

AEROSONIC CORP /DE/  
Form 10-K/A  
December 08, 2004

**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION**

**Washington, D.C. 20549**

**FORM 10-K/A**

**Amendment No. 2**

**S Annual Report Pursuant to Section 13 or 15(d) of The Securities Exchange Act of 1934**

**£ Transition Report Pursuant to Section 13 or 15(d) of The Securities Exchange Act of 1934**

**For the Fiscal Year Ended January 31, 2004**

**Commission File Number 1-11750**

**AEROSONIC CORPORATION**

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

**Delaware**  
**(State or other jurisdiction of incorporation or**  
**organization)**

**74-1668471**  
**I.R.S. Employer Identification No.)**

**1212 North Hercules Avenue**

**Clearwater, Florida 33765**

**(Address of principal executive offices and Zip Code)**

**Registrant s telephone number, including area code: (727) 461-3000**

**Securities registered pursuant to Section 12(b) of the Act:**

<b>Title of Each Class</b>	<b>Name of Each Exchange on Which Registered</b>
Common Stock, \$.40 par value	American Stock Exchange

**Securities registered pursuant to Section 12(g) of the Act: None.**

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

Yes  No

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K .

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

Yes  No

The aggregate market value of the voting stock held by non-affiliates of the registrant was approximately \$24,845,000 as of July 31, 2003 based upon the closing price of the Common Stock on the American Stock Exchange ( **Amex** ) on that date, and approximately \$20,791,000 as of March 31, 2004, based upon the closing price of the Common Stock on the Amex on that more recent date.

As of November 30, 2004, the issuer had 3,921,019 shares of Common Stock outstanding.

**Documents Incorporated by Reference: None.**

## EXPLANATORY NOTE

Aerosonic Corporation (the **Company**) is filing this Amendment No. 2 to its Annual Report on Form 10-K for its fiscal year ended January 31, 2004, as filed with the Securities and Exchange Commission on April 6, 2004 (the "**Original 2004 Form 10-K**"), primarily to correct errors in recording income taxes receivable and deferred income taxes in the fiscal year ended January 31, 2000, as carried on the balance sheet for each subsequent year through January 31, 2004 (the **Income Tax Error**), and to correct the resulting effects upon total assets, retained earnings, and shareholders' equity.

The Company erroneously recorded income taxes receivable resulting from tax refunds expected from the application of net operating loss carrybacks to tax years ended January 31, 1998 and 1999, for which the applicable statutes of limitations had expired. The prior period adjustment to correct the Income Tax Error results in a reduction of approximately \$572,000 in income taxes receivable, total assets, retained earnings and shareholders' equity, as of January 31, 2000 and at each subsequent year end. These adjustments, as reflected in this Amendment No. 2, do not affect earnings or cash flows in the Company's previously reported financial statements for the fiscal years ended January 31, 2004, 2003 or 2002, as included in its Original 2004 Form 10-K.

This Amendment No. 2 includes: all four Items of Part I of the Original 2004 Form 10-K, even though the only changes are in Items 1 and 2 to reflect changes in numerical references to Notes to the Financial Statements. (Since this Amendment No. 2 adds a new Note 2 to the Financial Statements, the Note numbers for subsequent Notes changed.) Items 3 and 4 of Part I and Items 5 and 7 remain unchanged from the Original 2004 Form 10-K, but are included to provide a convenient continuity of the text surrounding the changed Items, and to avoid referring back to the Original 2004 Form 10-K for such information. Since the previously filed Amendment No. 1 to the Original 2004 Form 10-K simply provided the complete form of Exhibits 23.1 and 23.2, Amendment No. 1 did not affect the text of any of the Items in Part I and Part II that preceded Item 8 of the Original 2004 Form 10-K.

**Actual Changes in this Amendment 2.** The actual changes in the Original 2004 Form 10-K included in this Amendment No. 2 are: **(1)** changes in the Financial Statement Note number references in Items 1, 2 and 7; **(2)** an update to Item 3, including events involving the SEC investigation and recent action by the SEC, and developments in the securities class action litigation, and resulting modifications to the Item 7 risk factor *Risks associated with the current SEC investigation and shareholder litigation*, and to Note 12 of the Financial Statements, and the announcement in Item 3 and in Note 12 of the Financial Statements of a settlement of the indemnification claim by Miriam Frank, widow of Herbert Frank, a former President and Chairman of the Company, **(3)** an amended and restated Item 6, Selected Financial Data; and **(4)** amendments to Item 8 that include: **(a)** amended and restated Consolidated Balance Sheets as at January 31, 2004 and 2003, **(b)** amended and restated Consolidated Statements of Shareholders' Equity for the years ended January 31, 2004, 2003, and 2002, **(c)** a new Note 2 discussing the restatement of prior years' financial statements resulting from the Income Tax Error, and **(d)** a correction to reflect the effect of the Income Tax Error in Note 7 to the Consolidated Financial Statements.

Notwithstanding that there are no changes in the Consolidated Statements of Operations for the Years Ended January 31, 2004, 2003 and 2002, the Consolidated Statements of Cash Flows for the Years Ended January 31, 2004, 2003 and 2002, or the remaining Notes to the Financial Statements included in this Amendment No. 2, a complete set of the Financial Statements (together with all of the Notes) has been included in this Amendment No. 2 in order to enable the reader to view, in a single document, the related information to which the changes made by this Amendment 2 apply.

## PART I

**THIS REPORT CONTAINS CERTAIN 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, WHICH ARE INTENDED TO BE COVERED BY THE SAFE HARBORS CREATED THEREUNDER. FORWARD-LOOKING STATEMENTS CAN BE IDENTIFIED BY THE USE OF FORWARD-LOOKING TERMINOLOGY SUCH AS MAY, WILL, SHOULD, EXPECT, ANTICIPATE, ESTIMATE, CONTINUE, PLANS, INTENDS AND WORDS SIMILAR IMPORT. ALTHOUGH THE COMPANY BELIEVES THAT THE ASSUMPTIONS UNDERLYING THE FORWARD-LOOKING STATEMENTS CONTAINED HEREIN ARE REASONABLE, ANY OF THE ASSUMPTIONS COULD BE INACCURATE. THEREFORE, THE COMPANY'S ACTUAL RESULTS COULD DIFFER MATERIALLY FROM THE RESULTS ANTICIPATED IN THESE FORWARD-LOOKING STATEMENTS. ADDITIONALLY, ACTUAL RESULTS MIGHT BE AFFECTED BY CERTAIN FACTORS SET FORTH HEREIN IN MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS. THE COMPANY UNDERTAKES NO OBLIGATION TO UPDATE PUBLICLY ANY FORWARD-LOOKING STATEMENTS, WHETHER AS A RESULT OF NEW INFORMATION, FUTURE EVENTS OR OTHERWISE.**

**Significant Events.** On March 17, 2003, Aerosonic Corporation (the **Company**) issued a press release stating that it had initiated an investigation into financial and accounting irregularities involving revenue and inventory reported during prior periods. On May 19, 2003, J. Mervyn Nabors resigned as the Company's Chairman and ceased all day-to-day involvement in management activity. Prior to this event, David A. Baldini was appointed President of the Company (on November 14, 2002) to replace Mr. Nabors in that capacity, and Gary E. Colbert was appointed Chief Financial Officer (on January 14, 2003), to replace Eric J. McCracken in that capacity, who had resigned in October 2002. Item 3 and Item 7 of this report include discussions of both an investigation by the U.S. Securities and Exchange Commission regarding the above referenced financial and accounting issues and a halt of trading in the Company's Common Stock imposed by the American Stock Exchange on September 25, 2003 that continued until November 25, 2003. Such investigation and trading halt also are discussed in several other portions of this report.

On October 31, 2003, the Company filed its Annual Report on Form 10-K for the fiscal year ended January 31, 2003 (the **2003 Form 10-K**). As discussed in the Company's 2003 Form 10-K, as a result of the Company's investigation into financial and accounting irregularities, the Company restated its financial statements for the fiscal years ended January 31, 1999, 2000, 2001 and 2002, and restated its previously reported unaudited financial information for the first three quarters of the fiscal year ended January 31, 2003. The Company's 2003 Form 10-K contains important information regarding such restatements, the contributing causes (including misstatements, falsification of inventory records, improper adjustments for obsolete and slow moving inventory, improper revenue recognition, improper fixed asset capitalization and errors in the application of Staff Accounting Bulletin No. 101 and generally accepted accounting principles) and the impact thereof on the Company and its operations and affairs.



**Item I. Business.**

The Company is a Delaware corporation formerly known as Instrument Technology Corporation ( **ITC** ). ITC, which was incorporated in 1968, was the surviving corporation of a merger, in 1970, with Aerosonic Corp., a Florida corporation ( **Aerosonic Florida** ). Aerosonic Florida, which was incorporated in 1957, ceased to exist as a separate corporation as a result of the merger. Following the merger, ITC changed its name to Aerosonic Corporation.

In January 1993, the Company acquired Avionics Specialties, Inc., a Virginia corporation ( **Avionics** ), from Teledyne Industries, Inc. ( **Teledyne** ). Prior to the acquisition, Avionics had been a division of Teledyne. Since the acquisition, Avionics has been maintained as an operating and wholly owned subsidiary of the Company.

As used herein, unless the context requires otherwise, references to Aerosonic, the Company, we or our include Aerosonic Corporation and its operating subsidiary, Avionics.

The Company is principally engaged in one business segment, which is the manufacture and sale of aircraft instruments. The Company consists of four operating divisions in three locations. The divisions are: the Clearwater, Florida Instrument Division ( **Clearwater Instruments** ), the Wichita, Kansas Division ( **Kansas Instruments** ), Avionics in Earlsyville, Virginia, and the Clearwater, Florida Precision Component Division ( **Precision Components** ).

Clearwater Instruments primarily manufactures altimeters, airspeed indicators, rate of climb indicators, microprocessor controlled air data test sets, and a variety of other flight instrumentation. Kansas Instruments is the source inspection location for our Wichita customers and is the primary location for Clearwater Instruments repair business. Avionics maintains three major product lines in the aircraft instrument segment: (1) angle of attack stall warning systems; (2) integrated multifunction probes, which are integrated air data sensors; and (3) other aircraft sensors and monitoring systems. In August 1998, the Company formed Precision Components as a new division to perform high volume precision machining of mechanical components, which was not significant to operations in the fiscal years ended January 31, 2004, 2003 or 2002.

The Company has a January 31 fiscal year end. Accordingly, all references in this Annual Report on Form 10-K to a fiscal year mean the fiscal year ended on January 31 of the referenced year; for example, references to fiscal year 2004 mean the fiscal year ended January 31, 2004.

## Industry

The current market niche for Aerosonic has been and will continue to be the design, development and supply of primary flight control systems components and instruments. These include altimeters, airspeed indicators, angle of attack, stall prevention systems, and air data measurement systems. All of these aircraft products are critical to aircraft operations, performance and safety.

With the cost of both commercial and military aircraft rising, the number of new aircraft programs continues to decrease in both the number of programs and quantity of aircraft being built. Increasing value to the customer has become extremely important to sustaining Aerosonic's market position as well as the Company's market share.

The military original equipment manufacturers ( **OEM** ), such as BAE Systems LTD, Bell Helicopter Textron Inc., Korea Aerospace Industries, Lockheed Martin Corporation ( **Lockheed** ), Sikorsky Aircraft Corporation, The Boeing Company ( **Boeing** ), and others, have increased their reliance on their subcontractors to carry a greater share of the aircraft responsibility, including system requirements, hardware design, and physical and electrical interfaces. This increased responsibility has allowed Aerosonic to develop a greater technical capability for serving its customer base. The evolution of this role has taken Aerosonic to a dominant position in its business segment within the military aircraft market.



This increased technical capability has also positioned the Company to push further into the commercial aircraft market with our new technologies. New development programs with Gulfstream Aerospace Corporation, Learjet Inc., and Raytheon Aircraft Company will allow us to increase and protect our market share.

The Company continues as an industry leader in the manufacturing of mechanical instruments. These products are used for both primary flight data as well as standby redundant instruments in cockpits that use electronic displays for primary flight data. As cockpit panel space becomes more valuable in the new age of glass displays, the Company has maintained a strong position with OEMs as a premier supplier of quality mechanical instruments in both the military and commercial aircraft marketplace.

