ENVIRONMENTAL TECTONICS CORPORATION
(Exact name of registrant as specified in its charter)

Pennsylvania	23-1714256
(State or other jurisdiction of incorporation or organization)	(IRS Employer Identification No.)

COUNTY LINE INDUSTRIAL PARK
SOUTHAMPTON, PENNSYLVANIA 18966
(Address of principal executive offices)
(Zip Code)

(215) 355-9100
(Registrant's telephone number, including area code)

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

Yes x No ____

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

Yes ____ No x

The number of shares outstanding of the registrant's common stock as of October 3, 2003 is: 7,157,239.

PART I - FINANCIAL INFORMATION

Item 1. Financial Statements

Environmental Tectonics Corporation
Consolidated Income Statements
(unaudited)
(amounts in thousands, except share and per share information)

	Thirteen Weeks Ended		Twenty-si
	August 29, 2003	August 23, 2002	August 29, 2003
Net Sales	$4,752	$11,041	$10,882
Cost of goods sold	2,966	7,778	6,809
Gross profit	1,786	3,263	4,073
Operating expenses:			
Selling and administrative	2,231	2,042	3,916
		113	
Research and development	(50)	-------	32
Operating (loss)/income	2,181	2,155	3,948
	(395)	1,108	125
Other expenses:			
Interest expense	389	125	767
Other, net	78	47	87
	467	172	854
(Loss)/income before income taxes	(862)	936	(729)
(Benefit from)/provision for income taxes	(238)	205	(171)
(Loss)/income before minority interest	(624)	731	(558)
Loss attributable to minority interest	2	5	6
Net (loss)/income	$(622)	$736	$(552)

Per share information:
(Loss)/income available to common

shareholders	$(622)	$736	$(552)
(Loss)/income per share: basic	$(0.09)	$0.10	$(0.08)
(Loss)/income per share: diluted	$(0.09)	$0.10	$(0.08)
Number of shares: basic	7,157,000	7,153,000	7,157,000
Number of shares: diluted	7,157,000	7,489,000	7,157,000

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

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Environmental Tectonics Corporation
Consolidated Balance Sheets

	August 29, 2003 (unaudited) (amounts in tho infor
Assets	
Current assets:	
Cash and cash equivalents	$ 384
Cash equivalents restricted for letters of credit	2,627
Accounts receivable, net	15,695
Costs and estimated earnings in excess of billings on uncompleted long-term contracts	7,518
Inventories	10,560
Deferred tax asset	689
Prepaid expenses and other current assets	1,762
Total current assets	39,235
Property, plant and equipment, at cost, net of accumulated depreciation of $10,313 at August 29, 2003 and $9,976 at February 28, 2003	4,956
Software development costs, net of accumulated amortization of $7,152 at August 29, 2003 and $6,819 at February 28, 2003	2,375
Goodwill and intangibles	477
Other assets, net	494
Total assets	$ 47,537
Liabilities and Stockholders' Equity Liabilities	
Current liabilities:	
Current portion of long-term debt	$ 278

Accounts payable - trade	2,305
Billings in excess of costs and estimated earnings on uncompleted long-term contracts	641
Customer deposits	4,047
Accrued liabilities	1,772
Total current liabilities	9,043
Long-term debt, less current portion:	
Credit facility payable to banks	200
Long-term bonds, net	4,370
Subordinated debt	7,523
Other	7
	12,100
Deferred income taxes	1,022
Total liabilities	22,165
Minority interest	42
Stockholders' Equity	
Common stock; $.05 par value; 20,000,000 shares authorized; 7,157,239 issued and outstanding at August 29, 2003 and February 28, 2003	358
Capital contributed in excess of par value of common stock	9,331
Accumulated other comprehensive loss	(194)
Retained earnings	15,835
Total stockholders' equity	25,330
Total liabilities and stockholders' equity	$ 47,537

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

Environmental Tectonics Corporation
Consolidated Statements of Cash Flows
(unaudited)

	Twenty-six Weeks	
	August 29, 2003	
	(amounts in thou	
Cash flows from operating activities:		
Net (loss)/income	$ (552)	

Adjustments to reconcile net (loss)/income to net cash (used in)/provided by operating activities:	
Depreciation and amortization	670
Non-cash interest expense	255
Provision for losses on accounts receivable and inventories	100
Minority interest	(6)
Changes in operating assets and liabilities:	
Accounts receivable	498
Costs and estimated earnings in excess of billings on uncompleted long-term contracts	(2,077)
Inventories	(2,166)
Prepaid expenses and other assets	(730)
Other assets	-
Accounts payable	527
Billings in excess of costs and estimated earnings on uncompleted long-term contracts	(822)
Customer deposits	1,047
Accrued income taxes	-
Other accrued liabilities	216
Net cash (used in)/provided by operating activities	(3,040)
Cash flows from investing activities:	
Acquisition of equipment	(207)
Capitalized software development costs	(484)
Net cash used in investing activities	(691)
Cash flows from financing activities:	
Borrowings under credit facility	200
Payments under credit facility	(600)
Repayment of long-term bonds	(275)
Cash equivalents restricted for letters of credit	562
Proceeds from issuance of common stock / warrants	-
Deferred finance charges/other	(52)
Net cash used in financing activities	(165)
Effect of exchange rate changes on cash	(25)
Net decrease in cash and cash equivalents	(3,921)
Cash and cash equivalents at beginning of period	4,305
Cash and cash equivalents at end of period	$384
Supplemental schedule of cash flow information:	
Interest paid	309
Income taxes paid	63

