ENVIRONMENTAL TECTONICS CORP
Form 10-Q
July 11, 2005

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

FORM 10-Q

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

FOR THE QUARTERLY PERIOD ENDED MAY 27, 2005

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 June 30, 2005 is: 9,019,376.

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	
	MAY 27, 2005	May 28, 2004
Net sales	$ 5,915	$ 6,175
Cost of goods sold	4,433	5,181
Gross profit	1,482	994
Operating expenses:		
Selling and administrative	2,627	2,430
Research and development	7	209
	2,634	2,639
Operating loss	(1,152)	(1,645)
Other expenses:		
Interest expense	550	344
Other, net	24	85
	574	429
Loss before income taxes	(1,726)	(2,074)
Benefit from income taxes	--	(614)
Loss before minority interest	(1,726)	(1,460)
Profit/(loss) attributable to minority interest	(3)	1
Net loss	$ (1,723)	$ (1,461)
Per share information:		
Basic and diluted loss per share	$ (.19)	$ (.19)
Basic and diluted weighted average shares	9,019,000	7,635,000

THE ACCOMPANYING NOTES ARE AN INTEGRAL PART OF THE CONSOLIDATED FINANCIAL STATEMENTS.

2

ENVIRONMENTAL TECTONICS CORPORATION
CONSOLIDATED BALANCE SHEETS

MAY 27, 2005 F

	(UNAUDITED) (AMOUNTS IN THO EXCEPT SHARE INF
ASSETS	
CURRENT ASSETS:	
Cash and cash equivalents	$ 6,816
Cash equivalents restricted	4,285
Accounts receivable, net	8,943
Costs and estimated earnings in excess of billings on uncompleted long-term contracts	3,389
Inventories	8,306
Deferred tax asset	1,786
Prepaid expenses and other current assets	1,751
Total current assets	35,276
Property, plant and equipment, at cost, net of accumulated depreciation of $11,668 at May 27, 2005 and $11,491 at February 25, 2005	4,253
Software development costs, net of accumulated amortization of $8,954 at May 27, 2005 and $8,658 at February 25, 2005	3,465
Goodwill and intangibles	477
Other assets, net	1
TOTAL ASSETS	$ 43,472
LIABILITIES AND STOCKHOLDERS' EQUITY	
LIABILITIES	
CURRENT LIABILITIES:	
Current portion of long-term debt	$ 275
Accounts payable - trade	1,570
Billings in excess of costs and estimated earnings on uncompleted long-term contracts	1,787
Customer deposits	1,687
Accrued liabilities	1,780
Total current liabilities	7,099
Long-term debt, less current portion:	
Credit facility payable to banks	--
Long-term bonds, net	3,820
Subordinated debt	8,082
	11,902
Deferred income taxes	1,786
TOTAL LIABILITIES	20,787
Minority interest	42
STOCKHOLDERS' EQUITY	
Common stock; $.05 par value; 20,000,000 shares authorized; 9,019,376 issued and outstanding at May 27, 2005 and February 25, 2005	450
Capital contributed in excess of par value of common stock	16,561
Accumulated other comprehensive loss	(126)
Retained earnings	5,758

Total stockholders' equity	22,643
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	$ 43,472

THE ACCOMPANYING NOTES ARE AN INTEGRAL PART OF THE CONSOLIDATED FINANCIAL STATEMENTS.

3

ENVIRONMENTAL TECTONICS CORPORATION
CONSOLIDATED STATEMENTS OF CASH FLOWS
(UNAUDITED)

	THIRTEEN W
	MAY 27, 2005
	(AMOUNTS IN THOU
CASH FLOWS FROM OPERATING ACTIVITIES:	
Net loss	$ (1,723)
Adjustments to reconcile net loss to net cash (used in) provided by operating activities:	
Depreciation and amortization	709
Non-cash interest expense	90
Provision for losses on accounts receivable and inventories	144
Minority interest	(3)
Changes in operating assets and liabilities:	
Accounts receivable	(1,022)
Costs and estimated earnings in excess of billings on uncompleted long-term contracts	(56)
Inventories	(425)
Prepaid expenses and other current assets	(240)
Other assets	--
Accounts payable	(1,323)
Billings in excess of costs and estimated earnings on uncompleted long-term contracts	254
Customer deposits	(560)
Other accrued liabilities	(908)
NET CASH (USED IN) PROVIDED BY OPERATING ACTIVITIES	(5,063)
CASH FLOWS FROM INVESTING ACTIVITIES:	
Acquisition of equipment	(99)
Capitalized software development costs	(194)
NET CASH USED IN INVESTING ACTIVITIES	(293)
CASH FLOWS FROM FINANCING ACTIVITIES:	
Payments under credit facility	--
Repayment of long-term bonds	(275)
Cash equivalents, restricted	395

Proceeds from issuance of common stock / warrants	--
Capitalized lease payments	--
NET CASH PROVIDED BY (USED IN) FINANCING ACTIVITIES	120
Effect of exchange rate changes on cash	11
Net (decrease) increase in cash and cash equivalents	(5,225)
Cash and cash equivalents at beginning of period	12,041
Cash and cash equivalents at end of period	$ 6,816
SUPPLEMENTAL SCHEDULE OF CASH FLOW INFORMATION:	
Interest paid	457
Income taxes paid	4

SUPPLEMENTAL INFORMATION ON NON-CASH OPERATING AND INVESTING ACTIVITIES:

During the thirteen-week period ending May 28, 2004, $593 was reclassified from inventory to fixed assets.

THE ACCOMPANYING NOTES ARE AN INTEGRAL PART OF THE CONSOLIDATED FINANCIAL STATEMENTS.

4

ENVIRONMENTAL TECTONICS CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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, Inc. ("ETC Delaware"), its wholly-owned subsidiaries, ETC Europe, its 99% owned subsidiary, and ETC-PZL Aerospace Industries, Ltd. ("ETC-PZL"), its 95% owned subsidiary.