## **Strategy**

The Company's goal is to continue to reposition its products for profitable growth and maintain dominance within niche markets. The Company intends to focus on the development of profitable long-term contracts. New aircraft cockpits increasingly are being developed through strategic alliances with market leaders. The Company is well positioned to take advantage of these strategic alliances. An increase in sales volume will depend upon new product introduction and further penetration of existing markets. The Company continues to hold a competitive advantage derived from its philosophy of vertical integration. The Company is substantially vertically integrated in its manufacturing and distributing activities.

## **Products and Distribution**

The Company's products are sold to manufacturers of commercial and private aircraft, both domestic and foreign, and the U.S. military services. For the fiscal year ended January 31, 2004, approximately 48% of the Company's total sales were to the private sector and 52% to United States military services. For the fiscal year ended January 31, 2003, approximately 60% of the Company's total sales were to the private sector and 40% to United States military services. This shift in volume is due to the increase in development activity for the F-35 development program as well as the ramp-up of production for the 32A contract, both of which are military applications. Domestic sales of the Company's products are made to many different commercial (non-government) customers, and there is an increasing movement toward development contracts for future applications. For the fiscal year ended January 31, 2004, sales related to development programs accounted for approximately 20% of net sales, or \$6.3 million, an increase of \$2.2 million from the fiscal year ended January 31, 2003, where such sales represented 16% of net sales. During fiscal year 2004, there were two commercial customers, Lockheed and Boeing, who represented 25% and 11%, respectively, of total revenues. A substantial amount of the business related to these customers is related to contracts each customer has with the U.S. Government. If the Company lost either of these customers, such a loss would have a material adverse effect on the Company's results of operations.

In addition, the Company sells its products to customers outside of the U.S. The aggregate percentage of international sales to overall sales was 13%, 17%, and 28% for the fiscal years ended January 31, 2004, 2003 and 2002, respectively.

Most of the Company's instrument sales are made directly through Company employees to OEMs or to the United States military, with the Company's remaining sales being made through other customers (who resell to aircraft operators).

The Company produces a full line of both three-inch and two-inch mechanical and electro-mechanical cockpit instruments. These instruments require no backup power, as they transfer valuable flight data to the pilot using only air pressure (from aircraft probes) as a power source. The Company also manufactures a state of the art air data test set used by aircraft OEMs, repair centers and the U.S. military.

The Company also produces an integrated multifunction probe ( **IMFP** ), which is a combination of existing technologies, including the angle of attack/air data sensing probe and pressure sensing electronics. This integrated approach to providing aircraft air data reduces the customers' system complexity with respect to aircraft troubleshooting and logistics support, increases reliability, and decreases system costs.

The Company has completed a redesign of the basic components of the angle of attack ( AOA )/stall warning product line. The combined stall warning transmitter merges existing technologies of AOA and stall warning into a single technical standard order C54 stall warning transmitter. This combined instrument has dramatically reduced the system weight and increased the system reliability.

The Company is currently developing a new product line that includes microprocessor-based sensors with an analog pointer display that have been selected by Cessna to be standby units on their new Mustang light jet program. The Microprocessor-based Standby Airspeed indicator and the Microprocessor-based Standby Altimeter indicator have completed their preliminary design review. These indicators combine the accuracy, robustness and the long term mean time before failure of electronic sensing presented with a pilot familiar analog pointer display. Initial deliveries of test instruments will be made during the second quarter of fiscal 2005.

Precision Components operates as a high precision machining operation. Precision Components products include a variety of mechanical parts primarily related to the optics industry. Some of the products include the mechanical components for rifle scopes, printing presses, microscopes and tank gun sights.

## **Customers**

The Company primarily markets its products to OEMs, particularly manufacturers of corporate and private jets, and to contractors of military jets. Customers include, among others, the U.S. Government and a majority of the OEMs throughout the world. The Company also markets its products to private aircraft owners through its network of authorized resellers.

## **Contracts**

The Company's contracts are normally for production or development. The Company's production contracts are typically fixed-price over a two to five year period, and the industry trend for such contracts is moving away from five year contracts and toward two year contracts. The Company also secures purchase orders from customers for product sales in the normal course of business that are binding contracts upon acceptance of the terms of orders by the Company.

Fixed-price contracts provide for a firm fixed price on a variety of products and quantities of those products. These contracts allow the Company to negotiate better overall prices that fit into customers' production programs. These long-term commitments also allow the Company to capitalize on quantity based price reduction for raw materials. Under the firm fixed-price contracts, the Company agrees to perform for an agreed-upon price. Accordingly, the

Company derives benefits from cost savings, but bears the risk of cost overruns.

Development contracts provide resources for technology advancement necessary for development of various products. The Company negotiates for and generally receives payments from customers based upon milestones that correlate with the costs incurred. Early in our fiscal year ended January 31, 2003, we were notified that a variation of the IMFP had been selected for use on the Joint Strike Fighter. Development of this system continued through fiscal year 2004 and is expected to conclude in fiscal year 2006. During the fiscal year ended January 31, 2004, the Company was awarded a development contract to provide the stall prevention system for the new G150 business aircraft being developed jointly by Gulfstream and Israeli Aircraft Industries.

As discussed in Note 13 to the Financial Statements, on February 5, 2004 the Company sold its Engine Vibration Monitoring System ( **EVMS** ) product line inventory to Beran Instruments Limited, a U.K. company. This sale, which also includes the U.S.-registered trademark **EVMS** , will allow the Company to concentrate on core technology developments in its other product lines.

In accordance with normal practice, most of our contracts with the U.S. Government and its agencies and departments are subject to partial or complete termination at any time at the government's convenience. Our government contracts generally contain provisions providing that in the event of a termination for convenience by the government, the Company shall have the right to recover allowable costs incurred to the date of termination as well as a proportionate share of the profit on the work completed, consistent with U.S. Government contract regulations and procedures.

## Sales and Marketing

The Company has generally focused sales efforts on government and military entities, OEMs and resellers. The Company intends to increase sales efforts with respect to retrofit, modifications and repair programs.

Due to the system impact of its components, the Company is involved at a very early stage with the aircraft manufacturers' engineers to integrate the components into the aircraft design. All of the Company's component instruments are integrated into the aircraft in order to help maintain the safe operation of the airplane.

At January 31, 2004, the Company's backlog of firm orders was approximately \$27,414,000, a decrease of approximately \$7,364,000 when compared to backlog as of January 31, 2003. The amount of backlog that is deliverable within twelve months was approximately \$22,446,000 at January 31, 2004, a decrease of approximately \$1,993,000 when compared to January 31, 2003. The majority of the reduction in the overall backlog is due to work that was completed on the Joint Strike Fighter development program during the 2004 fiscal year. The foregoing backlog amounts represent firm orders only and do not include current contract options. Such orders, however, may be subject to rescheduling and/or cancellation.

In January 2001, the Company moved its repair operations to the Kansas facility. The Company believes this improves its ability to provide prompt and effective repair and upgrade service.

## Government Regulation

The manufacture and installation of the Company's products in aircraft owned and operated in the U.S. are governed by U.S. Federal Aviation Administration ( **FAA** ) regulations. The regulations that have the most significant impact on the Company are the Technical Standard Order ( **TSO** ) and Type Certificate ( **TC** ) or Supplemental Type Certificate ( **STC** ) certifications. TSO outlines the minimum standards that a certain type of equipment has to satisfy to be TSO certified. Many OEMs and retrofitters prefer TSO-certified aviation equipment because it acts as an industry-wide stamp of approval. The Company also sells its products to European and other non-U.S. OEMs, which typically require approval from the Joint Aviation Authorities ( **JAA** ).

The Company has received TSO approval on over 400 different instruments, as well as 70 STCs. Most new instruments qualify for approval based on similarity. This provides a significant advantage to the Company and its customers by reducing the time required obtaining TSO approval on new instruments. The Company also has many

instruments with JAA approval.

## **Quality Assurance**

Product quality is critical in the aviation industry. The Company strives to maintain the highest standards within each of its divisions.

The Company is ISO 9001 certified. ISO 9001 standards are an international consensus on effective management practices for ensuring that a company can consistently deliver its products and related services in a manner that meets or exceeds customer quality requirements. ISO 9001 standards outline the minimum requirements a quality system must meet to achieve this certification.

As an ISO 9001-certified manufacturer, the Company can represent to its customers that it maintains high quality industry standards in the education of employees and the design and manufacture of its products. In addition, the Company's products undergo extensive quality control testing prior to being delivered to customers. As part of the Company's quality assurance procedures, the Company maintains detailed records of test results and quality control processes.

## **Patents and Licenses**

The Company has patents on certain commercial and military products such as air data probes. The Company also has certain registered trademarks. The patents and intellectual property portfolio, in the aggregate, is valuable to operations, however the Company does not believe the business, as a whole, is materially dependent on any single patent, trademark or copyright.

## **Research and Development**

The Company expended approximately \$167,000, \$745,000 and \$1,083,000 in research and development costs for potential new products and enhancements during the fiscal years ended January 31, 2004, 2003 and 2002, respectively. The reduction in expenditures in 2004 is a result of the redirection of resources toward specific customer contracts where such charges are classified as cost of sales. Approximately 28 engineers working at the Company, on a full-time or part-time basis, are involved in these activities.

The Company continued its various development efforts during fiscal year 2004 for both military and commercial applications, the most notable of which is the F-35 Joint Strike Fighter program. The Company plans to continue its design efforts in the satisfaction of its existing contractual obligations as well as its internal development of products for future customer applications.

## **Competition**

The markets for the Company's products are highly competitive and characterized by several industry niches in which a number of manufacturers specialize. The Company manufactures a larger variety of aircraft instruments than its competitors who, in most instances, compete with the Company on no more than a few types of aircraft instruments.

The Company believes that the principal competitive factors are price, development cycle time, responsiveness to customer preferences, product quality, technology, reliability and variety of products. Management believes that the Company's significant and long-standing customer relationships reflect its ability to compete favorably with respect to these factors.

## **Manufacturing, Assembly and Material Acquisition**

The Company's manufacturing processes (except for certain electronic products) includes the manufacture of all principal components and subassemblies for the instruments, the assembly of those components, and the testing of products at various stages in the manufacture and assembly process.

The Company manufactures, or has the capability to manufacture, principally all components and subassemblies for its instruments. Raw materials, such as glass lenses, raw metals and castings, generally are available from a number of sources and in sufficient quantities to meet current requirements, subject to normal lead times. The Company believes that retaining the ability to completely manufacture the instruments allows the Company the flexibility to respond to customers quickly and control the quality of its products.

When appropriate, less critical component parts are purchased under short and long term supply agreements. These purchased parts are normally standard parts that can be easily obtained from a variety of suppliers. This allows the company to lower overhead expenses and maintain control required to meet the exacting tolerances demanded in the industry.

### **Employees**

As of the fiscal year ended January 31, 2004, the Company employed 269 employees in its business operations. This consisted of 122 Clearwater Instrument employees, 15 Kansas Instrument employees, 125 Avionics employees and 7 Precision Component employees. The Company's future success depends on the ability to attract, train and retain quality personnel. The Company's employees are not represented by labor unions and management considers its relations with its employees to be good.

### **Available Information**

The Company's Annual Reports on Form 10-K, its Quarterly Reports on Form 10-Q, any Current Reports on Form 8-K, and any amendments to these reports are available on the Company's Internet website address [www.aerosonic.com](http://www.aerosonic.com) as soon as reasonably practicable after such materials are filed with or furnished to the SEC. The website address is intended to be an inactive textual reference only and none of the information contained on the Company's website is part of this report nor is incorporated by reference herein.



The Company's reports filed with the SEC also are available from the SEC, and can be obtained by accessing the SEC website at [www.sec.gov/edgar.html](http://www.sec.gov/edgar.html) or writing to the following address:

U.S. Securities and Exchange Commission

450 5th Street N.W.

Washington D.C. 20222

No charge is assessed for any access, viewing, printing or downloading reports from the Company's Internet website. Alternatively, if a paper copy of any such report (without exhibits) is desired, please write to Gary E. Colbert, Chief Financial Officer, Aerosonic Corporation, 1212 North Hercules Avenue, Clearwater, Florida 33765, and a copy of such requested report will be provided, free of charge.