Supplemental information on noncash operating and investing activities:
During the twenty-six weeks ended August 23, 2002, the Company reclassified $226 from inventory to property, plant and equipment and $515 from inventory to capitalized software.

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

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

1. Basis of Presentation

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

The accompanying consolidated financial statements have been prepared by Environmental Tectonics Corporation, 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 period presented may not be indicative of the full year's results, although the Company believes the disclosures are adequate to make the information presented not misleading. These financial statements should be read in conjunction with the financial statements and the notes thereto included in the Company's Annual Report on Form 10-K for the year ended February 28, 2003. Certain reclassifications have been made to the fiscal 2003 financial statements to conform with the fiscal 2004 presentation.

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 August 29, 2003			Thirteen we
	Loss (Numerator)	Shares (Denominator)	Per Share Amount	Loss (Numerator)
	(amounts in thousands, except share and per share i			
Basic EPS				

Net (loss)/earnings available to common stockholders	$(622)	7,157,000	$(0.09)	$736
Effect of dilutive securities				
Options	-	-		
Warrants	-	-		
Diluted EPS				
Net (loss)/earnings available to common stockholders plus assumed conversions	$(622)	7,157,000	$(0.09)	$736

	Twenty-six Weeks Ended August 29, 2003			Twenty-six W
	Income (Numerator)	Shares (Denominator)	Per Share Amount	Income (Numerator)
	(amounts in thousands, except share and per share i			
Basic EPS				
Net (loss)/earnings available to common stockholders	$(552)	7,157,000	$(0.08)	$1,321
Effect of dilutive securities				
Options	-	-		
Warrants	-	-		
Diluted EPS				
Net (loss)/earnings available to common stockholders plus assumed conversions	$(552)	7,157,000	$(0.08)	$1,321

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At August 29, 2003 there were stock options to purchase the Company's common stock totaling 422,000 shares which were not included in the computation of diluted earnings per share, as the effect of such would be anti-dilutive. Additionally, there was subordinated debt with a face value of $10,000,000 which

was convertible at an exercise price of $6.05 per share, equating to 1,653,000 shares if fully converted to common shares. Additionally, upon each conversion of the Note, the holder would be entitled to receive a warrant to purchase additional shares of common stock equal to ten percent of the shares issued pursuant to such conversion. If the entire face value of the Note were to be converted into common shares, warrants for an additional 165,000 shares would be issued, bringing the total shares to be issued to 1,818,000. Additionally, at August 29, 2003, there were warrants to purchase the Company's stock totaling 1,241,000 shares. None of these shares were included in the computation of diluted earnings per share as the effect would be anti-dilutive.

At August 23, 2002, there were employee stock options to purchase the company's stock totaling 329,000 shares which were not included in the computation of diluted earnings per share, as the effect of such options would be anti-dilutive.

3. Stock Options

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

At August 29, 2003, the Company had one stock-based employee compensation plan. The Company accounts for this plan under the recognition and measurement principles of APB Opinion 25, "Accounting for Stock Issued to Employees," and related interpretations. Stock-based employee compensation costs are not reflected in net income, as all options granted under the plan had an exercise price equal to the market value of the underlying common stock on the date of grant. The following table illustrates the effect on net income and earnings per share if the Company had applied the fair value recognition provisions of SFAS No. 123, to stock-based employee compensation (in thousands, except per share amounts).

	Thirteen Weeks Ended	
	August 29, 2003	August 23,
Net (loss)/income, as reported	$(622)	
Less: stock-based compensation costs determined under fair market value based methods for all awards	(10)	

Net (loss)/income, pro forma	$ (632)
(Loss)/earnings per share of common stock-basic:	
As reported	$ (0.09)
Pro forma	$ (0.09)
(Loss)/earnings per share of common stock--diluted:	
As reported	$ (0.09)
Pro forma	$ (0.09)

	Twenty-six Weeks Ended	
	August 29, 2003	August 23,
Net (loss)/income, as reported	$(552)	$
Less: stock-based compensation costs determined under fair market value based methods for all awards	(20)	
Net (loss)/income, pro forma	$(572)	$
(Loss)/earnings per share of common stock-basic:		
As reported	$ (0.08)	
Pro forma	$ (0.08)	
(Loss)/earnings per share of common stock--diluted:		
As reported	$ (0.08)	
Pro forma	$ (0.08)	

There were no grants of stock options during the twenty-six weeks ended August 29, 2003 or August 23, 2002.