The accompanying consolidated financial statements have been prepared by ETC, without audit, pursuant to the rules and regulations of the Securities and Exchange Commission, and reflect all adjustments which, in the opinion of management, are necessary for a fair presentation 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 25, 2005.

2. EARNINGS PER SHARE

Our calculation of earnings per share (EPS) in accordance with Statement of Financial Accounting Standards (SFAS) No. 128, "Earnings Per Share", is as follows:

	Thirteen weeks ended May 27, 2005			Thirteen weeks ende	
	Loss (Numerator)	Shares (Denominator)	Per Share Amount	Loss (Numerator)	Share (Denomin
		(amounts in thousands, except share and per share inform			
Basic EPS					
Net loss applicable to common stockholders	$1,723	9,019,000	$0.19	$1,461	7,635,00
Effect of dilutive securities					
Options		-			
Warrants		-			
Diluted EPS					
Net loss applicable to common stockholders plus assumed conversions	$1,723	9,019,000	$0.19	$1,461	7,635,00

At May 27, 2005 the Company had outstanding employee common stock options totaling 276,162 shares which were not included in the computation of diluted earnings per share, as the effect of such would be anti-dilutive. Additionally, the Company had 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 subordinated note, the holder is 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 amount of subordinated debt were to be converted into common shares, warrants to purchase an additional 165,289 shares would be issued, bringing the total shares to be issued to 1,818,182. None of these shares were included in the computation of diluted earnings per share as the effect would be anti-dilutive.

At May 28, 2004, the Company had outstanding employee common stock options totaling 357,802 shares which were not included in the computation of diluted earnings per share, as the effect of such options would be anti-dilutive. Additionally, the Company had 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 subordinated note, the holder is 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 amount of subordinated debt were to be converted into common shares, warrants to purchase an additional 165,289 shares would be issued, bringing the total shares to be issued to 1,818,182. Additionally, there were outstanding warrants to purchase the Company's stock totaling 803,048 shares. None of these shares were 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. (See Note 9, Recent Accounting Pronouncements, "Accounting for Share Based Payments", for a discussion of SFAS No. 123.)

At May 27, 2005, 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).

ENVIRONMENTAL TECTONICS CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS, CONTINUED

	Thirteen weeks ended	
	May 27, 2005	May 28, 2004
Net loss, as reported	$1,723	$ 1,461
Less: stock-based compensation costs determined under fair market value based methods for all awards	-	(7)
Net loss, pro forma	$ 1,723	$ 1,468

Loss per share of common stock-basic:		
As reported	$ 0.19	$ 0.19
Pro forma	$ 0.19	$ 0.19
Loss per share of common stock--diluted:		
As reported	$ 0.19	$ 0.19
Pro forma	$ 0.19	$ 0.19

There were no grants of stock options during the thirteen weeks ended May 27, 2005 or May 28, 2004.

4. ACCOUNTS RECEIVABLE

The components of accounts receivable are as follows:

	May 27, 2005
	(amounts in
U.S. Government receivables billed and unbilled contract costs subject to negotiation	$ 4,428
U.S. commercial receivables billed	2,854
International receivables billed and unbilled contract costs subject to negotiation	2,243
	9,525
Less allowance for doubtful accounts	(582)
	$ 8,943

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

Unbilled contract costs subject to negotiation as of May 27, 2005 and February 25, 2005, respectively, 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 $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 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. The Company has updated the claim for additional costs expended on claimable items since the original submission and has converted the claim to a complaint which will be filed in the Court of Federal Claims in July 2005. Additionally, the Company is reviewing the costs on the project for additional claim items which would be filed in a supplemental claim, if required.

ENVIRONMENTAL TECTONICS CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS, CONTINUED

This U. S. Government claim has followed the typical process of claim notification, preparation, submittal and 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. 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.

International receivables billed and unbilled contract costs subject to negotiation:

International receivables billed include $700,000 at May 27, 2005 and February 25, 2005 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 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). All arbitrators have

been chosen, including a third (umpire) arbitrator. The Company is currently preparing witness statements in anticipation of the arbitration hearings which are expected to begin in the next few months.

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 provides maintenance for the RTAF 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.

Historically, the Company has had positive experience with regard to its contract claims in that recoveries have exceeded the carrying value of claims, including significant settlement agreements in fiscal 2003, 2004 and 2005. However, there is no assurance that the Company will always have positive experience with regard to recoveries for its contract claims.

Net claims receivables were $3,004,000 at May 27, 2005 and February 25, 2005.

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 $778,000 at May 27, 2005 and $731,000 at February 25, 2005):

	May 27, 2005	February 25, 2005
	(amounts in thousands)	
Raw materials	$ 288	$ 290
Work in process	5,703	5,293
Finished goods	2,315	2,345
Total	$8,306	$7,928

6. STOCKHOLDERS' EQUITY

The components of stockholders' equity at February 25, 2005 and for the quarter ended May 27, 2005 were as follows:

(amounts in thousands, except share in

	Common stock shares	Common stock amount	Additional paid in capital	Accumulated other comp. loss
Balance at February 25, 2005	9,019,376	$450	$16,561	$(137)
Net loss for the thirteen weeks ended May 27, 2005				
Foreign currency translation adjustment				11
Total comprehensive loss				
Balance at May 27, 2005	9,019,376	$450	$16,561	$(126)

ENVIRONMENTAL TECTONICS CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS, CONTINUED

7 LONG TERM OBLIGATIONS AND CREDIT ARRANGEMENTS

The following table lists the long-term debt and other long-term obligations of the Company as of May 27, 2005.

		Payments due by Period	
Obligation	Total	Less than 1 year	1-3 years
Current portion of long-term debt	$ 275	$ 275	$ --
Subordinated debt, net of unamortized discount of $1,918	8,082	--	--
Long term bonds	3,820	--	825
Total obligations	$12,177	$ 275	$ 825

As part of our subordinated debt agreement, the Company must meet certain financial covenants including a Leverage Ratio, a Fixed Charge Ratio and a Tangible Net Worth Ratio. At May 27, 2005, the Company failed to meet these covenants but has obtained a waiver of such violations from the subordinated lender. This waiver applies to the period through May 27, 2006. Except as specified, the waiver does not constitute a modification or alteration of any

other terms or conditions in the respective agreements, 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.