## **Item 2. Properties.**

The following table sets forth the locations and general characteristics of the Company's principal properties:

<b><u>Location</u></b>	<b><u>Approximate Number of Square Feet of Factory and Office Area</u></b>
Clearwater, Florida	90,000
Wichita, Kansas	7,500
Charlottesville, Virginia	53,000

All of the Company's properties are well maintained, fully occupied by the Company and suitable for the Company's present level of production and usage. All locations operate one shift, five days a week. As of January 31, 2004, the Clearwater, Florida property, which is used by both Clearwater Instruments and Precision Components, was mortgaged in accordance with an Industrial Revenue Bond executed in 1987. Subsequent to January 31, 2004, this

mortgage was refinanced with Wachovia Bank N.A. (See Notes 8 and 13, **Financial Statements** )

The Earlysville, Virginia property was purchased from Teledyne Industries in April 1994. The property consists of a 53,000 square foot manufacturing facility on approximately 12 acres of land. As of January 31, 2004, the Virginia property was mortgaged by a long term note with SunTrust Bank N. A. Subsequent to January 31, 2004, this mortgage was repaid when the Company refinanced its debt with Wachovia Bank N.A. (See Notes 8 and 13, **Financial Statements** )

### **Item 3. Legal Proceedings.**

#### **SEC Formal Investigation and Action Against Former Executives**

The Company was the subject of a Formal Order of Investigation issued by the U.S. Securities and Exchange Commission (the **SEC** ) on May 13, 2003 with respect to potential violations of the federal securities laws in connection with the accounting misstatements and contributing causes disclosed by the Company in press releases dated March 17 and May 22, 2003 and further discussed in the Company's annual report for the fiscal year ended January 31, 2003 and the subsequent quarterly reports on Form 10-Q, which the Company brought to the attention of the SEC in conjunction with management's internal investigation, and other potential issues. The Company received a letter from the SEC dated October 27, 2004 advising the Company that the SEC investigation has been terminated as to the Company and that no enforcement action has been recommended to the Commission, as to the Company.

On October 18, 2004, the SEC filed a Complaint for Injunctive and Other Relief against John Mervyn Nabors, a former chief executive officer of the Company, and Eric J. McCracken, a former chief financial officer of the Company, alleging, among other charges, that Mr. Nabors and Mr. McCracken implemented various accounting schemes designed to artificially inflate the Company's reported pre-tax earnings, and that they caused the Company to report inflated earnings by recording fictitious and premature revenue. The SEC reported that Mr. Nabors has reached a settlement of this matter with the SEC and that concurrently with its Complaint, the SEC filed Mr. Nabors' Consent to the proposed judgment (without his admitting or denying the allegations of the SEC's Complaint), and the proposed Final Judgment, which permanently enjoins Mr. Nabors from violating antifraud and other provisions of the federal securities laws, bars Mr. Nabors from serving as an officer or director of a public company and orders him to pay disgorgement of \$210,200 and civil money penalties of \$50,000 to a fund for the benefit of defrauded investors, including those who held the Company's shares during the time period alleged in the SEC Complaint. The SEC's case against Mr. McCracken is pending.

### **Matters Relating to the American Stock Exchange**

On July 30, 2003, the Company received a deficiency letter from the American Stock Exchange ( **Amex** ) informing the Company that it was not in compliance with the Amex continued listing standards. The deficiency letter cited, among other things, the Company's disclosures regarding underlying causes of its financial misstatements and the late filing of the Company's 2003 Form 10-K and the Form 10-Q for the quarter ended April 30, 2003. On August 20, 2003, the Company provided a response, which included a plan to achieve compliance with applicable Amex rules. On September 24, 2003, the Company submitted an amended compliance plan to the Amex, which included an undertaking by the Company to file its 2003 Form 10-K no later than October 31, 2003 and to file both its April 30 and July 31, 2003 Forms 10-Q no later than November 15, 2003. On October 8, 2003, the Amex accepted the Company's compliance plan, as amended, and informed the Company that its listing on the Amex would be continued with the understanding that the Company would implement its compliance plan within the timeframe specified in the plan.

On September 25, 2003 (prior to the October 8, 2003 Amex acceptance of the Company's compliance plan), the Amex halted trading in the Company's Common Stock due to the lack of current financial information concerning the Company. Trading in the Company's Common Stock was resumed by the Amex on November 25, 2003, after the October 31, 2003 filing of the Company's 2003 Form 10-K and the November 20, 2003 filing of its Forms 10-Q for April 30 and July 31, 2003.

### **Additional Proceedings and Matters**

A claim had been asserted by Miriam Frank, on behalf of the estate of the Company's former President and Chairman Herbert J. Frank, for indemnification with respect to fines paid and legal expenses incurred by Mr. Frank in connection with an investigation by the United States government of the unauthorized use of foreign-manufactured components in aircraft clocks manufactured and sold by the Company (the **Government Action** ) and for which Mrs. Frank claims the Company was obligated to indemnify Mr. Frank. In May 2004, the Company negotiated a settlement whereby the Company paid Mrs. Frank \$35,000 in exchange for a release from any and all future claims that could arise from this matter.

### **Securities Class Action Litigation**

On November 12, 2003, a class action lawsuit was filed in the United States District Court for the Middle District of Florida by Sebastian P. Gaeta, individually and on behalf of all other similarly situated (the **Gaeta Suit** ), against the Company, PricewaterhouseCoopers LLP, the Company's former independent registered certified public accounting

firm, J. Mervyn Nabors, a former director and former President and CEO of the Company, Eric J. McCracken, a former Chief Financial Officer of the Company, and Michael T. Reed, a former Controller of the Company. The action alleges violations of Sections 10(b) and 20(a) of the Securities Exchange Act of 1934 (the **Exchange Act**) and Rule 10b-5 promulgated under that act, including, among other things, that the Company made materially false statements concerning the Company's financial condition and its future prospects. The plaintiff alleges that he suffered damages as the result of his purchase and sale of the Company's Common Stock during the asserted Class Period from November 13, 1998 through March 17, 2003. The action seeks compensatory and other damages, and costs and expenses associated with the litigation.

Shortly after the Gaeta Suit was filed, two other putative class actions (the "**Pratsch Suit**" and "**Suarez Suit**") were filed against the same defendants as in the Gaeta Suit and predicated upon alleged violations of the same securities laws, asserting that plaintiffs purchased the Company's stock at artificially inflated prices during the Class Period and have been damaged thereby. The Pratsch Suit and Suarez Suit assert a Class Period from May 3, 1999 through March 17, 2003. At a February 27, 2004 hearing, plaintiffs in the Suarez Suit voluntarily withdrew their complaint. On February 27, 2004, the Court entered an order consolidating the Gaeta Suit and Pratsch Suit into one case entitled "In re Aerosonic Corporation Securities Litigation," appointing Lead Plaintiffs (the "Miville Group"), approving the selection of Lead Plaintiffs Counsel (Berger & Montague P.C.) On April 27, 2004, Lead Plaintiffs filed an amended and consolidated class action complaint that alleges violation of Sections 10(b) and 20(a) of the Exchange Act and Rule 10b-5 including, among other things, that the Company made materially false statements concerning the Company's financial condition and its future prospects. The amended complaint also added as a defendant, Andrew Nordstrud, a former employee of the company. On June 28, 2004, the Company responded to the amended complaint by filing a motion to dismiss, and each of the other defendants also moved to dismiss the amended complaint. On August 27, 2004 Lead Plaintiffs filed a memorandum of law as a comprehensive opposition to the motion to dismiss.

The outcome of the consolidated class action lawsuit cannot be adequately determined, and the impact upon the Company cannot be assessed, at this time. Any resolution of such litigation could have a material adverse effect upon the Company's financial position, results of operations, and cash flow.

#### **Item 4. Submission of Matters to a Vote of Security Holders.**

The Company held its annual meeting of shareholders for fiscal year 2003 on December 18, 2003, at which time shareholders elected six directors to serve on the six member board, until the next annual meeting. The six elected directors, each of whom had been serving as a director prior to the meeting, include: David A. Baldini, Charles M. Foster, Robert J. McGill, William C. Parker, P. Mark Perkins and David M. Vosen.

The election of directors was the only matter voted upon at the annual meeting and 3,715,532 shares were voted at the meeting. Mr. Baldini received a vote of 3,600,443 shares with 115,089 shares withheld, Mr. Foster received a vote of 3,626,859 shares with 88,673 shares withheld, Mr. McGill received a vote of 3,626,859 shares with 88,673 shares withheld, Mr. Parker received a vote of 3,224,257 shares with 491,275 shares withheld, Mr. Perkins received a vote of 3,626,859 shares with 88,673 shares withheld and Mr. Vosen received a vote of 3,626,871 shares with 88,661 shares withheld. There were 0 abstentions.

## **Part II**

#### **Item 5. Market for Registrant's Common Stock and Related Security Holder Matters.**

The Company's Common Stock is listed on the American Stock Exchange under the symbol "AIM". As discussed above in Item 3. Legal Proceedings Matters Relating to the American Stock Exchange, on September 25, 2003, the Amex halted trading in the Company's Common Stock due to the lack of current financial information concerning the Company. The Amex permitted trading to resume on November 25, 2003, after the Company brought its reporting obligations up to date by filing its 2003 Form 10-K on October 31, 2003 and its Forms 10-Q for the quarters ended April 30 and July 31, 2003 on November 20, 2003.

The range of high and low sales prices as reported by the Amex for each of the quarters of the fiscal years ended January 31, 2004 and January 31, 2003 is as follows:

**Fiscal Year Ended January 31, 2004**

	<b><u>Quarter</u></b>		<b><u>Price</u></b>		<b><u>Price</u></b>
1	..	High	\$ 15.45	Low	\$ 9.40
2	..	High	\$ 10.48	Low	\$ 8.00
3	..	High	\$ 10.80	Low	\$ 9.65
4	..	High	\$ 12.30	Low	\$ 7.00

**Fiscal Year Ended January 31, 2003**

	<b><u>Quarter</u></b>		<b><u>Price</u></b>		<b><u>Price</u></b>
1	..	High	\$ 28.00	Low	\$ 18.85
2	..	High	\$ 29.50	Low	\$ 22.50
3	..	High	\$ 24.75	Low	\$ 21.30
4	..	High	\$ 21.50	Low	\$ 13.51

During those same periods, no cash dividends were paid. The Company does not anticipate or intend on paying a dividend in the foreseeable future. Rather, the Company intends to retain its earnings to finance the development and expansion of its business. Additionally, covenants in our long-term debt documents impose significant restrictions on our ability to pay dividends. Any future payment of any dividends on the Company's Common Stock and the amount thereof will depend on the Company's earnings, financial requirements, compliance with the above described covenants, and other factors deemed relevant by the Company's Board of Directors.

As of March 12, 2004, the Company's outstanding shares of Common Stock were owned by approximately 1,440 shareholders of record.

The following table sets forth information with respect to the Company's equity compensation plans.

<u>Plan Category</u>	Number of securities to be issued upon exercise  of outstanding options, warrants and rights	Weighted-average exercise price of outstanding options, warrants and rights	Number of securities remaining available for future issuance under equity compensation plans (excluding those reflected  in column (a))
	(a)	(b)	(c)
Equity compensation plans approved by security holders	-----	N/A	N/A
Equity compensation plans not approved by security holders	-----	N/A	N/A
<b>Total</b>	-----	N/A	N/A

In 1993, the Company's Board of Directors and stockholders approved the Aerosonic Corporation 1993 Incentive Stock Option Plan, pursuant to which the Company was authorized to issue options for up to 300,000 shares of Common Stock to its employees (including officers), directors and consultants. Following the adoption of the plan by the Company's Board of Directors, options were granted to a limited number of employees, all of which have been exercised or have expired pursuant to their terms. As of March 2003, no additional options may be granted pursuant to the terms of the plan. The Company does not have any other equity compensation plans or arrangements.

**Item 6. Selected Financial Data.**

The following selected financial data as of January 31, 2004 and 2003 and for each of the three years in the period ended January 31, 2004 have been derived from the Company's audited Consolidated Financial Statements included elsewhere herein. The selected financial data as of January 31, 2002 and 2001 have been derived from audited financial information not separately presented herein. The selected financial data as of January 31, 2000 has been derived from unaudited financial information.