4. Accounts Receivable

The components of accounts receivable are as follows:

	August 29, 2003	Februa 200
	(amounts in thous	
U.S. Government receivables billed and unbilled contract costs subject to negotiation	$ 2,599	
U.S. commercial receivables billed	1,950	
International receivables billed and unbilled contract costs subject to negotiation	11,592	
	16,141	
Less allowance for doubtful accounts	(446)	
	$15,695	

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

Unbilled contract costs subject to negotiation as of August 29, 2003 and February 28, 2003, primarily represent claims made against the U.S. Government under a contract for a submarine rescue decompression chamber project. These costs totaling $2,453,000 were recorded beginning in fiscal year 2002 and include $1,691,000 recorded during fiscal year 2003 and $186,000 during fiscal year 2004.

International receivables billed and unbilled contract costs subject to negotiation:

International receivables billed includes $700,000 at August 29, 2003 and February 28, 2003, respectively, related to a contract with the Royal Thai Air Force ("RTAF").

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

The open balance of $700,000 due on the contract represents the total net exposure to the Company on this contract. On June 16, 2003, the Company's Thai attorneys filed for arbitration in Thailand seeking recovery of the open balance of $700,000 due on this contract. On October 8, 2003, the Thai government filed their defense with the Thai Arbitration Institute. This document is currently being translated into English. It is expected that the next step will be a conference, in the near future, among the parties to discuss the possibility of a settlement. However, 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 has enjoyed a favorable relationship with the RTAF. It currently has both maintenance and upgrade contracts with the RTAF for the trainers that are the subject of the dispute and has sold a significant amount of additional equipment to the RTAF since this dispute began, therefore it is not anticipated that the initiation of legal action against the RTAF will have any material adverse impact on future sales to the RTAF. At this point, the Company is not able to determine what, if any, impact the extended completion period will ultimately have upon the receipt

of final payment.

Unbilled contract costs subject to negotiation represent claims made or to be made against an international customer for two contracts covering 1997 to the present. Trade and claims receivables and resulting revenue aggregating $9,450,000 have been recorded. Claim costs have been incurred in connection with customer caused delays, errors in specifications and designs, other out-of-scope items and exchange losses and may not be received in full during fiscal 2004. In conformity with accounting principles generally accepted in the United States, revenue recorded by the Company from a claim does not exceed the incurred contract costs related to the claim. The Company is currently in arbitration with the international customer on both contracts. As a related item, during the third quarter of fiscal 2000, this international customer, citing failure to deliver product within contract terms, assessed liquidated damages totaling approximately $1,600,000 on two contracts currently in progress. The Company disputes the basis for these liquidated damages and plans to contest them vigorously. However, following generally accepted accounting principles, the Company has reduced contract values and corresponding revenue recognition by approximately $1,600,000.

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

The Company is currently mediating and arbitrating the disputes which have arisen under the two contracts in the United Kingdom but is unable to assess the ultimate impact of either the termination or the balance due on the contracts on its current operations and financial condition. With respect to the centrifuge contract, the Company and the U.K. Ministry of Defense have a mediation scheduled for October 2003 to attempt to resolve their differences.

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

5. Inventories

Inventories are valued at the lower of cost or market using the first in, first out (FIFO) method and consist of the following (net of reserves of $746,000 and $646,000 at August 29, 2003 and February 28, 2003, respectively):

	August 29, 2003	February 28, 2003

	(amounts in thousands)	
Raw materials	$311	$322
Work in Process	7,476	5,629
Finished Goods	2,773	2,543
Total	$10,560	$8,494

6. Stockholders' Equity

The components of stockholders' equity at February 28, 2003 and August 29, 2003 were as follows:

(amounts in thousands, except share in

	Common Stock		Additional Paid in Capital	Accumulated Other Comp. Loss	Re Ear
	Shares	Amount			
Balance at February 28, 2003	7,157,239	$ 358	$ 9,331	$ (169)	$ 16,
Net loss for the twenty-six weeks ended August 29, 2003	--	--	--	--	(
Foreign currency translation adjustment	--	--	--	(25)	-
Total comprehensive loss	--	--	--	--	-
	--	--	--	--	-
Balance at August 29, 2003	7,157,239	$ 358	$ 9,331	$ (194)	$ 15,

7. Long Term Debt

The following table lists the long-term debt and other long-term obligations of the Company as of August 29, 2003.

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	200	--	200	
Capital Leases	10	3	7	
Subordinated debt, net of unamortized discount of $ 2,477	7,523	--	--	
Long term bonds	4,370	--	825	
Total Obligations	$12,378	$ 278	$ 1,032	

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At August 29, 2003, the Company was in violation of one of its financial covenants in both its Bank Credit Agreement and its Convertible Note and Warrant Purchase Agreement, specifically the requirement to maintain a specified Leverage Ratio. This violation occurred as a result of the second quarter fiscal 2004 net loss. As of the date of this Quarterly Report on Form 10-Q, the Company had obtained waivers for this covenant violation from both the Bank and the Note holder.