Refinancing

The Company has historically financed operations through a combination of cash generated from operations, equity offerings, subordinated borrowings and bank debt. On February 19, 2003, the Company refinanced its operations (the "Refinancing"). The Refinancing was effected through the issuance of subordinated convertible notes to H.F. Lenfest and a credit agreement (the "Agreement") with PNC Bank, National Association ("PNC"). The total proceeds from this refinancing were $29,800,000.

Bank Credit and Facility

The PNC Agreement has had numerous amendments the most recent of which is discussed below. Currently, the facility is for $5,000,000 and use of the facility is restricted to the issuance of international letters of credit. The facility is secured by (i) the grant of a first and prior security interest in all of the personal property of EnTCo, and ETC Delaware, each a wholly-owned subsidiary of the Company, in favor of PNC; (ii) the Company's grant of a first and prior security interest in all of the Company's accounts, deposits and all other negotiable and non-negotiable instruments owned by the Company in favor of PNC; (iii) the Company's grant of a first and prior mortgage

on all of the Company's real property in favor of PNC; and (iv) the Company's grant of a first and prior security interest in all of the Company's rights to (a) all of the shares of capital stock of each of EnTCo and ETC Delaware and (b) 65% of the shares of capital stock owned by the Company of each of its foreign subsidiaries in favor of PNC. In addition, the PNC credit agreement requires that EnTCo and ETC Delaware guarantee the Company's obligations under the PNC facility. The current $5 million letter of credit facility is also personally guaranteed by Mr.Lenfest.

On February 22, 2005, the Agreement was amended. This amendment required the Company to increase the deposit as security in the restricted cash account to an amount equal to 100% of the sum of the amount available to be drawn on the Bond Letter of Credit ($4,225,000 at May 27, 2005). Additionally the EXIM borrowing facility was cancelled and the Tangible Net Worth covenant was reduced to $12,000,000 for all future reporting periods beginning with February 25, 2005. The rate on the Reimbursement Letter of Credit which backs the Company's long-term bonds was reduced to 0.75% per annum.

As of May 27, 2005 the Company had used approximately $1,959,000 of the facility for international letters of credit.

Subordinated Convertible Debt

In connection with the financing provided by Mr. Lenfest on February 19, 2003, the Company entered into a Convertible Note and Warrant Purchase

Agreement with Mr. Lenfest (the "Note"), 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 (the "Note") and (ii) warrants to purchase 803,048 shares of the Company's common stock. Upon the occurrence of certain events, the Company would 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. (For the period from December 1, 2003 through November 30, 2005, the rate has been reduced to 8% per annum.) At the Company's option, the quarterly interest payments may be deferred and added to the outstanding principal. The Note entitles Mr. Lenfest to convert all or a portion of the outstanding principal of, and 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 Note are secured by a second lien on all of the assets of the Company, junior in rights to the lien in favor of PNC Bank, including all real property owned by the Company.

ENVIRONMENTAL TECTONICS CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS, CONTINUED

Prior to the consummation of the refinancing, Advanced Technology Asset Management, LLC ("ATAM") (formerly 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 PNC 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 such issuance, the anti-dilution rights contained in its warrant. In exchange for ATAM's consent, the Company 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 its warrants and received a total of 437,820 shares of common stock of the Company. The Company received proceeds of $586,410 from the exercise of these warrants.

As a condition of amending the Agreement on August 24, 2004, 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 was issued a warrant to purchase 200,000 shares of stock under the same terms and conditions as his existing warrant for 803,048 shares.

On February 14, 2005, Mr. Lenfest exercised all of his outstanding warrants and received 1,003,048 shares of common stock for approximately $3.9 million. Additionally, on February 14, 2005, Mr. Lenfest purchased 373,831 shares of the Company's common stock for approximately $2.0 million.

Under the Note the Company must meet certain financial covenants including a Leverage Ratio, a Fixed Charge Ratio and a Tangible Net Worth Ratio. At May 27, 2005 the Company failed to meet each of these financial covenants but has obtained a waiver from the subordinated lender. This waiver applies to the period through May 27, 2006. 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.

Long-Term Bonds

On March 15, 2000, the Company issued approximately $5,500,000 of unregistered Taxable Variable Rate Demand/Fixed Rate Revenue Bonds (Series of 2000). Net proceeds from these bonds were used to repay a $4,100,000 advance taken on the Company's revolving credit facility and to finance construction of an addition to the Company's main plant in Southampton, Pennsylvania. The bonds are secured by an irrevocable direct pay Letter of Credit issued by PNC which expires on February 17, 2006 and which is secured by all assets of the Company. At February 25, 2005 they were also fully cash collateralized. The bonds carry a maturity date of April 1, 2020, bear a variable interest rate which adjusts each week to a rate required to remarket the bonds at full principal value (currently at 3.19% on May 6, 2005) with a cap of 17%, and are subject to mandatory redemption of $275,000 per year for 19 years and $245,000 for the 20th year.

On June 30, 2005 the Company directed the trustee for the bonds to issue a redemption notice for all of the Company's outstanding bonds. The Company intends on August 1, 2005 to utilize the restricted cash now being held by PNC to redeem all outstanding bonds. As of May 27, 2005, all deferred financing charges associated with this bond issue had been fully amortized to the statement of operations.

Although it is expected that the bonds will be redeemed on August 1, 2005, they are classified as long-term on the balance sheet. This is due to the fact that the decision to redeem the bonds and mailing of the notification of redemption to the bondholders both occurred after the end of the fiscal quarter, namely May 27, 2005. Additionally, the notice to redeem is revocable up to the point that the trust account is funded to effect the redemption, which will not occur until the day of actual redemption.