	<b>Years Ended January 31,</b>				
	<b>2004</b>	<b>2003</b>	<b>2002</b>	<b>2001</b>	<b>2000<sup>(1)</sup></b>
	<b>as Restated</b>	<b>as Restated</b>	<b>as Restated</b>	<b>as Restated</b>	<b>as Restated</b>
Revenue	\$ 31,113,000	\$ 25,672,000	\$ 26,686,000	\$ 23,528,000	\$ 23,271,000
Cost of sales	(22,494,000)	(16,783,000)	(17,441,000)	(15,381,000)	(18,812,000)
Gross Profit	8,619,000	8,889,000	9,245,000	8,147,000	4,459,000
Selling, general and administrative expenses	(8,421,000)	(7,776,000)	(8,082,000)	(8,130,000)	(7,538,000)
Operating income (loss)	198,000	1,113,000	1,163,000	17,000	(3,079,000)
Other income (expense)	(121,000)	(129,000)	(431,000)	(349,000)	(418,000)
Income (loss) before income taxes	77,000	984,000	732,000	(332,000)	(3,497,000)



Income tax benefit (expense) <sup>(2)</sup>	465,000	22,000	(21,000)	(10,000)	(206,000)
Net income (loss) <sup>(2)</sup>	\$ 542,000	\$ 1,006,000	\$ 711,000	\$ (342,000)	\$ (3,703,000)
Basic and diluted earnings per share	\$ 0.14	\$ 0.26	\$ 0.18	\$ (0.09)	\$ (0.94)
Total assets <sup>(3)</sup>	\$ 18,391,000	\$ 16,653,000	\$ 15,484,000	\$ 14,950,000	\$ 16,937,000
Long term debt <sup>(4)</sup>	\$ 2,416,000	\$ 3,411,000	\$ 4,374,000	\$ 5,404,000	\$ 4,293,000

(1)

During the preparation of the Company's Annual Report on Form 10-K for the fiscal year ended January 31, 2003, the Company was unable to determine the full extent of adjustments that would be necessary for a fair presentation of the restated financial information included herein for the fiscal year ended January 31, 2000 due to unavailability of certain accounting records for periods predating the fiscal year ended January 31, 2001. See Note 2 to Consolidated Financial Statements in the Company's Annual Report on Form 10-K for the fiscal year ended January 31, 2003 for a discussion of the restatement of the Company's results for the fiscal years ended January 31, 1999, 2000, 2001, 2002.

(2)

Income tax expense and Net loss for the fiscal year ended January 31, 2000 have been increased by \$572,000 as a result of this Amendment No. 2.

(3)

The change in Total assets as a result of this Amendment No. 2 is as follows:

	2004	2003	2002	2001	2000
Total Assets As Reported	\$ 18,985,000	\$ 17,269,000	\$ 16,093,000	\$ 15,522,000	\$ 17,509,000

Total Assets	As		\$	\$	\$	\$
Restated		\$ 18,391,000	16,653,000	15,484,000	14,950,000	16,937,000

(4)

Long term debt is defined as all outstanding long term debt and capital leases, including current maturities.

## **Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations.**

Management's Discussion and Analysis of Results of Operations and Financial Condition ( **MD&A** ) is provided as a supplement to the accompanying consolidated financial statements and footnotes to help provide an understanding of our business, financial condition, changes in financial condition and results of operations. The MD&A is organized as follows:

**Overview.** This section provides a discussion of recent events which we believe are important to understanding the Company's financial condition and the information set forth in the MD&A.

**Results of Operations.** This section provides an analysis of results of operations for the three fiscal years presented in the accompanying consolidated statements of operations.

**Liquidity and Capital Resources.** This section provides an analysis of cash flows, a discussion of outstanding debt and commitments, both firm and contingent, that existed as of January 31, 2004, and trends, demands, commitments, events and uncertainties with respect to the Company's ability to finance its continuing operations.

**Critical Accounting Policies.** This section discusses the accounting policies (i) that require the Company to make estimates that are highly uncertain at the time the estimate is made, (ii) for which a different estimate which could have been made would have a material impact on the Company's financial statements, (iii) that are the most important and pervasive policies utilized, and (iv) that are the most sensitive to material change from external factors. In addition, our significant accounting policies, including the critical accounting policies, are summarized in Note 1 to the accompanying consolidated financial statements.

**Cautionary Statement and Additional Trends and Uncertainties.** This section cautions on the basis of certain forward looking statements which are susceptible to uncertainty and changes in circumstances and discusses important trends and uncertainties that may impact the Company's financial condition and results of operations.

### **Overview**

In March 2003, the Company announced that it had discovered apparent accounting discrepancies in previously reported financial information. As announced in March 2003 and on subsequent dates, upon discovery of such misstatements, the Company took immediate steps to quantify the extent of any incorrect financial reporting, discover the cause thereof, correct any problems and prevent future misstatements, including commencing a comprehensive internal review and notifying the U.S. Securities and Exchange Commission, the Company's auditor, the American Stock Exchange, and the public of the existence of the apparent misstatements. The nature and extent of the misstatements are fully disclosed in the Company's Annual Report on Form 10-K for the fiscal year ended January 31, 2003.

## **Results of Operations**

### *Revenues*

Revenues increased \$5,441,000, or 21%, to \$31,113,000 for fiscal year 2004, from \$25,672,000 for fiscal year 2003.

This growth was driven by an increase in revenue of \$2,900,000 for the Joint Strike Fighter program, as well as an increase in core instrument sales of approximately \$3,028,000. These increases were partially offset by a decrease in Precision Component revenue of approximately \$703,000.

Revenues for the fiscal year ended January 31, 2003 decreased \$1,014,000, or 4% to \$25,672,000 when compared to the results for fiscal year 2002. The decrease in revenue resulted primarily from a decrease in demand for commercial products that was partially offset by an increase in demand for government products. For fiscal year 2003, the overall decrease in product sales was \$3,320,000, or 16%, to \$17,900,000 when compared to fiscal year 2002. However, such decrease in product sales was largely offset by the initiation of the Joint Strike Fighter development program, which was the primary reason for an increase in sales related to development projects of \$2,193,000. The Company also experienced an increase in sales related to spare parts and repairs in fiscal year 2003 of approximately \$113,000 when compared to fiscal year 2002.

### *Cost of Sales*

Cost of sales increased \$5,711,000 or 34%, to \$22,494,000, or 72% of revenues, for fiscal year 2004 from \$16,783,000, or 65% of revenues, for fiscal year 2003. This increase in cost was primarily due to lower margins on the Joint Strike Fighter ( **JSF** ) development program, as approximately \$260,000 of costs were incurred for what the Company believes were changes on scope and for which no additional revenue has yet been recognized. In addition, the rate of growth in JSF program costs incurred exceeded the rate of growth in revenues recognized as additional testing was required during certain aspects of the development cycle. Also, a shift in product mix where instrumentation revenues increased and represented a larger percentage of volume than in fiscal year 2003 (while revenues for repairs and spare parts remained relatively the same) put downward pressure on gross margins.

Cost of sales decreased \$658,000 or 4%, to \$16,783,000, or 65% of revenues, for fiscal year 2003 from \$17,441,000 or 65% of revenues, for fiscal year 2002. This decrease in cost is primarily due to a reduction in revenue, as the change in sales mix that resulted in lower product sales was offset by higher sales of spare parts, repairs and development projects.

### *Selling, General and Administrative Expenses*

Selling, general and administrative ( **SG&A** ) expense increased \$645,000, or 8%, to \$8,421,000, or 27% of revenue, for fiscal year 2004 from \$7,776,000, or 30% of revenues for fiscal year 2003. The increase in SG&A expense was attributable to one-time charges for auditing and legal fees related to the Company's restatement of results of approximately \$1,679,000, a retirement contract of approximately \$134,000 and a consulting arrangement with the Company's former Chairman and Chief Executive Officer of approximately \$134,000. These one-time charges were partially offset by reductions in engineering costs of approximately \$652,000 that are largely due to the redeployment of engineering staff to the F-35 program where the engineering costs are absorbed in cost of sales, a reduction in compensation and benefits in general and administrative expense of approximately \$275,000 and a reduction in consulting fees of approximately \$100,000.

SG&A expense decreased \$306,000, or 4%, to \$7,776,000, or 30% of revenue, for fiscal year 2003 from \$8,082,000, or 30% of revenue for fiscal year 2002. SG&A expense was 30% of revenues in fiscal year 2003 as well as in fiscal year 2002. The decrease was attributable to decreased commission expenses for sales in Europe and Japan as well as the redirection of engineering resources from internally-funded research and development efforts to customer-funded design work for the Joint Strike Fighter program.

### *Interest Expense*

Net interest expense decreased \$38,000, or 18% to \$169,000 in fiscal year 2004 from net interest expense of \$207,000 in fiscal year 2003. The net interest expense decrease was primarily due to lower average outstanding debt during the year and lower interest rates.

Net interest expense decreased \$218,000, or 51%, to \$207,000 in fiscal year 2003 from net interest expense of \$425,000 in fiscal year 2002. The net interest expense decrease was primarily due to lower average outstanding debt during the year and lower interest rates.

***Other Income (Expense)***

Other income, net decreased \$30,000 to \$48,000 in fiscal year 2004 from other income, net \$78,000 in fiscal year 2003. The decrease was primarily related to the one-time litigation settlement in fiscal year 2003 and was partially offset by foreign exchange gains on British Pound transactions.

Other income, net increased \$84,000 to \$78,000 in fiscal year 2003 from other income, net of (\$6,000) in fiscal year 2002. The increase was primarily related to the settlement of litigation.

### *Income Tax Expense*

Income tax expense was a benefit of \$465,000 for fiscal year 2004 as compared to an income tax benefit of \$22,000 for fiscal year 2003. The income tax obligations that arise from pretax income for fiscal year 2004 are offset by the reversal of a portion of the deferred tax valuation allowance that had been previously recognized; as it is more likely than not that the deferred tax asset benefits will be realized in future periods.

The effective rate decreased 601.7% to (603.9%) in fiscal year 2004 from (2.2%) in fiscal year 2003. The decrease in the effective tax rate is primarily due to the reversal of a portion of the deferred tax valuation allowance that had been previously recognized.

Income tax expense was a benefit of \$22,000 for fiscal year 2003 as compared to an expense of \$21,000 for fiscal year 2002. The income tax obligations that arise from pretax income for fiscal year 2003 are offset by tax credits for research and development expenditures obtained through the filing of amended tax returns in the third quarter of fiscal year 2003 plus the change in the deferred tax allowance recognized in fiscal year 2003.

The effective tax rate decreased to (2.2%) in fiscal year 2003 from 2.9% in fiscal year 2002. The decrease in the effective tax rate is primarily due to the impact of the research and development credits that were recognized during fiscal year 2003 as well as the smaller change in the deferred tax valuation allowance recognized in fiscal year 2003 versus the large change in the deferred tax valuation allowance recognized in fiscal year 2002.

### *Income*

Net income decreased \$464,000 to \$542,000, or 1.7% of revenue, for fiscal year 2004 from net income of \$1,006,000, or 3.9% of revenue, for fiscal year 2003. Earnings per share decreased \$0.12 to \$0.14 for fiscal year 2004 from earnings per share of \$0.26 in fiscal year 2003.

Net income increased \$295,000 or 41% to \$1,006,000, or 3.9% of revenue, for fiscal year 2003 from \$711,000, or 2.7% of revenue, for fiscal year 2002. Earnings per share increased \$0.08 to \$0.26 for fiscal year 2003 from \$0.18 in fiscal year 2002.

### ***Inflation***

The Company does not believe that inflation has had a material effect on the Company's financial position or results of operations. However, the Company cannot predict the future effects of inflation.

### **Liquidity and Capital Resources**

Cash provided by operating activities was \$2,214,000 for fiscal year 2004, compared to \$93,000 for fiscal year 2003. The Company incurred substantial costs for professional services in fiscal year 2004, and a significant portion remained in accounts payable at January 31, 2004, resulting in a provision of cash of approximately \$673,000. In addition, a large payment that was accrued as an account payable but was paid subsequent to January 31, 2004 resulted in a provision of cash of approximately \$650,000. The ramp-up of production for the 32A government contract as well as the shipment of finished goods that were held at January 31, 2003 contributed to the cash provided by the decline in inventory of approximately \$1,317,000. Also, a reduction in accrued liabilities due to the payment of professional fees that were accrued at January 31, 2003 contributed to cash used due to a decline in accrued expenses and other liabilities of approximately \$534,000.

Cash provided by operating activities was \$93,000 for fiscal year 2003 as compared to cash provided by operating activities of \$1,775,000 for fiscal year 2002. The decrease was primarily attributable to an increase in inventory balances in anticipation of fulfillment of orders for the 32A government contract that was awarded in May 2002 and the commencement of a product development contract for a government product application.

Cash used in investing activities was \$403,000 for fiscal year 2004 as compared to \$681,000 for fiscal year 2003. The decrease was primarily attributable to the deferral of capital investment activity.