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8. Business Segment Presentation:

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

	ATS	Industrial Group	Total
		(amounts in thousands)	
Thirteen weeks ended August 29, 2003			
Net Sales	$ 2,676	$ 2,076	$ 4,752
Interest Expense	300	89	389
Depreciation and Amortization	232	213	445
Operating Income/(Loss)	54	(131)	(77)
Income Tax Benefit	(68)	(61)	(129)
Goodwill and Intangibles	477	--	477
Identifiable Assets	28,009	8,139	36,148
Expenditures For Segment Assets	86	26	112
Thirteen weeks ended August 23, 2002			
Net Sales	$ 9,326	$ 1,715	$ 11,041
Interest Expense	107	18	125
Depreciation and Amortization	253	52	305
Operating Income/(Loss)	1,462	(140)	1,322
Income Tax Provision/(Benefit)	297	(35)	262
Goodwill and Intangibles	477	--	477
Identifiable Assets	27,597	5,886	33,483
Expenditures For Segment Assets	61	13	74

Reconciliation to consolidated amounts	2003	2002
Corporate Assets	$ 11,389	$ 9,234

Total Assets	$ 47,537	$ 42,717
Segment operating (loss)/income	$ (77)	$ 1,322
Less interest expense	(389)	(125)
Less income taxes benefit/(expense)	129	(262)
Total (loss)/profit for segments	(337)	935
Corporate home office expenses	(318)	(214)
Interest and other expenses	(78)	(47)
Income tax benefit	109	57
Minority interest	2	5
Net (loss)/income	$ (622)	$ 736

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	ATS	Industrial Group	Total
		(amounts in thousands)	
Twenty-six weeks ended August 29, 2003			
Net Sales	$ 5,661	$ 5,221	$ 10,882
Interest Expense	594	173	767
Depreciation and Amortization	449	476	925
Operating Income	235	516	751
Income Tax (Benefit)/Provision	(125)	221	96
Goodwill and Intangibles	477	--	477
Identifiable Assets	28,009	8,139	36,148
Expenditures For Segment Assets	160	47	207
Twenty-six weeks ended August 23, 2002			
Net Sales	$ 17,118	$ 5,130	$ 22,248
Interest Expense	232	34	266
Depreciation and Amortization	458	174	632
Operating Income/(Loss)	3,005	(275)	2,730
Income Tax Provision/(Benefit)	765	(84)	681
Goodwill and Intangibles	477	--	477
Identifiable Assets	27,597	5,886	33,483
Expenditures For Segment Assets	92	17	109

Reconciliation to consolidated amounts	2003	2002
Corporate Assets	$ 11,389	$ 9,234
Total Assets	$ 47,537	$ 42,717
Segment operating income	$ 751	$ 2,730
Less interest expense	(767)	(266)
Less income taxes	(96)	(681)

Total (loss)/profit for segments	(112)	1,783
Corporate home office expenses	(626)	(547)
Interest and other expenses	(87)	(150)
Income tax benefit	267	204
Minority interest	6	31
Net (loss)/income	$ (552)	$ 1,321

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

Approximately 43% of sales totaling $2,020,000 in the thirteen weeks ended August 29, 2003, were made to one domestic customer and one international customer in the sterilizer and ATS segments respectively. Approximately 73% of sales totaling $8,107,000 in the thirteen weeks ended August 23, 2002 were made to one domestic customer in the ATS segment.

Approximately 37% of sales totaling $3,992,000 in the twenty-six weeks ended August 29, 2003, were made to one domestic customer and one international customer in the sterilizer and ATS segments respectively. Approximately 65% of sales totaling $14,383,000 in the twenty-six weeks ended August 23, 2002 were made to one domestic customer in the ATS segment.

Included in the segment information for the thirteen weeks ended August 29, 2003 are export sales of $2,665,000. Of this amount, there are sales to or relating to governments or commercial accounts in Malaysia ($1,280,000), Nigeria ($474,000), and Korea ($275,000). Sales to the U.S. Government and its agencies aggregated $330,000 for the period.

Included in the segment information for the thirteen weeks ended August 23, 2002 are export sales of $1,351,000. Of this amount, there are sales to or relating to commercial accounts in China of $335,000 and Thailand of $306,000. Sales to the U.S. Government and its agencies aggregated $855,000 for the period.

Included in the segment information for the twenty-six weeks ended August 29, 2003 are export sales of $5,636,000. Of this amount, there are sales to or relating to commercial accounts in Malaysia of $2,094,000. Sales to the U.S. Government and its agencies aggregated $665,000 for the period.

Included in the segment information for the twenty-six weeks ended August 23, 2002 are export sales of $4,037,000. Of this amount, there are sales to or relating to commercial accounts in China of $1,847,000 and Thailand of $893,000. Sales to the U.S. Government and its agencies aggregated $1,434,000 for the period.