Operating Capital

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 its business. This capital may be difficult to obtain and the cost of this additional capital is likely to be relatively high. However, because we have established businesses in many markets, significant fixed assets including a building, and other valuable business assets which can be used for security, we believe that we will be able to locate such additional capital and that the actions by PNC will not have a long-term material adverse effect on our business.

The Company believes that existing cash balances at May 27, 2005 and cash expected to be generated from operating activities will be sufficient to meet its future obligations through at least May 27, 2006.

In reference to the Company's outstanding claims with the U.S. Navy, to the extent the Company is unsuccessful in recovering a significant portion of recorded claim contract costs, and to the extent that significant additional legal expenses are required to bring the dispute to resolution, such events could have a material adverse effect on the Company's liquidity and results of operations. Historically, the Company has had a favorable experience in that recoveries have exceeded recorded claims, including significant settlement agreements in fiscal 2003, 2004 and 2005. (See Note 4 to the Consolidated Financial Statements, Accounts Receivable).

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:

(amounts in thousands)	ATS	Industrial Group	Total
Thirteen weeks ended May 27, 2005			
Net sales	$ 3,475	$ 2,440	$ 5,915
Interest expense	375	175	550
Depreciation and amortization	294	179	473
Operating loss	(92)	(851)	(943)
Income tax	--	--	--
Goodwill and intangibles	477	--	477
Identifiable assets	16,426	7,677	24,103
Expenditures for segment assets	67	32	99
Thirteen weeks ended May 28, 2004			
Net sales	$ 4,401	$ 1,774	$ 6,175
Interest expense	237	107	344
Depreciation and amortization	327	147	474
Operating loss	(744)	(632)	(1,376)
Income tax benefit	320	224	544
Goodwill and intangibles	477	--	477
Identifiable assets	19,541	8,251	27,792
Expenditures for segment assets	41	17	58

Reconciliation to consolidated amounts	2006	2005
Corporate assets	19,369	19,345
Total assets	$43,472	$47,137
Segment operating loss	$ (943)	$(1,376)
Interest expense	(550)	(344)
Income tax benefit	--	544
Total loss for segments	(1,493)	(1,176)
Corporate home office expenses	(209)	(269)
Interest and other expenses	(24)	(85)
Income tax benefit	--	70
Minority interest	3	(1)
Net loss	(1,723)	$(1,461)

Segment operating income consists of net sales less applicable costs and expenses relating to these revenues. Unallocated general corporate expenses and other expenses such as letter of credit fees 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 22% of sales totaling $1,318,000 in the thirteen weeks ended May 27, 2005 were made to one domestic customer in the ATS segment. Approximately 44% of sales totaling $2,688,000 in the thirteen weeks ended May 28, 2004 were made to three international customers in the ATS segment.

Included in the segment information for the thirteen weeks ended May 27, 2005 are export sales of $2,378,000. Of this amount, there are sales to or relating to governments or commercial accounts in China of $546,000. Sales to the U.S. Government and its agencies aggregated $1,492,000 for the period. Included in the segment information for the thirteen weeks

ended May 28, 2004 are export sales of $3,678,000. Of this amount, there are sales to or relating to governments or commercial accounts in Malaysia ($1,225,000), Australia ($745,000), and Egypt ($718,000). Sales to the U.S. Government and its agencies aggregated $447,000 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 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

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:

- abnormal amounts of idle facilities, freight, handling costs, and spoilage should be recognized as charges of the current period.

- 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.

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

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 such 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 revenues, 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 our 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, (v) statements made about the possible outcomes of litigation involving the Company; and (vi) 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 25, 2005, 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

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, real time interactive training programs, and equipment and to control, modify, simulate and measure environmental conditions. These products include pilot training systems ("PTS"), disaster management software and products, 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 ended May 27, 2005:

- unfavorable global economic and political conditions;
- continued product development and marketing costs associated with our ATFS technology;
- continuing product enhancement costs in our simulation line;
- higher costs of capital and amortization of deferred finance charges; and
- litigation and claims costs.

Our sales efforts continued to be hampered by unfavorable global economic and political conditions. We saw many of our potential new contracts delayed by budget constraints and delays of our customers located throughout the world. This was especially true in our ATS business, where most of the sales are to international customers.

In the first quarter of fiscal 2006 we continued our education and marketing efforts to introduce our Authentic Tactical Flight Simulator ("ATFS") to the U.S. military. The evolution of these exciting and state-of-the-art technologies is an important step in our goal of integrating flight and aeromedical training in a simulator device. This technology allows a fighter pilot to practice tactical air combat maneuvers such as dodging enemy missiles, ground fire and aircraft obstacles while experiencing the real life environment of a high-G Force fighter aircraft. These flight trainers provide a low cost and extremely less risky alternative to actual air flight. We believe that armed forces agencies of various governments will appreciate the efficiency of these technologies, especially in this time of fiscal conservatism and budgetary constraints throughout the world. Given the continuing budget cutbacks in the U.S. military, this product offers a low cost and safe alternative to the current approach to training.

Given the highly advanced nature of our disaster management line of simulation products, additional funds were required to enhance applications and functionality of our proprietary software. We expect this effort to continue in fiscal 2006.

One of the greatest challenges we face is adequately funding the cash requirements of large, long-term multi-year projects. Although these contracts normally incorporate milestone payments, the cash flows associated with production and material requirements tend to vary significantly over time. These projects are usually cash positive in the early stages and cash negative during the production phase. Funding these contracts requires a significant amount of operating funds and may hamper other types of business. In fiscal 2005, our bank took certain actions which effectively eliminated our ability to borrow cash under our existing agreement to support operations. These actions also resulted in us being required to issue additional common stock warrants in consideration for a limited guarantee to secure the Company's letter of credit bank facility which increased amortization expense associated with the deferred finance charges on these warrants. Although we had a strong cash balance at fiscal 2005 year end, during the first quarter of fiscal 2006 cash flow from operations was negative as we paid legal bills, primarily related to litigation, and value added taxes in England resulting from a settlement agreement. We may need to obtain additional sources of capital in order to continue growing and operating our business. Because we have established businesses in many markets, significant fixed assets including a building, and other business assets which can be used for security, we believe that we will be able to locate such additional sources of capital and that the bank actions will not have a long-term material adverse effect on our business.