Cash used in investing activities was \$681,000 for fiscal year 2003 as compared to \$617,000 for fiscal year 2002. The decrease was primarily attributable to a slight decrease in investment in Machinery and Equipment.

Cash used in financing activities was \$795,000 for fiscal year 2004 as compared to cash used of \$857,000 in fiscal year 2003. This decrease in cash usage was primarily due to lower debt repayment obligations as well as the absence of treasury stock purchases.

Cash used in financing activities was \$857,000 for fiscal year 2003 as compared to cash used of \$530,000 in fiscal year 2002. This increase in cash usage was primarily due to repayments of a portion of the Company's long-term debt.

To accommodate fluctuation in cash flow, the Company had a \$1,000,000 revolving credit facility, which was set to expire in May 2003. As discussed below, the Company recently was in default under this facility with respect to, among other things, representations and warranties it made regarding encumbrances on the collateral, and covenants to provide annual and quarterly financial statements and maintain certain financial ratios, although waivers of such defaults were obtained. The Company requested and was granted subsequent extensions of this credit facility until September 5, 2003, December 5, 2003 and, most recently, until April 30, 2004. The credit facility originally bore interest at the trailing 90-day treasury index plus 2.75%. As a result of the extensions of the credit line, the interest rate for this facility has been changed to the prime rate, which was 4.00% as of September 5, 2003. At January 31, 2004, this facility was fully utilized.

As described in Note 13 to the Financial Statements, the Company completed a refinancing of its existing debt with Wachovia Bank, N.A. on February 25, 2004 (the **Wachovia Refinancing**). The new debt facilities consist of a \$3,000,000 term loan, a \$2,500,000 revolving credit facility and a \$211,000 term loan. The proceeds from the refinancing were used to repay all of the Company's debt obligations to First Commercial Bank and SunTrust Bank N.A.

The Company had been in breach of certain covenants and other provisions of the documents related to its Industrial Development Revenue Bond ( **IDRB** ), the Mortgage on its Earlysville, Virginia property, and the Term Notes and Line of Credit with First Commercial Bank.

The Company had previously obtained written waivers for breaches of covenant violations that had occurred during fiscal year 2004. As of January 31, 2004, the Company was still in violation of certain financial covenants, but the underlying debt obligations were subsequently repaid out of the Wachovia Refinancing in February 2004. The Company also had negotiated an extension of its Term Notes and Line of Credit with First Commercial Bank to April 30, 2004. Consequently, the Company had no covenant violations with respect to its obligations to First Commercial

Bank as of January 31, 2004. All loan obligations to First Commercial Bank were paid out of the proceeds of the Wachovia Refinancing in February 2004.

Future capital requirements depend on numerous factors, including research and development, expansion of products lines, and other factors. Management believes that cash and cash equivalents, together with the Company's cash flow from operations and current borrowing arrangements will provide for these necessary capital expenditures. Furthermore, the Company may develop and introduce new or enhanced products, respond to competitive pressures, invest or acquire businesses or technologies or respond to unanticipated requirements or developments, which would require additional resources.

As shown in the table below, as of January 31, 2004, there are liquidation payments that were due with respect to long-term debt and other contractual obligations in fiscal year 2005 and beyond:

<b>Contractual Obligations</b>	<b>Payments Due by Period</b>				
	<b><u>Total</u></b>	<b><u>Less than One Year</u></b>	<b><u>1 - 3 Years</u></b>	<b><u>4 - 5 Years</u></b>	<b><u>After 5 Years</u></b>
	\$	\$	\$	\$	\$
Purchase Commitments	7,680,000	7,084,000	596,000	-	-
Long-Term Debt <sup>(1)</sup>	3,000,000	200,000	600,000	400,000	1,800,000
Operating Leases	1,216,000	398,000	818,000	-	-
Total Contractual Cash Obligations	\$ 11,896,000	\$ 7,682,000	\$ 2,014,000	\$ 400,000	\$ 1,800,000

(1)

The long term debt reflects the payments that are due as a result of the Wachovia Refinancing that was completed subsequent to January 31, 2004.

The Company's ability to maintain sufficient liquidity in fiscal year 2005 and beyond is highly dependent upon achieving expected operating results. The Company has successfully negotiated new credit facilities with its lenders in order to provide more operating flexibility for the Company than it previously had. However, failure to achieve expected operating results could have a material adverse effect on our liquidity and our operations in fiscal year 2005, and could require us to consider further measures, including deferring planned capital expenditures, reducing discretionary spending and, if necessary, selling assets.

## **Acquisitions**

Currently, the Company has no arrangements or understandings with respect to any acquisitions. Nevertheless, the Company continues to monitor acquisition opportunities. The Company's ability to consummate any acquisitions, including a merger with another entity, is substantially limited by covenants in the Company's long term debt documents.

## **Environmental Matters**

In accordance with a consent agreement with the Department of Environmental Protection that was signed by the Company in 1993, the Company's environmental consultant developed an interim remedial action plan to contain and remediate certain contamination on and underlying the Company's property located in Clearwater, Florida. During 1997, the Company recorded a provision of approximately \$175,000 related to the estimated costs to be incurred under this plan. As of January 31, 2000, the Company had utilized all amounts originally recorded in other accrued expenses, and the phase-one remediation had been completed.

During the third quarter of fiscal year 2001, management assessed the post-remediation monitoring expense related to the 1993 environmental clean up and determined that such remaining monitoring would cost approximately \$125,000. This amount was accrued and expensed during the third quarter, fiscal year 2001, and the reserve was fully utilized as of January 31, 2003. Significant efforts have resulted in a successful remediation of contamination of the Company's property, and the estimated remaining remediation costs to be incurred are expected to be approximately \$38,000, for which a reserve has been provided as of January 31, 2004.

## **Critical Accounting Policies**

The discussion and analysis of our financial condition and results of operations are based upon the accompanying consolidated financial statements, which have been prepared in accordance with accounting principals generally accepted in the United States. The preparation of those financial statements and this Annual Report on Form 10-K requires us to make estimates and judgments that affect the reported amount of assets and liabilities, revenues and expenses, and related disclosure items, including disclosure of contingent assets and liabilities, at the date of our financial statements. Actual results may differ from these estimates under different assumptions or conditions, and as a result of trends and uncertainties identified above under **RESULTS OF OPERATIONS** and **LIQUIDITY AND CAPITAL RESOURCES** and below under **CAUTIONARY STATEMENT AND ADDITIONAL TRENDS AND UNCERTAINTIES**. Further, such differences could be material.

Set forth below is a discussion of the Company's critical accounting policies. The Company considers critical accounting policies to be those (i) that require the Company to make estimates that are highly uncertain at the time the estimate is made, (ii) for which a different estimate which could have been made would have a material impact on the Company's financial statements, (iii) that are the most important and pervasive policies utilized, and (iv) that are the most sensitive to material change from external factors. Additionally, the policies discussed below are critical to an understanding of the financial statements because their application places the most significant demands on management's judgment, with financial reporting results relying on estimates about the effect of matters that are highly uncertain. Specific risks for these critical accounting policies are described in the following paragraphs. The impact and any associated risks related to these policies on business operations is discussed throughout this MD&A where such policies affect reported and expected financial results.

For a detailed discussion regarding the application of these and other accounting policies, see Note 1 to the accompanying consolidated financial statements. Senior management has discussed the development and selection of the critical accounting estimates and the related disclosure included herein with the Audit Committee of the Board of Directors.

### ***Revenue Recognition***

The Company manufactures most of its products on a build-to-order basis and ships products upon completion. The Company has a policy of strict adherence to the provisions of SAB 101 in order to accurately state its revenues in each accounting period. For certain situations, some judgment is required, but most sales have clear revenue recognition criteria.

Revenue sources for product sales are largely from sales to commercial and government customers. The majority of customer sales terms are F.O.B. origin, although some customer terms are F.O.B. destination. For those customers where terms are origin, revenue is generally recognized upon shipment, unless additional prevailing factors would not be in accordance with the revenue recognition requirements of SAB 101. For those customers whose terms are destination, revenue is generally not recognized until goods arrive at the customers' premises and all other revenue recognition criteria are met.

The Company experiences a certain degree of sales returns that varies over time. Generally such returns occur within no more than 90 days after shipment by the Company to its customers. In accordance with SFAS 48 Revenue Recognition When Right of Return Exists, the Company is able to make a reasonable estimation of expected sales returns based upon history and as contemplated by the requirements of SFAS 48. For example, sales returns may occur if delivery schedules are changed by customers after products have shipped or if products are received by customers but do not meet specifications. In such cases, customers may choose to return products to the Company. Absent such circumstances, customers do not have a right to return products if the Company has met all contractual

obligations. The Company has established a sales return reserve that approximates an expected level of sales returns over a 90-day period and, as of January 31, 2004, that reserve is \$75,000.

From time to time, the Company will jointly develop products with its customers for future applications. In such circumstances, the Company recognizes revenue on a percentage of completion basis, measured by the percentage of costs incurred to date to estimated total costs for the contract. This method is used because management considers expended costs to be the best available measure of progress on the contracts. The percentage of completion contract costs include direct labor, material, subcontracting costs, test facilities, and other indirect costs as allocated. Other operating costs are charged to expense as incurred. During fiscal 2003, the Company secured one long-term fixed-price contract for the development of instrumentation for the Joint Strike Fighter program. Costs and estimated earnings on this contract as of the years ended January 31, 2004 and 2003 are as follows:

	<b>2004</b>	<b>2003</b>
Costs incurred to date	\$ 7,553,000	\$ 2,534,000
Estimated earnings	1,333,000	447,000
	8,886,000	2,981,000
Less billings to date	(7,488,000)	(2,485,000)
Costs and estimated profits in excess of billings	\$ 1,398,000	\$ 496,000

Occasionally the Company enters into research and development contracts with customers. The Company accounts for such contracts on the basis of the lesser of non-refundable cash versus percentage of completion.

***Accounts Receivable Allowance for Doubtful Accounts and Credit Losses***

The Company continuously evaluates its customers and provides reserves for anticipated credit losses as soon as collection becomes compromised. The Company does maintain a limited reserve in anticipation that smaller accounts may become a collection issue, which occurs from time to time based on historical experience. However, most of the Company's customers are financially sound and the Company's history of bad debts is relatively low. While credit losses have historically been within expectations and the provisions established, the Company cannot guarantee that it will continue to experience the same credit loss rates that have been experienced in the past. Measurement of such losses requires consideration of historical loss experience, including the need to adjust for current conditions, and judgments about the probable effects of relevant observable data, including present economic conditions such as delinquency rates and financial health of specific customers.

***Provisions for Excess and Obsolete Inventory Losses and Residual Value Losses***

The Company values inventory at the lower of cost (using a method that approximates the first-in, first-out method) or net realizable value. Reviews of inventory quantities on hand have been conducted to determine if usage or sales history supports maintaining inventory values at full cost or if it has instead become necessary to record a provision for slow moving, excess and obsolete inventory based primarily on estimated forecasts of product demand and production requirements for the subsequent twelve months. Estimates of future product demand may prove to be inaccurate, in which case the Company may understate or overstate the provision required for excess and obsolete inventory. Although the Company endeavors to ensure the accuracy of forecasts of future product demand, any significant unanticipated changes in demand or technological developments could have a significant impact on the value of inventory and consequently reported operating results.

***Work In Process Inventories***

Management employs certain methods to estimate the value of work in process inventories for financial reporting purposes. Company practice has been to conduct cycle counts of inventory at its Earlysville, Virginia operations throughout the year and to conduct a full physical inventory at the Company's Clearwater, Florida operations at the close of business each fiscal year. During the 2004 fiscal year, the Company began a practice of conducting cycle counts at its Clearwater, Florida operations. Generally, for items that are in process at the end of a fiscal year, management will make an estimate during the physical inventory process regarding the percentage of completion of such items in order to accurately reflect costs incurred to date on the production of the items that are still in process. These estimates are affected by the nature of the operation at which the items are located at the time a physical inventory is conducted, and are subject to judgment. This practice was employed for the fiscal year ended January 31, 2004.

***Manufacturing Overhead Cost Application***

The Company establishes its inventoriable cost of manufacturing overhead by calculating its overhead costs as a percentage of direct labor and applying that percentage to direct labor that has been charged to inventory on a twelve month rolling average basis. This application percentage is reviewed at least quarterly and is adjusted at least annually.