9. Recent Accounting Pronouncements

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

In April 2002, the Financial Accounting Standards Board (FASB) issued SFAS No. 145, "Rescission of FASB statements No. 4, 44, and 64, Amendment of FASB No. 13, and Technical Corrections." SFAS No. 145 changes the accounting principles governing extraordinary items by clarifying, and to some extent, modifying, the existing definition and criteria, specifying disclosure for extraordinary items and specifying disclosure requirements for other unusual or infrequently occurring events and transactions that are not extraordinary items. SFAS No. 145 is effective for financial statements issued for fiscal years beginning after June 15, 2002, with early adoption encouraged. The adoption of SFAS No. 145 did not have a significant impact on the financial condition or results of operations of the Company.

Accounting for Costs Associated with Exit or Disposal Activities:

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

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

In January 2003, the FASB issued FASB Interpretation 46 (FIN 46), Consolidation of Variable Interest Entities. FIN 46 clarifies the application of Accounting Research Bulletin 51, Consolidated Financial Statements, for certain entities that do not have sufficient equity at risk for the entity to finance its activities without additional subordinated financial support from other parties or in which equity investors do not have the characteristics of a controlling financial interest ("variable interest entities"). Variable interest entities within the scope of FIN 46 will be required to be consolidated by their primary beneficiary. The primary beneficiary of a variable interest entity is determined to be the party that absorbs a majority of the entity's expected losses, receives a majority of its expected returns, or both. FIN 46 applies immediately to variable interest entities created after January 31, 2003, and to variable interest entities in which an enterprise acquires an interest after

that date. It applies in the first fiscal year or interim period beginning after June 15, 2003, to variable interest entities in which an enterprise holds a variable interest that it acquired before February 1, 2003. The adoption of FIN 46 did not have a material effect on the Company's consolidated financial position, results of operations, or cash flows.

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

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

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

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

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

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 difference include, but are not limited to, those discussed in the Company's Annual Report on Form 10-K for the fiscal year ended February 28, 2003, in the section entitled "Risks Particular to Our Business." Shareholders are urged to review these risks carefully prior to making an investment in the Company's common stock.

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

Overview

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

The Company recognizes revenue using three methods:

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

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

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

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

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

Critical Accounting Policies

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

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

Revenue Recognition on Long-Term Contracts

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

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

Accounts Receivable

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

Results of Operations
Thirteen weeks ended August 29, 2003 compared to thirteen weeks ended August 23, 2002.

Net Income.

The Company had a net loss of $622,000, or ($0.09) per share (diluted), during the second quarter of fiscal 2004 versus a net income of $736,000, or $.10 per share (diluted), for the second quarter of fiscal 2003, representing a decrease of $1,358,000 or 184.5%. This decrease was due to a significant decrease in sales and gross profit margin and an increase in selling, general and administrative and interest expense, partially offset by decreased estimated taxes.

Sales.

Sales for the second quarter of fiscal 2004 were $4,752,000 as compared to $11,041,000 for the second quarter of fiscal 2003, a decrease of $6,289,000 or 57.0%. The primary contributor to the sales decrease was reduced revenues for domestic entertainment (down $8,100,000) due to the completion of a major entertainment project. Providing partial offsets were increased domestic sterilizer sales, which benefited from a new Ethylene Oxide ("ETO") sterilizer project, increased revenues from international Aircrew Training Systems, which benefited from a centrifuge project in Malaysia, and higher sales for service and spares.

Domestic Sales.

Overall, domestic sales in the second quarter of fiscal 2004 were $1,757,000 as compared to $8,835,000 in the second quarter of fiscal 2003, a decrease of $7,079,000 or 80.1%. This decrease was primarily due to the decrease in entertainment sales. Domestic sales represented 37.0% of the Company's total sales in the second quarter of fiscal 2004, down from 80.0% for the second quarter of fiscal 2003. Sales to the U.S. Government in the second quarter of fiscal 2004 were $330,000 as compared to $855,000 in the second quarter of fiscal 2003, a decrease of $525,000, and represented 6.9% of total sales in the second quarter of fiscal 2004 versus 7.7% for the second quarter of fiscal 2003.

International Sales.

International sales for the second quarter of fiscal 2004 were $2,665,000 as compared to $1,351,000 in the second quarter of fiscal 2003, an increase of $1,314,000 or 97.3%, and represented 56.1% of total sales, as compared to 12.2% in the second quarter of fiscal 2003. Throughout the Company's history, most of the sales for Aircrew Training Systems have been made to international customers. In the thirteen weeks ended August 29, 2003, international sales totaling at least ten percent of total international sales were made to Malaysia ($1,280,000), Nigeria ($474,000) and Korea ($275,000). In the thirteen weeks ended August 23, 2002, there were no international sales totaling at least ten percent of total international sales. Fluctuations in sales to international countries from year to year primarily reflect revenue recognition on the level and stage of development and production on multi-year long-term contracts.

Gross Profit.