17

In addition, we face the following challenges and business goals in order to make fiscal 2006 a successful year:

- Aircrew Training Systems
  - Market all the aeromedical products we technologically enhanced in fiscal 2004 and 2005.

    We have heavily invested in enhancing functionality and

product capability of three ATS products: our centrifuge-based flight simulator, our General Aviation Trainer (GAT), and our Gyro-IPT. Repeat sales of these state-of-the-art simulators will allow us to recoup the costs of our non-recurring engineering and design effort.

- Continue to evolve ATFS.

  Our challenge will be to find funding to continue this critical development objective, either through U.S. government grants or a customer order.

Entertainment

- Develop a business model for the entertainment line which addresses the three types of contractual arrangements which are common in the amusement and educational venues: outright purchases, leasing and revenue sharing. Additionally, we will need to locate the capital required to support this type of business structure.

- Expand the entertainment line by repeat sales and the introduction of story line enhancements.

- Continue our rebuilding efforts for "big-ticket" amusement products which have been severely hampered by the amusement market's negative perception of our capabilities in the entertainment industry due to actions by a former customer with whom we are currently in litigation.

Environmental

- Bring the environmental line back to profitability by refocusing the selling effort towards domestic contracts for standardized products.

ADMS

- Develop a service business to supplant the sale of our Advanced Disaster Management Systems (ADMS). During fiscal 2005, we received a contract to perform airport certification and emergency drill training using software and technology developed for the ADMS line at the Baltimore-Washington International Airport. We believe this is a new and undeveloped market with good potential.

Claims and Litigation

- Continue to pursue outstanding commercial litigation and the Company's claim against the U.S. government.

  At May 27, 2005, we were involved in major commercial and government litigation which will require a significant amount of our time and effort. These activities will potentially detract from other business issues and require significant funding.

Liquidity

- We do not currently have a bank facility which can be used to

borrow funds for operations.

During fiscal 2005, our bank took certain actions which effectively eliminated our ability to borrow cash under our existing agreement to support operations. Thus, 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.

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 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 25, 2005, which was filed with the Securities and Exchange Commission on May 26, 2005.

There have been no changes to our critical accounting policies since fiscal 2005 year- end. The reader is referred to the Company's Annual Report on Form 10-K for the fiscal year ended February 25, 2005 in the section entitled "Critical Accounting Policies" under the Management's Discussion and Analysis of Financial Condition and Results of Operations.

19

RESULTS OF OPERATIONS

THIRTEEN WEEKS ENDED MAY 27, 2005 COMPARED TO THIRTEEN WEEKS ENDED MAY 28, 2004

($000) Summary Table of Results

	FY 06	FY 05	$ variance	% variance
			( )=unfavorable	
SALES				
DOMESTIC	$ 2,045	$ 2,050	$ (5)	-- %
US GOV'T	1,492	447	1,045	233.8
INT'L	2,378	3,678	(1,300)	(35.4)
	-------	-------	-------	-------

TOTAL SALES	5,915	6,175	(260)	(4.2)
GROSS PROFIT	1,482	994	488	49.1
SG&A EXPENSES	2,627	2,430	(197)	(8.1)
R&D EXPENSES	7	209	202	96.7
INTEREST EXP	550	344	(206)	(59.9)
OTHER EXP.,NET	24	85	61	71.8
INCOME TAXES	--	(614)	(614)	(100.0)
MINORITY INTEREST	(3)	1	4	400.0
NET LOSS	$(1,723)	$(1,461)	$ (262)	(17.9%)
NET LOSS PER SHARE				
(DILUTED)	$ (.19)	$ (.19)	$ --	$ --

NET LOSS

The Company had a net loss of $1,723,000, or $0.19 per share (diluted), during the first quarter of fiscal 2006 compared to a net loss of $1,461,000, or $.19 per share (diluted), for the first quarter of fiscal 2005, representing a variance of $262,000. This decrease was due primarily to a decrease in sales, an increase in selling, general and administrative expenses and interest expense and a reduced income tax benefit partially offset by an increased gross margin and reduced R&D expenses.

SALES

Sales for the first quarter of fiscal 2006 were $5,915,000 as compared to $6,175,000 for the first quarter of fiscal 2005, a decrease of $260,000 or 4.2%. The sales decrease primarily reflected a significant decrease in both domestic and international PTS (down $893,000, 98.8% and $1,389,000, 44.7%, respectively) and U.S. Government hyperbaric sales (down $252,000, 99.3%) partially offset by increases across the board in the other business units, most notably domestic and international environmental sales (up $350,000, 36.3% in total) and domestic sterilizer sales, up $116,000, 87.1%. The decrease domestically in PTS sales reflected the sale in the prior period of a GAT for use by the U.S. Air Force and reduced activity internationally for a centrifuge project in Malaysia. The reduction in Hyperbaric sales reflected less POC revenue for the U.S. Navy decompression chamber project, which is the subject of an outstanding claim. Higher environmental and sterilizer sales reflected generally increased activity.

DOMESTIC SALES

Overall, domestic sales in the first quarter of fiscal 2006 were

$2,045,000 as compared to $2,050,000 in the first quarter of fiscal 2005, a decrease of $5,000, as the aforementioned significant reduction in PTS sales coupled with reduced simulation sales was almost completely offset by increases in the other product areas. Domestic sales represented 34.6% of the Company's total sales in the first quarter of fiscal 2006, up from 33.2% for the first quarter of fiscal 2005. U.S. Government sales in the first quarter of fiscal 2006 were $1,492,000 as compared to $447,000 in the first quarter of fiscal 2005 and represented 25.2% of total sales in the first quarter of fiscal 2006 versus 7.2% for the first quarter of fiscal 2005.