***Deferred Tax Asset Valuation Allowance***

The Company accounts for income taxes in accordance with Statement of Financial Accounting Standards ( **SFAS** ) No. 109, Accounting for Income Taxes. Under this method, deferred tax liabilities and assets are determined based on the difference between the financial statement carrying amounts and tax bases of assets and liabilities using enacted tax rates in effect in the years in which the differences are expected to reverse. A valuation allowance is provided against the future benefit of deferred tax assets if it is determined that it is more likely than not that the future tax benefits associated with the deferred tax asset will not be realized.



***Long-Lived Assets***

The useful lives of property, plant and equipment for purposes of computing depreciation are:

Land Improvements	15-20 Years
Buildings and improvements	25-30 Years
Machinery and equipment	3-10 Years
Patterns, dies, and tools	3-5 Years
Furniture and fixtures	5-10 Years

Management periodically evaluates long-lived assets for potential impairment and will record an impairment charge whenever events or changes in circumstances indicate the carrying amount of the assets may not be fully recoverable. As of January 31, 2004 and 2003, management does not believe that any assets are impaired.

The Company will capitalize production costs for computer software that is to be utilized as an integral part of a product when both (a) technological feasibility is established for the software and (b) all research and development activities for the other components of the product have been completed. Amortization is charged to expense at the greater of the expected unit sales versus units sold or the straight line method for a period of three years from the date the product becomes available for general release to customers.

***Other Accounts Affected by Management Estimates***

From time to time, management will utilize estimates when preparing the financial statements of the Company. Such areas include amortization and other accruals.

The Company has established a provision for warranty claims in anticipation of a certain degree of warranty activity, which generally is a minimal expense. This provision is based upon recent warranty experience. The Company's warranty experience is as follows:

	<b>For the year ended January 31,</b>		
	<b>2004</b>	<b>2003</b>	<b>2002</b>
Beginning reserve balance	\$ 50,000	\$ 20,000	\$ 20,000
Costs incurred	(160,000)	(51,000)	(44,000)
Replenish reserve for costs incurred	160,000	51,000	44,000
Increase in estimate	100,000	30,000	-
Ending reserve balance	\$ 150,000	\$ 50,000	\$ 20,000

The following table summarizes other significant areas which require management estimates:

	<b>For the year ended January 31,</b>		
	<b>2004</b>	<b>2003</b>	<b>2002</b>
Allowance for Doubtful Accounts	\$ 152,000	\$ 372,000	\$ 81,000
Warranty Reserve	150,000	50,000	20,000
Reserve for Sales Returns	75,000	75,000	-
Depreciation	683,000	638,000	600,000
Amortization	142,000	265,000	280,000

Deferred Tax Valuation Allowance

-	530,000	618,000
\$	\$	\$
1,202,000	1,930,000	1,599,000

***Recent Accounting Pronouncements***

In November 2002, the FASB issued FIN 45, *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others (an interpretation of FAS No. 5, 57 and 107 and rescission of FASB Interpretation No. 34)*, which modifies the accounting and enhances the disclosure of certain types of guarantees. FIN 45 requires that upon issuance of certain guarantees, the guarantor must recognize a liability for the fair value of the obligation it assumes under the guarantee. FIN 45's provisions for the initial recognition and measurement are to be applied to guarantees issued or modified after December 31, 2002. The disclosure requirements are effective for financial statements of annual periods that end after December 15, 2002. The Company does not believe the adoption of FIN 45 has a material impact on its financial statements.

In January 2003, the FASB issued FIN No. 46, *Consolidation of Variable Interest Entities*, ("**FIN 46**"). FIN 46 clarifies the application of Accounting Research Bulletin No. 51, *Consolidated Financial Statements*, to certain entities in which equity investors do not have the characteristics of a controlling financial interest or do not have sufficient equity at risk for the entity to finance its activities without additional subordinated financial support from other parties. FIN 46 applies immediately to variable interest entities (**VIEs**) created after January 31, 2003, and to variable interest entities in which an enterprise obtains 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 Company has not identified any VIEs for which it is the primary beneficiary or has significant involvement.

In December 2003, the FASB issued FIN No. 46 (revised December 2003), *Consolidation of Variable Interest Entities ("**FIN 46-R**")* to address certain FIN 46 implementation issues. The effective dates and impact of FIN 46 and FIN 46-R are as follows:

(i)

For special purpose entities ( **SPEs** ) created prior to February 1, 2003, the Company must apply either the provisions of FIN 46 or early adopt the provisions of FIN 46-R at the end of the first interim or annual reporting period ending after December 15, 2003.

(ii)

For non-SPEs created prior to February 1, 2003, the Company is required to adopt FIN 46-R at the end of the first interim or annual reporting period ending after March 15, 2004.

(iii)

For all entities, regardless of whether a SPE, that were created subsequent to January 31, 2003, the provisions of FIN 46 were applicable for variable interests in entities obtained after January 31, 2003. The Company is required to adopt FIN 46-R at the end of the first interim or annual reporting period ending after March 31, 2004.

The adoption of the provisions applicable to SPEs and all other variable interests obtained after January 31, 2003 did not have a material impact on the Company's consolidated financial statements. The Company is currently evaluating the impact of adopting FIN 46-R applicable to non-SPEs created prior to February 1, 2003, but does not expect a material impact.

In May 2003, the FASB issued FAS No. 149, *Amendment of Statement No. 133 on Derivative Instruments and Hedging Activities*, ("**FAS 149** "). FAS 149 is effective for contracts entered into or modified after June 30, 2003 and for hedging relationships designated after June 30, 2003. FAS 149 amends and clarifies financial accounting and reporting for derivative instruments, including certain derivative instruments embedded in other contracts and for hedging activities. FAS 149 also amends FAS 133 for decisions made as part of the Derivatives Implementation Group process that effectively required amendments to FAS 133, in connection with other FASB projects dealing with financial instruments and in connection with implementation issues raised in relation to the application of the definition of a derivative. The adoption of FAS 149 did not have an impact on the Company's consolidated financial statements.

In May 2003, the FASB issued SFAS No. 150, *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity*, ("**FAS 150**"). FAS 150 is effective for 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. FAS 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 reclassify certain instruments previously classified as equity as a liability. The adoption of FAS 150 did not have an impact on the Company's consolidated financial statements.

In December 2003, the FASB issued SFAS No. 132 (revised 2003), *Employers' Disclosures about Pensions and Other Postretirement Benefits*, an amendment of SFAS No. 87, 88 and 106, and a revision of SFAS No. 132. The statement is effective for fiscal years and interim periods ending after December 15, 2003. This Statement revises employers' disclosures about pension plans and other postretirement benefit plans. It does not change the measurement or recognition of those plans required by SFAS No. 87, 88 and 106. The new rules require additional disclosures about the assets, obligations, cash flows, and net periodic benefit cost of defined benefit pension plans and other postretirement benefit plans. The Company currently does not have any pension or other postretirement benefit plans other than a qualified 410(k) plan and the adoption of this statement did not have an impact on the Company's consolidated financial statements.

### **Cautionary Statement and Additional Trends and Uncertainties**

As set forth in Part I of this Annual Report on Form 10-K, the MD&A contains forward looking statements that are based on current expectations, estimates and projections about the Company and the industry in which it operates. These statements are not guarantees of future performance and involve certain risks, uncertainties and assumptions. Accordingly, actual outcomes and results may differ materially from what is expressed or forecast in such forward-looking statements. Additionally, past performance is not necessarily indicative of future results of operations. In particular, the Company's results of operations, revenue, liquidity and capital resources may be impacted materially and unfavorably by a number of risk factors, trends and uncertainties. Set forth below are some of the risk factors, trends and uncertainties which we believe could have a material and unfavorable impact on the Company's results of operations, revenue, liquidity, capital resources and any investment in the Company. Additional risk factors, trends and uncertainties are discussed above. The following list is not exhaustive, and other factors which are not presently apparent to us also may have a material and unfavorable impact.

#### ***Risks associated with dependence on the aviation industry***

The September 11, 2001 terrorist attacks severely impacted conditions in the commercial and business aviation industry. As a result, new commercial aircraft orders and refurbishments dropped significantly. Additionally, high airline operating costs, weak air travel and low-ticket prices have damaged many carriers' financial condition. Those factors have combined to cause a major decline in new aircraft orders and aircraft refurbishing, which in turn has resulted in lower demand from the Company's business airplane manufacturer customer base. Such drop in demand from our commercial manufacturing customer base affected financial results for the fiscal years ended January 31, 2003 and 2004.

Although we have worked to offset the negative impact of such factors by increasing our U.S. Government contracts, we expect these adverse industry conditions to have a material adverse impact on our results of operations and financial condition until such time as conditions in the industry improve. The commercial and business aircraft market

conditions could also deteriorate further if there is an outbreak or escalation of national or international hostilities or additional terrorist attacks. As happened after the September 2001 terrorist attacks, reinstatement of flight restrictions would negatively impact the market for aviation equipment and would adversely affect the commercial sector of our business.

*Risks associated with dependence on U.S. Government contracts*

Our dependence on revenue from U.S. Government contracts subjects us to a number of risks, including the risk that we may not be successful in bidding for future contracts and the risk that U.S. Government funding for these contracts may be delayed or diverted to other uses.

We perform work on a number of contracts with the Department of Defense and other agencies and departments of the U.S. Government. Sales under contracts with the U.S. Government as a whole, including sales under contracts with the Department of Defense, as prime contractor or subcontractor, represented approximately 52 % of our total revenue for fiscal year 2004 and 40% of our total revenue for fiscal year 2003.

Government contracts are conditioned upon the continuing availability of Congressional appropriations. Congress typically appropriates funds for a given program on a fiscal-year basis even though contract performance may take more than one year. As a result, at the beginning of a major program, a contract is typically only partially funded, and additional monies are normally committed to the contract by the procuring agency only as appropriations are made by Congress for future fiscal years.

While the overall U.S. military budget declined in real dollars from the mid-1980s through the early 1990s, as a result of the September 11th terrorist attacks and given the current Middle East and global situation, U.S. defense spending has increased and is expected to increase over the next several years. Increased defense spending does not necessarily correlate to increased business for the Company, because not all the programs in which the Company participates or has current capabilities may be earmarked for increased funding.

Most of our U.S. Government contracts are subject to termination by the U.S. Government either at its convenience or upon the default of the contractor. Termination-for-convenience provisions permit only the recovery of costs incurred or committed, settlement expenses, and profit on work completed prior to termination. Termination-for-default imposes liability on the contractor for excess costs incurred by the U.S. Government in procuring undelivered items from another source.

A substantial majority of our U.S. Government contracts are fixed price type contracts. A majority of these contracts are for mature products and costs are well established. However, some contracts include costs associated with product development. These types of contracts bear the inherent risk that actual performance cost may exceed the fixed contract price.

We, like other U.S. Government contractors, are subject to various audits, reviews and investigations (including private party whistleblower lawsuits) relating to our compliance with federal and state laws. In addition, we have a compliance program designed to surface issues that may lead to voluntary disclosures to the U.S. Government. Generally, claims arising out of these U.S. Government inquiries and voluntary disclosures can be resolved without resorting to litigation. However, should a business unit or division of the Company involved in a government contract be charged with violation of law, or should the U.S. Government determine that the unit or division is not a presently responsible contractor, that unit or division, and conceivably the Company as a whole, could be temporarily suspended or, in the event of a conviction, could be debarred for up to three years from receiving new U.S. Government contracts or government-approved subcontracts. In addition, we could expend substantial amounts in defending against such charges and in damages, fines and penalties if such charges are proven or result in negotiated settlements.

The financial misstatements and the contributing factors discussed herein could prompt the U.S. Government to initiate debarment proceedings against the Company. However, Aerosonic believes that it is not a target for debarment due, in part, to the remedial actions it has taken. Accordingly, Aerosonic would actively contest any debarment proceeding. Nevertheless, there is no assurance that the U.S. Government will not institute a debarment proceeding against Aerosonic or that Aerosonic will be successful in contesting any such proceeding. If Aerosonic were to be debarred from U.S. Government defense contracts, it would have a material adverse effect on Aerosonic's results of operations, revenue, liquidity and capital resources.



*Risks associated with aviation industry regulations*

The aerospace industry is heavily regulated and failure to comply with applicable laws or regulations could reduce our sales, or require us to incur additional costs to achieve compliance, which could have a material adverse effect on our results of operations.