Gross profit for the second quarter of fiscal 2004 was $1,786,000 as compared to $3,263,000 in the second quarter of fiscal 2003, a decrease of $1,477,000 or 45.3%. This decrease reflected the decrease in sales which was only partially offset by an 8.0 percentage point increase in the gross profit rate as a percent of sales. Increased gross profit rates as a percent of sales were evidenced in domestic sterilizer and international ATS sales.

Selling and Administrative Expenses.

Selling and administrative expenses for the second quarter of fiscal 2004 were $2,231,000 as compared to $2,042,000 in the first quarter of fiscal 2003, an increase of $189,000 or 9.3% as compared to the second quarter of fiscal 2003, primarily reflecting increased legal and claim costs.

Research and Development Expenses.

Research and development expenses, which are charged to operations as incurred, were a net credit of $50,000 for the second quarter of fiscal 2004 as compared to an expense of $113,000 for the second quarter of fiscal 2003, reflecting a decrease of $163,000 or 144.3%. The net credit in the current period reflected government grants in our Turkish subsidiary under a government research award for work on our multi-axis centrifuge tactical flight simulator. Most of the Company's research efforts, which were and continue to be a significant cost of its business, are included in cost of sales for applied research for specific contracts, as well as research for feasibility and technology updates.

Interest Expense.

Interest expense for the second quarter of fiscal 2004 was $389,000 as compared to $125,000 for the second quarter of fiscal 2003, representing an increase of $264,000 or 211.2%. This increase reflected interest charges at a higher effective interest rate for the Company's subordinated debt borrowed in February 2003 (including amortization of debt discounts arising out of the beneficial conversion option and associated warrants issued) and amortization of deferred financing costs for the Company's February 2003 refinancing.

Provision for Income Taxes.

The Company's tax benefit for the second quarter of fiscal 2004 reflected an estimated 30% rate domestically and a consolidated estimated rate of 27.6%. The lower than statutory effective tax rate domestically reflects the ongoing effect of offsetting research and development tax credits. The international rate reflects a recalculation in ETC Europe, a subsidiary of the Company, of the estimated tax loss carry-forward which will be used to offset any current year tax liability. The consolidated rate for the second quarter of fiscal 2003 reflected an estimated rate of 21.9%, reflecting additional research and development tax credits.

Results of Operations
Twenty-six weeks ended August 29, 2003 compared to twenty-six weeks ended August 23, 2002.

Net Income.

The Company had a net loss of $552,000, or ($0.08) per share (diluted), during the first half of fiscal 2004 versus net income of $1,321,000, or $.18 per share (diluted), for the first half of fiscal 2003, representing a decrease of $1,873,000 or 141.8%. This decrease was due to a decrease in sales and gross profit margin and an increase in interest expense, partially offset by decreased selling and administrative expenses and estimated taxes.

Sales.

Sales for the first half of fiscal 2004 were $10,882,000 as compared to $22,248,000 for the first half of fiscal 2003, a decrease of $11,366,000 or 51.1%. The primary contributors to the sales decrease were reduced revenues for domestic entertainment (down $14,207,000) due to the completion of a major entertainment project and for overall environmental sales (down $2,445,000) as a series of projects were delayed. Providing partial offsets were increased

domestic sterilizer sales (up $2,211,000), which benefited from a new ETO sterilizer project, increased international Aircrew Training Systems (up $2,964,000), which benefited from a centrifuge project in Malaysia, and higher overall simulation sales for various projects (up $548,000).

Domestic Sales.

Overall, domestic sales in the first half of fiscal 2004 were $4,581,000 as compared to $16,776,000 in the first half of fiscal 2003, a decrease of $12,195,000 or 72.7%. This decrease was primarily due to the decrease in entertainment sales. Domestic sales represented 42.1% of the Company's total sales in the first half of fiscal 2004, down from 75.4% for the first half of fiscal 2003. Sales to the U.S. Government in the first half of fiscal 2004 were $665,000 as compared to $1,434,000 in the first half of fiscal 2003, a decrease of $769,000, 53.6%, and represented 6.1% of total sales in the first half of fiscal 2004 versus 6.5% for the first half of fiscal 2003.

International Sales.

International sales for the first half of fiscal 2004 were $5,636,000 as compared to $4,038,000 in the first half of fiscal 2003, an increase of $1,598,000 or 39.6%, and represented 51.8% of total sales, as compared to 18.1% in the first half of fiscal 2003. Throughout the Company's history, most of the sales for Aircrew Training Systems have been made to international customers. In the first half of fiscal 2004, international sales totaling at least ten percent of total international sales were made to Malaysia ($2,094,000). In the first half of fiscal 2003, international sales totaling at least ten percent of total international sales were made to China ($1,847,000) and Thailand ($893,000). Fluctuations in sales to international countries from year to year primarily reflect revenue recognition on the level and stage of development and production on multi-year long-term contracts.

Gross Profit.