INTERNATIONAL SALES

International sales for the first quarter of fiscal 2006 were $2,378,000 as compared to $3,678,000 in the first quarter of fiscal 2005, a decrease of $1,300,000 or 35.4%, and represented 40.2% of total sales, as compared to 59.6% in the first quarter of fiscal 2005. Throughout the Company's history, most of the sales for PTS have been made to international customers. In the first quarter of fiscal 2006, international sales totaling at least ten percent of total international sales were made to China ($546,000). In the first quarter of fiscal 2005, international sales totaling at least ten percent of total international sales were made to Malaysia ($1,225,000), Australia ($745,000) and Egypt ($718,000). Fluctuations in sales to international countries from year to year primarily reflect POC revenue recognition on the level and stage of development and production on multi-year long-term contracts.

GROSS PROFIT

Gross profit for the first quarter of fiscal 2006 was $1,482,000 as compared to $994,000 in the first quarter of fiscal 2005, an increase of $488,000 or 49.1%. This increase reflected a 9.0 percentage point increase in the gross profit rate as a percent of sales which completely offset the aforementioned sales decrease. The increased gross profit rate as a percent of sales reflected improvements in the environmental, PTS and simulation product area rates, which were partially offset by reduced rates in the other product areas. The primary impact on gross profit resulted from higher U.S. Government PTS sales at a higher gross profit rate.

SELLING AND ADMINISTRATIVE EXPENSES

Selling and administrative expenses for the first quarter of fiscal 2006 were $2,627,000 as compared to $2,430,000 in the first quarter of fiscal 2005, an increase of $197,000 or 8.1%. Most of the variance resulted from higher legal costs associated with the Company's ongoing litigation with Disney.

RESEARCH AND DEVELOPMENT EXPENSES

Research and development expenses, which are charged to operations as incurred, were $7,000 for the first quarter of fiscal 2006 as compared to $209,000 for the first quarter of fiscal 2005, reflecting a decrease of $202,000 or 96.7%. The decrease primarily reflected the receipt in our Turkish subsidiary of grant funds from the Turkish Government for qualified technical research. Our Turkish subsidiary currently has three reimbursement programs. 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 quarter of fiscal 2006 was $550,000 as

compared to $344,000 for the first quarter of fiscal 2005, representing an increase of $206,000 or 59.9%. This increase primarily reflected increased amortization of deferred finance expenses from the Company's February 2003 refinancing and additional amortization of deferred financing charges associated with the issuance in fiscal 2005 of common stock warrants in connection with a limited guarantee issued in the Company's favor by Mr. Lenfest to PNC to secure international letters of credit. As of May 27, 2005 all deferred financing charges associated with the Company's issuance of long-term bonds in February 2003 had been fully amortized to the statement of operations.

OTHER INCOME/EXPENSE, NET

Other income/expense, net, was a net expense of $24,000 for the first quarter of fiscal 2006 versus a net expense of $85,000 for the first quarter of fiscal 2005, a decrease of $61,000 or 71.8%. This decrease primarily reflected reduced bank charges.

INCOME TAXES

Although the company reported a pre-tax operating loss during the current fiscal quarter, no offsetting income tax benefit and corresponding deferred tax asset was recorded, due to the uncertain nature of their ultimate realization based on past performance and the potential that sufficient taxable income may not be generated in the near future. The Company will recognize these benefits only as reassessment demonstrates that they are realizable. Realization is entirely dependent upon future earnings in specific tax jurisdictions.

As of February 25, 2005 the Company had approximately $7.2 million of federal and $12.5 million of state net loss carry forwards available to offset future income taxes, expiring in 2025. The Company has established a full valuation allowance of the same amount against these carry forward benefits. While the need for this valuation allowance is subject to periodic review, if the allowance is reduced, the tax benefits of the carry forwards will be recorded in future operations as a reduction of the company's income tax expense.

22

The Company's tax benefit for the first quarter of fiscal 2005 reflected an estimated 30% rate domestically and a consolidated estimated rate of 29.6%. The domestic tax rate reflected the estimated impact of timing differences and foreign sales and domestic research and development tax credits. The international rate reflects no tax benefit for ETC Europe, a subsidiary of the Company, since we are not assured there will be future tax liabilities to utilize any current tax benefits.

LIQUIDITY AND CAPITAL RESOURCES

During the thirteen weeks ended May 27, 2005, operating activities required $5,063,000 of the Company's cash. This reflected the net operating loss, an increase in accounts receivable and inventories, and a decrease in accounts payable, customer deposits and other accrued liabilities. Cash requirements to support operations included the payment of significant legal bills and value added taxes in the Company's European subsidiary, both associated with the international claim settlement in February, 2005, and an increase in trade receivables due to the nature and timing of milestone billings on various contracts. Acting as partial offsets were add-backs for non-cash expenses such as depreciation, software amortization and amortization of deferred finance charges.

The Company's investing activities required $293,000 during the thirteen weeks ended May 27, 2005 which consisted of purchases of capital

equipment and capitalized software.

The Company's financing activities generated $120,000 during the thirteen weeks ended May 27, 2005, as a scheduled annual repayment on the Company's long-term bonds was completely offset by a reduction in the Company's cash collateral restricted cash account. The cash collateral account serves as security for the Company's long-term bonds. On June 30, 2005 the Company directed the trustee for the bonds to issue a redemption notice for all of the Company's outstanding bonds. The Company intends on August 1, 2005 to utilize the restricted cash now being held by PNC to redeem all outstanding bonds. As of May 27, 2005, all the deferred financing charges associated with this bond issue had been fully amortized to the statement of operations.

Refinancing

The Company has historically financed operations through a combination of cash generated from operations, equity offerings, subordinated borrowings and bank debt. On February 19, 2003, the Company refinanced its operations (the "Refinancing"). The Refinancing was effected through the issuance of subordinated, convertible notes to H.F. Lenfest, an individual, and a credit agreement (the "Agreement") with PNC Bank, National Association ("PNC"). The total proceeds from this refinancing were $29,800,000.