The Federal Aviation Administration (the **FAA**) prescribes standards and licensing requirements for aircraft components, including virtually all of our products. Comparable agencies, such as the U.K. Civil Aviation Authority and the Japanese Civil Aviation Board, regulate these matters in other countries. If we fail to obtain a required license for one of our products or services or lose a license previously granted, the sale of the subject product or service would be prohibited by law until such license is obtained or renewed. In addition, designing new products to meet existing regulatory requirements and retrofitting installed products to comply with new regulatory requirements can be both expensive and time consuming.

From time to time the FAA proposes new regulations. These new regulations generally cause an increase in costs to comply with these regulations. To the extent the FAA implements rule changes in the future, we may incur additional costs to achieve compliance.

***The challenge to compete against larger well-established companies***

We compete with numerous established companies. Some of these companies have significantly greater financial, technological and marketing resources. Our ability to be an effective competitor will depend in large part on our success in causing our products to be selected for installation in new aircraft, including next generation aircraft, and in avoiding product obsolescence.

***Risks associated with rapid technological change and products that are subject to obsolescence as a result thereof***

Our operating results depend in part on our ability to introduce new and enhanced products on a timely basis. Successful product development and introduction depend on numerous factors, including our ability to anticipate customer and market requirements, changes in technology and industry standards, our ability to differentiate our offerings from offerings of our competitors, and market acceptance.

The markets for a number of our products and services are generally characterized by rapid technological development, evolving industry standards, changes in customer requirements and new product introductions and enhancements. A faster than anticipated change in one or more of the technologies related to our products or services or in market demand for products or services based on a particular technology could result in faster than anticipated obsolescence of certain of our products or services and could have a material adverse effect on our business, results of operations and financial condition. Currently accepted industry standards are also subject to change, which may contribute to the obsolescence of our products or services.

In order to remain competitive, we must make substantial investments in research and development to develop new and enhanced products and continuously upgrade our process technology and manufacturing capabilities. We may be unable to fund all of these needs or possible acquisitions. Our ability to raise additional capital may depend on a variety of factors, some of which will not be within our control, including investor perceptions of us, our businesses and the industries in which we operate, and general economic conditions. We may be unable to successfully raise additional capital, if needed.

***Risks related to the Company's handling and use of hazardous substances and related environmental matters***

Our operations require the handling and use of hazardous substances, and we are subject to federal, state and local laws, regulations, rules and ordinances relating to pollution, the protection of the environment and the use or cleanup

of hazardous substances and wastes. From time to time, our operations could result in violations under such environmental laws, including spills or other releases of hazardous substances into the environment. We may incur substantial costs or experience interruptions in our operations for actual or alleged violations or compliance requirements arising under environmental laws. Additionally, we may be liable for the costs of investigating and cleaning up environmental contamination on or from our properties. In the event of a major incident, we could incur material costs or experience interruption in our operations as a result of addressing the incident and implementing measures to prevent such incidents in the future, as well as potential litigation that could arise from such an incident. In addition, we could incur significant expenditures in order to comply with existing or future environmental laws. Based on available information, we are aware of only one existing environmental matter, which is discussed above under Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations Environmental Matters.

*We are subject to significant restrictive operational and financial covenants.*

As noted above and in Note 13 to the Consolidated Financial Statements, the Company successfully refinanced its long term debt instruments in February 2004. The new facilities contain fewer restrictive financial covenants than the preceding debt instruments, but do contain covenants that restrict our ability to declare and pay dividends and require the Company to obtain consent or a waiver prior to taking certain other corporate actions, including the disposition of assets, mergers and changes in corporate management. Among other things, these covenants may prevent the Company from consummating potential dispositions or acquisitions, and may deter or prevent an acquisition or merger of the Company.

*We are subject to the risks associated with international sales.*

During fiscal year 2004, international sales accounted for approximately 13% of our total revenues. We anticipate that future international sales will continue to account for a significant percentage of our revenues. Risks associated with these sales include:

Political and economic instability;

Export controls;

Changes in legal and regulatory requirements;

U.S. and foreign government policy changes affecting the markets for our products;

Changes in tax laws and tariffs;

Convertibility and transferability of international currencies; and

Exchange rate fluctuations.

Any of these factors could have a material adverse effect on our business, results of operations and financial condition. Exchange rate fluctuations may negatively affect the cost of our products to international customers and therefore reduce our competitive position.

*Attracting and retaining key personnel is an essential element of our future success*

Our future success depends to a significant extent upon the continued service of our executive officers and other key management and technical personnel and on our ability to continue to attract, retain and motivate qualified personnel. Recruiting and retaining skilled technical personnel is highly competitive. The loss of the services of one or more of our key employees or our failure to attract, retain and motivate qualified personnel could have a material adverse effect on our business, financial condition and results of operations.

***Risks associated with terrorism and world conflict***

United States and global responses to the Middle East conflict, terrorism, perceived nuclear, biological and chemical threats and other global crises increase uncertainties with respect to U.S. and other business and financial markets. Several factors associated, directly or indirectly, with the Middle East conflict, terrorism, perceived nuclear, biological and chemical threats and other global crises and responses thereto, may adversely affect the Company.

While some of our products that are sold to the U.S. Government may experience greater demand as a result of increased U.S. Government defense spending, various responses could realign U.S. Government programs and affect the composition, funding or timing of our government programs. U.S. Government spending could shift to defense programs in which we do participate.

The Company has contracts with governments of certain states located in the Middle East. The instability in that region, as well as U.S., local or global responses to potentially controversial policies or actions adopted or taken by such governments, may negatively impact those contracts.

The Company has contracts with the government of South Korea. Recent actions and perceived provocations by the government of North Korea have resulted in increased concern regarding the stability of the Korean armistice. Additionally, reports indicate that North Korea may be moving to produce and test nuclear weapons or otherwise provoke the U.S. and international community. Resulting instability on the Korean peninsula, and any U.S., local or global responses to perceived provocations by the government of North Korea, could impact the Company's contracts with South Korea. While an escalation of hostilities on the Korean peninsula might lead to increased military spending by South Korea, there is no certainty that the Company's contracts with South Korea would benefit. Additionally, it is possible that any instability in that region could have a negative impact on the Company's contracts.

*Risks associated with significant stock price fluctuation and the regulatory action by the American Stock Exchange*

The market price of our Common Stock ranged from a high of \$12.30 per share to a low of \$7.00 per share during 52 week period ended March 31, 2004. The accounting misstatements, resulting restatements, contributing factors, and the SEC investigation discussed herein, in the attached financial statements, and in the Company's Annual Report on Form 10-K for the fiscal year ended January 31, 2003 might continue to have an adverse effect on the price of our Common Stock.

The average daily trading volume in our Common Stock on the American Stock Exchange ( **Amex** ) for the six month period ended February 27, 2004 was approximately 4,241 shares per day and the daily trading volume in our Common Stock during the same period ranged from a low of zero shares traded to a high of 48,200 shares traded. As discussed under Item 3. Legal Proceedings Matters Relating to the American Stock Exchange, on September 25, 2003, the American Stock Exchange halted trading in the Company's Common Stock. Although the Amex permitted trading of the Company's stock to resume on November 25, 2003, the Amex may be less tolerant of any future failure of the Company to comply with Amex listing standards, due to the delayed reporting in calendar year 2003. Such lack of tolerance could involve a prompt delisting initiative by the Amex. Future trading volume in our Common Stock may be low, and, in such event, stockholders could have difficulty selling their Common Stock and any large volume sales could cause a decline in the price.

Other factors and general market conditions that could affect our stock price are:

Our quarterly operating results and variations therein;

Changes in earnings estimates by securities analysts;

Changes in our business;

Changes in the market's perception of our business;

Changes in the businesses, earnings estimates or market perceptions of our competitors or customers;

Changes in the outlook for the aviation industry;

Changes in general market or economic conditions unrelated to our performance;

Changes in the legislative or regulatory environment;

Changes in U.S. defense spending or appropriations;

Increased military or homeland defense activities;

An outbreak or escalation of national or international hostilities;

Terrorist attacks;

Sales of significant blocks of our Common Stock; and

The outcome of the SEC formal investigation concerning the accounting issues discussed herein and other potential issues.

Additionally, the stock market has experienced extreme price and volume fluctuations in recent years that have significantly affected the quoted prices of the securities of many companies, including companies in our industry. The changes often appear to occur without regard to specific operating performance. The price of our Common Stock could fluctuate based upon factors that have little or nothing to do with our Company and these fluctuations could materially reduce our stock price. When a stock's price continues to fluctuate significantly over a sustained period, the risk of loss, including a total loss, is increased.





***Risks associated with the SEC investigation and the current shareholder litigation***

The Company was the subject of a Formal Order of Investigation issued by the U.S. Securities and Exchange Commission (the **SEC**) on May 13, 2003 with respect to potential violations of the federal securities laws in connection with the accounting misstatements and contributing causes disclosed by the Company in press releases dated March 17 and May 22, 2003 and further discussed in the Company's annual report for the fiscal year ended January 31, 2003 and the subsequent quarterly reports on Form 10-Q, which the Company brought to the attention of the SEC in conjunction with management's internal investigation, and other potential issues. The Company received a letter from the SEC dated October 27, 2004 advising the Company that the SEC investigation has been terminated as to the Company and that no enforcement action has been recommended to the Commission as to the Company.

The Company is a defendant in securities class action lawsuits brought by several plaintiffs, as discussed above under Item 3. Legal Proceedings - Securities Class Action Litigation. The outcome of such litigation cannot be adequately determined at this time, nor can the impact on the Company be adequately assessed. Any resolution of such litigation could have a material adverse effect upon the Company's financial position, results of operations, and cash flow.

***We do not plan to pay cash dividends on our Common Stock in the foreseeable future***

We intend to retain our earnings to finance the development and expansion of our business. Additionally, covenants in our long-term debt agreements impose significant restrictions on our ability to pay dividends.

***Risks related to the inherent limitations of internal control systems***

The Company continues to take action to assure compliance with the internal controls, disclosure controls and other requirements of the Sarbanes-Oxley Act of 2002 and prudent industry practice. However, we cannot guarantee that our internal controls and disclosure controls will prevent all error and all fraud. A control system, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the control system are met. In addition, the design of a control system must reflect the fact that there are resource constraints and the benefit of controls must be relative to their costs.

Due to the inherent limitations in all control systems, no evaluation of controls can provide absolute assurance that all control issues and instances of fraud, if any, within the Company have been detected. These inherent limitations include the realities that judgments in decision-making can be faulty and that breakdowns can occur because of simple

error or mistake. Further, controls can be circumvented by individual acts of some persons, by collusion of two or more persons, or by management override of the controls.

The design of any system of controls also is based in part upon certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions. Over time, a control may be inadequate because of changes in conditions or the degree of compliance with the policies or procedures may deteriorate. Because of inherent limitations in a cost effective control system, misstatements due to error or fraud may occur and not be detected.

**SIGNATURES**

**Pursuant to the requirements of Section 13 or 15(d) 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.**

AEROSONIC CORPORATION

(Registrant)

By: /s/David A. Baldini

Date: December 7, 2004

**Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the Registrant and in the capacities and on the dates indicated.**

/s/ David A. Baldini

**David. A. Baldini**

Date: December 7 2004

**Chairman of the Board,**

**President and Chief Executive Officer**

/s/ Gary E. Colbert

Date: December 7, 2004

**Gary E. Colbert**

**Executive Vice President and Chief Financial  
Officer,**

**Treasurer and Secretary**

/s/ P. Mark Perkins

**P. Mark Perkins**

Date: December 7, 2004

**Executive Vice President and Director**

/s/ Robert J. McGill

**Robert J. McGill, Director**

Date: December 7, 2004

/s/ William C. Parker

**William C. Parker, Director**

Date: December 7, 2004

/s/ David M. Vosen

**David M. Vosen, Director**

Date: December 7, 2004

/s/ Thomas E. Whytas Jr.

**Thomas E. Whytas, Jr., Director**

Date: December 7, 2004

**AEROSONIC CORPORATION AND SUBSIDIARY**

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**REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM**

To the Board of Directors and Shareholders

of Aerosonic Corporation:

We have audited the accompanying consolidated balance sheet of Aerosonic Corporation and subsidiary as of January 31, 2004, and the related consolidated statements of operations, shareholders' equity, and cash flows for the year then ended. Our audit also includes the financial statement schedule listed in the accompanying index at Item 15(a) for the year ended January 31, 2004. These financial statements and schedule are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements and schedule based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of Aerosonic Corporation and subsidiary at January 31, 2004 and the results of their operations and their cash flows for the year then ended in conformity with U.S. generally accepted accounting principles. Also, in our opinion, the related financial statement schedule, when considered in relation to the basic financial statements taken as a whole, presents fairly in all material respects the information set forth therein for the year ended January 31, 2004.