Gross profit for the first half of fiscal 2004 was $4,073,000 as compared to $6,846,000 in the first half of fiscal 2003, a decrease of $2,773,000 or 40.5%. This decrease reflected the decrease in sales which was only partially offset by a 6.6 percentage point increase in the gross profit rate as a percent of sales. Increased gross profit rates as a percent of sales were evidenced in domestic sterilizer and international ATS sales.

Selling and Administrative Expenses.

Selling and administrative expenses for the first half of fiscal 2004 were $3,916,000 as compared to $4,444,000 in the first half of fiscal 2003, a decrease of $528,000 or 11.9% as compared to the first half of fiscal 2003, primarily reflecting a reimbursement in the first quarter of fiscal 2004 of prior period legal and claim expenses associated with an arbitration hearing in January 2003. Additional savings were evidenced in the Company's European and Polish subsidiaries.

Research and Development Expenses.

Research and development expenses, which are charged to operations as incurred, were $32,000 for the first half of fiscal 2004 as compared to $219,000 for the first half of fiscal 2003, reflecting a decrease of $187,000 or 85.4%. This decrease reflected government grants in our Turkish subsidiary under a

government research award for work on our multi-axis centrifuge tactical flight simulator. Most of the Company's research efforts, which were and continue to be a significant cost of its business, are included in cost of sales for applied research for specific contracts, as well as research for feasibility and technology updates.

Interest Expense.

Interest expense for the first half of fiscal 2004 was $767,000 as compared to $266,000 for the first half of fiscal 2003, representing an increase of $501,000 or 188.4%. This increase reflected interest charges at a higher effective interest rate for the Company's subordinated debt borrowed in February 2003 (including amortization of debt discounts arising out of the beneficial conversion option and associated warrants issued) and amortization of deferred financing costs for the Company's February 2003 refinancing.

Provision for Income Taxes.

The Company's tax provision for the first half of fiscal 2004 reflected an estimated 30.0% rate domestically and a consolidated estimated rate of 23.5%. The lower than statutory effective tax rate domestically reflects the ongoing effect of offsetting research and development tax credits. The international rate reflects a recalculation in ETC Europe, a subsidiary of the Company, of the estimated tax loss carry-forward which will be used to offset any current year tax liability. The consolidated rate for the first half of fiscal 2003 reflected an estimated rate of 27.0% reflecting additional research and development tax credits.

Liquidity and Capital Resources

During the twenty-six week period ended August 29, 2003, the Company used $3,040,000 to support operating activities. This was primarily the result of the net loss coupled with an increase in costs and estimated earnings in excess of billings on uncompleted long-term contracts, inventories, prepaids, and a reduction in billings in excess of costs and estimated earnings on uncompleted long-term contracts. Acting as partial offsets were non-cash expenses and an increase in customer deposits. Generally speaking, the cash usage reflected a production build on long-term contracts and a build-up in inventory of costs for contracts which were not finished by the end of the period, partially offset by additional cash from deposits from customers.

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The Company's investing activities used $691,000 during the twenty-six weeks ended August 29, 2003, which consisted of purchases of capital equipment and capitalized software.

The Company's financing activities used $165,000 during the twenty-six weeks ended August 29, 2003, consisting of repayments on the Company's bank line and long-term bonds partially offset by a reduction in the Company's cash collateral restricted cash account. This account serves as security for any of the Company's international letters of credit which are not covered under the Company's bank facility.

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

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

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

The terms and conditions of the revolving loan and the line of credit are set forth in a Credit Agreement, as amended, between the Company and PNC Bank. Availability under both the main facility and the EXIM facility are determined each month based on a borrowing base consisting of a portion of the Company's receivables, inventory and costs and estimated earnings in excess of billings, net of billings in excess of costs and estimated earnings on uncompleted long-term contracts. As of August 29, 2003, availability under the $14,800,000 revolving facility was $7,705,000, of which the Company had utilized $6,644,000 primarily to support international letters of credit, and availability under the EXIM facility was $97,000, which was fully available.

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

At August 29, 2003, the Company was in violation of one of its financial covenants in both its Bank Credit Agreement and its Convertible Note and Warrant Purchase Agreement, specifically the requirement to maintain a specified Leverage Ratio. This violation occurred as a result of the second quarter fiscal 2004 net loss. As of the date of this Quarterly Report on Form 10-Q, the Company has obtained waivers for this covenant violation from both the Bank and the Note holder. Notwithstanding the covenant violation at August 29, 2003, it is the opinion of management based on the current sales backlog and forecasted new contract bookings that it is not probable that the Company will have additional covenant violations going forward. However, should there be unforeseen delays in completing existing contracts or should the receipt of new contracts be delayed, it is possible that additional covenant violations may occur.

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

and matures on February 18, 2009. The note entitles Mr. Lenfest to convert all or a portion of the outstanding principal of plus accrued and unpaid interest on the note into shares of common stock at a conversion price of $6.05 per share. The warrants may be exercised into shares of common stock at an exercise price equal to the lesser of $4.00 per share or two-thirds of the average of the high and low sale prices of the common stock for the 25 consecutive trading days immediately preceding the date of exercise.