Bank Credit and Facility

The PNC Agreement has had numerous amendments the most recent of which is discussed below. Currently, the facility is for $5,000,000 and use of the facility is restricted to the issuance of international letters of credit. The facility is secured by (i) the grant of a first and prior security interest in all of the personal property of the Company, EnTCo, and ETC Delaware, each a wholly-owned subsidiary of the Company, in favor of PNC; (ii) the Company's grant of a first and prior security interest in all of the Company's accounts, deposits and all other negotiable and non-negotiable instruments owned by the Company in favor of PNC; (iii) the Company's grant of a first and prior mortgage on all of the Company's real property in favor of PNC; and (iv) the Company's grant of a first and prior security interest in all of the Company's rights to (a) all of the shares of capital stock of each of EnTCo and ETC Delaware and (b) 65% of the shares of capital stock owned by the Company of each of its foreign subsidiaries in favor of PNC. In addition, the PNC credit agreement requires that EnTCo and ETC Delaware guarantee the Company's obligations under the PNC facility. The current $5 million letter of credit facility is also personally guaranteed by Mr. Lenfest.

23

On February 22, 2005, the Agreement was amended. This amendment required the Company to increase the deposit as security in the restricted cash account to an amount equal to 100% of the sum of the amount available to be drawn on the Bond Letter of Credit ($4,225,000 at May 27, 2005). Additionally the EXIM borrowing facility was cancelled and the Tangible Net Worth covenant was reduced to $12,000,000 for all future reporting periods beginning with February 25, 2005. The rate on the Reimbursement Letter of Credit which backs the Company's long-term bonds was reduced to 0.75% per annum.

As of May 27, 2005 the Company had used approximately $1,959,000 of the facility for international letters of credit.

Subordinated Convertible Debt

In connection with the financing provided by Mr. Lenfest on February 19, 2003, the Company entered into a Convertible Note and Warrant Purchase

Agreement with Mr. Lenfest (the "Note"), 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 (the "Note") 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. (For the period from December 1, 2003 through November 30, 2005, the rate has been reduced to 8% per annum.) At the Company's option, the quarterly interest payments may be deferred and added to the outstanding principal. The note entitles Mr. Lenfest to convert all or a portion of the outstanding principal of, and 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 lien on all of the assets of the Company, junior in rights to the lien in favor of PNC Bank, including all real property owned by the Company.

Prior to the consummation of the refinancing, Advanced Technology Asset Management, LLC ("ATAM") (formerly 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 PNC 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 such issuance, the anti-dilution rights contained in its warrant. In exchange for ATAM's consent, the Company 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 its warrants and received a total of 437,820 shares of common stock of the Company. The Company received proceeds of $586,410 from the exercise of these warrants.

24

As a condition of amending the Agreement on August 24, 2004, 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 was issued a warrant to purchase 200,000 shares of stock under the same terms and conditions as his original warrant for 803,048 shares.

On February 14, 2005, Mr. Lenfest exercised all of his outstanding warrants and received 1,003,048 shares of common stock for approximately $3.9 million. Additionally, on February 14, 2005, Mr. Lenfest purchased 373,831 shares of the Company's common stock for approximately $2.0 million.

Under the Note the Company must meet certain financial covenants including a Leverage Ratio, a Fixed Charge Ratio and a Tangible Net Worth Ratio. At May 27, 2005 the Company failed to meet each of these financial covenants but has obtained a waiver from Mr. Lenfest. This waiver applies to the period through May 27, 2006. 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.

Long-Term Bonds

On March 15, 2000, the Company issued approximately $5,500,000 of unregistered Taxable Variable Rate Demand/Fixed Rate Revenue Bonds (Series of 2000). Net proceeds from these bonds were used to repay a $4,100,000 advance taken on the Company's revolving credit facility and to finance construction of an addition to the Company's main plant in Southampton, Pennsylvania. The bonds are secured by an irrevocable direct pay Letter of Credit issued by PNC which expires on February 17, 2006 and which is secured by all assets of the Company. At February 25, 2005 they were also fully cash collateralized. The bonds carry a maturity date of April 1, 2020, bear a variable interest rate which adjusts each week to a rate required to remarket the bonds at full principal value (currently at 3.19% on May 6, 2005) with a cap of 17%, and are subject to mandatory redemption of $275,000 per year for 19 years and $245,000 for the 20th year.

On June 30, 2005 the Company directed the trustee for the bonds to issue a redemption notice for all of the Company's outstanding bonds. The Company intends on August 1, 2005 to utilize the restricted cash now being held by PNC to redeem all outstanding bonds. As of May 27, 2005, all deferred financing charges associated with this bond issue had been fully amortized to the statement of operations.

Although it is expected that the bonds will be redeemed on August 1, 2005, they are classified as long-term on the balance sheet. This is due to the fact that the decision to redeem the bonds and mailing of the notification of redemption to the bondholders both occurred after the end of the fiscal quarter, namely May 27, 2005. Additionally, the notice to redeem is revocable up to the point that the trust account is funded to effect the redemption, which will not occur until the day of actual redemption.

Operating Capital

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 its business. This capital may be difficult to obtain and the cost of this additional capital is likely to be relatively high. However, because we have established businesses in many markets, significant fixed assets including a building, and other valuable business assets which can be used for security, we believe that we will be able to locate such additional capital and that the actions by PNC will not have a long-term material adverse effect on our business.

The Company believes that existing cash balances at May 27, 2005 and cash expected to be generated from operating activities will be sufficient to meet its future obligations through at least May 27, 2006.

In reference to the Company's outstanding claims with the U.S. Navy, to the extent the Company is unsuccessful in recovering a significant portion of recorded claim contract costs, and to the extent that significant additional legal expenses are required to bring the dispute to resolution, such events could have a material adverse effect on the Company's liquidity and results of operations. Historically, the Company has had a favorable experience in that recoveries have exceeded recorded claims, including significant settlement agreements in fiscal 2003, 2004 and 2005. (See Note 4 to the Consolidated

Financial Statements, Accounts Receivable).