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

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

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

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

	Payments Due by Period (in thousands)				
	Total	Less Than 1 Year	1-3 Years	4-5 Years	After 5 Years
Long-term debt, including current maturities	$12,378	$ 278	$ 1,032	$ 550	$10,518
Operating leases	530	249	281	-	-
Total	12,908	$ 527	$ 1,313	$ 550	$10,518

Contract Claims

Historically, the Company has had positive experience with regard to its contract claims in that recoveries have exceeded the carrying value of

claims. As of August 29, 2003, claims recorded against the U.S. Government totaled $2,453,000 and claims recorded against an international customer totaled $9,450,000.

The Company is currently mediating and arbitrating the disputes which have arisen under two contracts with one of its international customers in the United Kingdom but is unable to assess the ultimate impact of the arbitration on current operations and financial condition. With respect to the centrifuge contract, the Company and the U.K. Ministry of Defense have a mediation scheduled for October 2003 to attempt to resolve their differences.

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

The Company has an open receivable balance of $700,000 due from the RTAF. This amount represents the total net exposure to the Company on this contract. On June 16, 2003, the Company's Thai attorneys filed for arbitration in Thailand seeking recovery of the open balance of $700,000 due on the contract. On October 8, 2003, the Thai government filed their defense with the Thai Arbitration Institute. This document is currently being translated into English. It is expected that the next step will be a conference, in the near future, among the parties to discuss the possibility of a settlement. 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 has enjoyed a favorable relationship with the RTAF. It currently has both maintenance and upgrade contracts with the RTAF for trainers that are the subject of the dispute and has sold a significant amount of additional equipment to the RTAF since this dispute began, so it is not anticipated that the initiation of legal action against the RTAF will have any material adverse impact on future contracts with the RTAF. At this point, the Company is not able to determine what, if any, impact the extended completion period will ultimately have upon the receipt of final payment under this contract.

Backlog

The Company's sales backlog at August 29, 2003 and February 28, 2003, for work to be performed and revenue to be recognized under written agreements after such dates was approximately $16,049,000 and $21,454,000 respectively. In addition, the Company's training, maintenance and upgrade contracts backlog at August 29, 2003, and February 28, 2003, for work to be performed and revenue to be recognized after that date under written agreements was approximately $3,461,000 and $3,931,000 respectively. Of the August 29, 2003 backlog, approximately $11,792,000 was under contracts for ATS and maintenance support including $4,578,000 for the Royal Malaysian Air Force.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

Not Applicable.

Item 4. Controls and Procedures.

Under the supervision and with the participation of the Company's management, including the Company's principal executive officer and principal financial officer, the Company has evaluated the effectiveness of the design and operation of the Company's disclosure controls and procedures as of August 29, 2003 (the "Evaluation Date"), and, based on their evaluation, the Company's principal executive officer and principal financial officer have concluded that these controls and procedures were effective as of the Evaluation Date. There were no significant changes in the Company's internal controls or in other factors that could significantly affect these controls subsequent to the Evaluation Date.

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

Part II - OTHER INFORMATION

Item 1. Legal Proceedings

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

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

each of the claims of AMI and intends to vigorously defend itself against these claims. At this time, however, the Company is unable to predict the outcome of this matter.

In June 2003, Entertainment Technology Corporation, a wholly-owned subsidiary of the Company, filed suit against Walt Disney World Co. and other entities ("Disney") in the United States District Court for the Eastern District of Pennsylvania, alleging breach of contract for, among other things, failure to pay all amounts due under contract for the design and production of the amusement park ride "Mission: Space" located in Disney's Epcot Center. In response, in August 2003, Disney filed counterclaims against both Entertainment Technology Corporation and the Company (under a guarantee) for, among other things, alleged failures in performance and design in the contract. Disney is seeking damages in excess of $150,000. Entertainment Technology Corporation and the Company believe that they have valid defenses to each of Disney's counterclaims and intend to vigorously defend against these counterclaims. At this time, however, discovery has not commenced and Entertainment Technology Corporation and the Company are unable to predict the outcome of this matter.

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

Item 2. Changes in Securities and Use of Proceeds

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

Item 3. Defaults Upon Senior Securities

None.

Item 4. Submission of Matters to Vote of Security Holders

None.

Item 5. Other Information

None.

Item 6. Exhibits and Reports on Form 8-K

(a) Exhibits:

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

incorporated herein by reference.

31.1 Certification dated October 14, 2003 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 October 14, 2003 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 October 14, 2003 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 July 18, 2003, the Company filed a Current Report on Form 8-K reporting its financial results for the first quarter of fiscal 2004.

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Signatures

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

ENVIRONMENTAL TECTONICS CORPORATION
(Registrant)

Date: October 14, 2003 By:/s/ William F. Mitchell

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

Date: October 14, 2003 By:/s/ Duane Deaner

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