The following table presents our contractual cash flow commitments on long-term debt and operating leases. See Note 7 to the Consolidated Financial Statements for additional information on our long-term debt and operating leases.

	PAYMENTS DUE BY PERIOD (IN THOUSANDS)			
	TOTAL	LESS THAN 1 YEAR	1-3 YEARS	4-5 YEARS
Long-term debt, including current maturities	$12,177	$275	$ 825	$8,632
Operating leases	740	156	318	188
Total	$12,917	$431	$1,143	$8,820

- Long-term debt is reported net of unamortized discount of $1,918,000 on the Company's subordinated debt. See "Note 7. Long-Term Obligations and Credit Arrangements" to the Consolidated Financial Statements.

Off-Balance Sheet Arrangements

There were no off-balance sheet arrangements during the fiscal quarter ended May 27, 2005 that have or are reasonably likely to have a current or future effect on our financial condition, changes in financial condition, revenues or expenses, results of operations, liquidity, capital expenditures or capital resources that is material to the Company's investors.

Contract Claims (See Note 4 to the Consolidated Financial Statements, Accounts Receivable)

Historically, the Company has had positive experience with regard to its contract claims in that recoveries have exceeded the carrying value of claims, including significant settlement agreements in fiscal 2003, 2004 and 2005. As of May 27, 2005, claims recorded against the U.S. Government totaled $3,004,000.

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 2006. In conformity with accounting principles generally accepted in the United States of America, revenue recorded for 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. The Company was not provided a copy of the Government's Technical Report which 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, basically denying the claim in full. The Company has updated the claim for

additional costs expended on claimable items since the original submission and has converted the claim to a complaint which was filed in the court of Federal Claims in July 2005. Additionally, the Company is reviewing the costs on the project for additional claim items which would be filed in a supplemental claim, if required.

This U. S. Government claim has followed the typical process of claim notification, preparation, submittal and 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. 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.

The open balance of $700,000 due on the contract represents the total net exposure on this contract. On June 16, 2003, the Company filed for arbitration in Thailand seeking recovery of this open balance. On October 8, 2003, the Thai government filed their defense with the Thai Arbitration Institute (TAI). All arbitrators have been chosen, including a third (umpire) arbitrator. The Company is currently preparing witness statements in anticipation of the arbitration hearings which are expected to begin in the next few months. 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 provides maintenance for the RTAF 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.

Backlog

Our sales backlog at May 27, 2005 and February 25, 2005, for work to be performed and revenue to be recognized under written agreements after such dates, was $17,039,000 and $19,084,000, respectively. In addition, our training, maintenance and upgrade contracts backlog at May 27, 2005 and February 25, 2005, for work to be performed and revenue to be recognized after such dates under written agreements, was $1,756,000 and $2,232,000, respectively. Of the May 27, 2005 backlog, we have contracts for approximately $13,320,000 for aircrew training systems and maintenance support, including $3,218,000 for the Japanese Defense Agency.

The Company's order flow does not follow any seasonal pattern as the Company receives orders in each fiscal quarter of its fiscal year.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

The company is exposed to various market risks, 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 currency exchange rates. The Company does not enter into derivatives or other financial instruments for trading or speculative purposes. The Company also has not entered into financial instruments to manage and reduce the impact of changes in interest rates and foreign currency exchange rates although we may enter into such transactions in the future. A portion of the Company's indebtedness bears interest at rates that vary with the prime rate of interest. Accordingly, any increases in the applicable prime rate of interest will reduce the Company's earnings. With respect to currency risk, where the Company has a contract which is denominated in a foreign currency, it often establishes local in-country bank accounts and funds in-country expenses in the local currency, thus creating a "natural" currency hedge for a portion of the contract.

ITEM 4. CONTROLS AND PROCEDURES.

Under the supervision and with the participation of the Company's management, including the Company's chief executive officer and chief financial officer, the Company has evaluated the effectiveness of the design and operation of the Company's disclosure controls and procedures as of May 27, 2005 (the "Evaluation Date"), and, based on this evaluation, the Company's 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 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 chief executive officer and chief 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 us in the Court of Common Pleas in Philadelphia, Pennsylvania, seeking payment of $902,000 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 alleged that it contacted the investors in our February 2003 financing transaction and that it earned the claimed financing fees pursuant to the terms of the B&S Agreement. We have responded to the complaint and have also filed a counterclaim for breach of contract and professional malpractice. We believe that we have valid defenses to each of the claims of B&S and intend to vigorously defend ourselves against these claims. We have had some settlement discussions with B&S but, as of the date of the filing of this Report on Form 10-Q, no agreement had been reached. At this time, we are 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 us (under a guarantee) for, among other things, alleged failures in performance and design in the contract. Disney is seeking damages in excess of $65 million plus punitive damages. Both EnTCo and we believe that we have valid defenses to each of Disney's counterclaims and intend to vigorously defend ourselves against these counterclaims. At this time, discovery is completed and the case is scheduled to be placed in the trial pool on September 19, 2005. Neither EnTCo nor we are able to predict the outcome of this matter.

Certain other claims, suits, and complaints arising in the ordinary course of business have been filed or are pending against us. In our opinion, after consultation with legal counsel handling these specific maters, all such matters are reserved for or 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 significant effect on our financial position or results of operations if disposed of 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 amended and restated Bylaws were filed as Exhibit 3.2 to Registrant's Form 8-K dated May 25, 2005, and are incorporated herein by reference.
31.1	Certification dated July 11, 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 July 11, 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 July 11, 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 May 27, 2005, the Company filed a Current Report on Form 8-K reporting its financial results for the fourth quarter of fiscal 2005 as well as its financial results for fiscal 2005 and disclosing the adoption of amended and restated Bylaws of the Company, effective as of May 25, 2005.

31

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: July 11, 2005 By:/s/ William F. Mitchell

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

Date: July 11, 2005 By:/s/ Duane Deaner

Duane Deaner,

Chief Financial Officer
(Principal Financial and Accounting Officer)