As discussed in Note 2, the accompanying consolidated financial statements have been restated.

/s/ TEDDER, JAMES, WORDEN & ASSOCIATES, P.A.

Orlando, Florida

March 24, 2004, except for Notes 2 and 7 as to which the date is November 30, 2004, Note 12 as to which the date is October 27, 2004, and Note 13 as to which the date is May 25, 2004.

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**Report of Independent Registered Certified Public Accounting Firm**

To the Board of Directors and Shareholders

of Aerosonic Corporation:

In our opinion, the consolidated financial statements listed in the accompanying table of contents present fairly, in all material respects, the financial position of Aerosonic Corporation and its subsidiary at January 31, 2003, and the results of their operations and their cash flows for each of the two years in the period ended January 31, 2003 in conformity with accounting principles generally accepted in the United States of America. In addition, in our opinion, the financial statement schedule listed in the accompanying index presents fairly, in all material respects, the information set forth therein when read in conjunction with the related consolidated financial statements. These financial statements and financial statement schedule are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements and financial statement schedule based on our audits. We conducted our audits of these statements in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

As indicated in Note 2 to these consolidated financial statements, the Company has restated its consolidated financial statements as of January 31, 2003 and 2002, and as of February 1, 2001.

As discussed in Note 8 to these consolidated financial statements, the Company has significant maturities of debt in April 2004. Management's plans with respect to these maturities are also described in Note 8.

/s/ PRICEWATERHOUSECOOPERS LLP

Tampa, Florida

October 27, 2003, except for the information in Note 8, as to which the date is October 30, 2003, and the information in Notes 2 and 7, as to which the date is November 30, 2004

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**AEROSONIC CORPORATION AND SUBSIDIARY**

**CONSOLIDATED BALANCE SHEETS**

**January 31, 2004 and 2003**

<b>ASSETS</b>	<b>2004 as restated</b>	<b>2003 as restated</b>
<b>Current Assets:</b>		
Cash and cash equivalents	\$ 1,276,000	\$ 260,000
Receivables net allowance for doubtful accounts of \$152,000 and \$372,000	3,896,000	3,592,000
Income taxes receivable	1,270,000	207,000
Costs and estimated profits in excess of billings	1,398,000	496,000
Inventories	5,683,000	5,582,000
Prepaid expenses	190,000	420,000
Deferred income taxes	559,000	416,000
Total current assets	14,272,000	10,973,000
Property, plant and equipment, net	3,954,000	4,218,000

Income taxes receivable	-	1,282,000
Deferred income taxes	38,000	16,000
Capitalized software costs and other assets, net	127,000	164,000
Total Assets	\$ 18,391,000	\$ 16,653,000

### LIABILITIES AND SHAREHOLDERS' EQUITY

#### Current liabilities:

Long-term debt and notes payable due within one year	\$ 200,000	\$ 1,121,000
Revolving credit facilities	1,000,000	755,000
Accounts payable, trade	2,910,000	973,000
Compensation and benefits	779,000	774,000
Income tax payable	-	239,000
Accrued expenses and other liabilities	2,343,000	2,100,000
Total current liabilities	7,232,000	5,962,000
Long term debt and notes payable due after one year	2,216,000	2,290,000
Total liabilities	9,448,000	8,252,000
Commitments and contingencies		
Shareholders' equity:		
Common stock \$.40 par value: authorized 8,000,000 shares; issued 3,986,262	1,595,000	1,595,000

shares; outstanding 3,921,019 shares in 2004 and 2003

Additional paid-in capital		
	4,559,000	4,559,000
Retained earnings		
	3,485,000	2,943,000
Less treasury stock: 65,243 shares in 2004 and 2003, at cost		
	(696,000)	(696,000)
Total shareholders' equity		
	8,943,000	8,401,000
Total liabilities and shareholders' equity		
	\$ 18,391,000	\$ 16,653,000

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

**AEROSONIC CORPORATION AND SUBSIDIARY**  
**CONSOLIDATED STATEMENTS OF OPERATIONS**  
**For the Years Ended January 31, 2004, 2003 and 2002**

	<b>2004</b>	<b>2003</b>	<b>2002</b>
Revenue			
	\$31,113,000	\$25,672,000	\$26,686,000
Cost of sales			
	22,494,000	16,783,000	17,441,000
Gross margin			
	8,619,000	8,889,000	9,245,000
Selling, general and administrative expenses			
	8,421,000	7,776,000	8,082,000
Operating income			
	198,000	1,113,000	1,163,000
Other income (expense):			
Interest expense			
	(169,000)	(207,000)	(425,000)
Miscellaneous (expense) income			
	48,000	78,000	(6,000)
	(121,000)	(129,000)	(431,000)
Income before income taxes			
	77,000	984,000	732,000
Income tax benefit (expense)			
	465,000	22,000	(21,000)

Net income			
	\$ 542,000	\$ 1,006,000	\$ 711,000
Basic and diluted earnings per share			
	\$ 0.14	\$ 0.26	\$ 0.18
Basic weighted average shares outstanding			
	3,921,019	3,920,832	3,919,845
Diluted weighted average shares outstanding			
	3,921,019	3,920,832	3,919,845

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

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**AEROSONIC CORPORATION AND SUBSIDIARY**  
**CONSOLIDATED STATEMENTS OF SHAREHOLDERS' EQUITY**

**For the Years Ended January 31, 2004, 2003 and 2002**

	<b>Common Stock</b>	<b>Additional Paid-In Capital</b>	<b>Retained Earnings</b>	<b>Treasury Stock</b>	<b>Total Shareholders' Equity</b>
Balance at February 1, 2001, as previously reported	\$ 1,595,000	\$ 4,457,000	\$ 1,798,000	\$ (621,000)	\$ 7,229,000
Restatement adjustment (Note 2)	-	-	(572,000)	-	(572,000)
Balance at February 1, 2001, as restated	1,595,000	4,457,000	1,226,000	(621,000)	6,657,000
Net Income	-	-	711,000	-	711,000
Balance at January 31, 2002, as restated	1,595,000	4,457,000	1,937,000	(621,000)	7,368,000
Net Income	-	-	1,006,000	-	1,006,000
Employer 401K match 7,674 shares	-	102,000	-	75,000	177,000
Purchase of 6,500 shares of treasury stock	-	-	-	(150,000)	(150,000)
Balance at January 31, 2003, as restated	1,595,000	4,559,000	2,943,000	(696,000)	8,401,000
Net Income	-	-	542,000	-	542,000



Balance at January 31, 2004, as restated

	\$	\$	\$	\$	
1,595,000		4,559,000	3,485,000	(696,000)	\$ 8,943,000

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

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**AEROSONIC CORPORATION AND SUBSIDIARY**  
**CONSOLIDATED STATEMENTS OF CASH FLOWS**  
**For the Years Ended January 31, 2004, 2003 and 2002**

	2004	2003	2002
Cash Flow from operating activities:			
Net Income (loss)			\$
	\$542,000	\$1,006,000	711,000
Adjustments to reconcile net income to net cash from operating activities:			
Bad debt expense			
	(73,000)	291,000	4,000
Stock-based compensation			
	-	177,000	-
Depreciation			
	683,000	638,000	600,000
Amortization			
	142,000	265,000	280,000
Loss on disposal of property			
	29,000	-	-
Deferred income taxes			
	(165,000)	(231,000)	(138,000)
Changes in assets and liabilities:			
Receivables			
	(231,000)	(560,000)	557,000

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Income taxes receivable and payable	(20,000)	(277,000)	(349,000)
Inventories	(101,000)	(1,398,000)	89,000
Prepaid Expenses	230,000	(289,000)	(9,000)
Capitalized software costs and other assets	(105,000)	10,000	(6,000)
Accounts payable, trade	1,937,000	175,000	(455,000)
Costs and estimated profits in excess of billings	(902,000)	(496,000)	-
Accrued expenses and other liabilities	248,000	782,000	491,000
Net cash provided by operating activities	2,214,000	93,000	1,775,000
Cash flows from investing activities:			
Proceeds on sale of property	16,000	-	-
Capital expenditures	(419,000)	(681,000)	(617,000)
Net cash used in investing activities	(403,000)	(681,000)	(617,000)
Cash flow from financing activities:			
Proceeds/ (payments) from revolving credit facilities	245,000	255,000	500,000
Purchase of treasury stock	-	(150,000)	-
Principal payments on long-term debt and notes payable	(1,040,000)	(962,000)	(1,030,000)

Net cash used in financing  
activities

	(795,000)	(857,000)	(530,000)
Net increase (decrease) in cash and cash equivalents.			
	1,016,000	(1,445,000)	628,000
Cash and cash equivalents at beginning of year			
	260,000	1,705,000	1,077,000
Cash and cash equivalents at end of year			
	\$	\$	\$
	1,276,000	260,000	1,705,000
Supplemental disclosure of cash flow information:			
Cash paid during the year for:			
Interest			
	\$	\$	\$
	172,000	254,000	434,000
Income taxes			
	\$	\$	\$
	54,000	613,000	496,000
Noncash investing and financing activities			
Acquisition of property under a capital lease			
	\$	\$	\$
	45,000	-	-

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

**AEROSONIC CORPORATION AND SUBSIDIARY**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**1. Description of Business and Summary of Significant Accounting Policies**

*Description of Business*

The primary business of Aerosonic Corporation and subsidiary (the **Company**) is to manufacture and sell aircraft instrumentation to government and commercial users from its plants located in Florida, Virginia and Kansas. The Company's customers are located worldwide.

*Principles of Consolidation*

The consolidated financial statements include the accounts of Aerosonic Corporation (which operates as the Clearwater, Florida Instrument division, Precision Component division and Wichita, Kansas Instrument division) and its wholly-owned subsidiary, Avionics Specialties, Inc., and are presented in accordance with the accrual method of accounting. All significant intercompany balances and transactions have been eliminated in consolidation.

*Use of Estimates*

The preparation of the financial statements in conformity with accounting principles generally accepted in the United States of America requires the Company to make estimates and judgments that affect reported and contingent amounts of assets, liabilities, revenues and expenses, including such items as inventory costs, allowance for accounts receivable, deferred tax valuation allowances, and percentage-of-completion accounting. Actual results may differ from these estimates under different assumptions or conditions, and such differences could be material.

*Cash and Cash Equivalents*

The Company considers all highly liquid investments purchased with an original maturity of three months or less to be cash equivalents.

***Accounts Receivable Allowance for Doubtful Accounts and Credit Losses***

The Company continuously evaluates its customers and provides reserves for anticipated credit losses as soon as collection becomes compromised. The Company does maintain a limited reserve in anticipation that smaller accounts may become a collection issue, which occurs from time to time based on historical experience. However, most of the Company's customers are financially sound and the Company's history of bad debts is relatively low. Measurement of such losses requires consideration of historical loss experience, including the need to adjust for current conditions, and judgments about the probable effects of relevant observable data, including present economic conditions such as delinquency rates and financial health of specific customers.

***Inventories***

The Company values inventory at the lower of cost (using a method that approximates the first-in, first-out method) or net realizable value. Reviews of inventory quantities on hand have been conducted to determine if usage or sales history supports maintaining inventory values at full cost or if it has instead become necessary to record a provision for slow moving, excess and obsolete inventory based primarily on estimated forecasts of product demand and production requirements for the subsequent twelve months and actual usage for the previous two years.

During production, the Company uses standards to estimate product costs. These standards are reviewed and updated periodically by management and approximate costing under the FIFO method. Differences between standard and actual costs have not been material.

Management employs certain methods to estimate the value of work in process inventories for financial reporting purposes. Company practice has been to conduct cycle counts of inventory at its Earlysville, Virginia operations throughout the year and to conduct a full physical inventory at the Company's Clearwater, Florida operations at the close of business each fiscal year. During the 2004 fiscal year, the Company began a practice of conducting cycle counts at its Clearwater, Florida operations. Generally, for items that are in process at the end of a fiscal year, management will make an estimate during the physical inventory process regarding the percentage of completion of such items in order to accurately reflect costs incurred to date on the production of the items that are still in process. These estimates are affected by the nature of the operation at which the items are located at the time a physical inventory is conducted, and are subject to judgment. This practice was employed for the fiscal year ended January 31, 2004.

***Property, Plant and Equipment***

Property, plant and equipment are stated at cost. Depreciation on plant and equipment is calculated on the straight-line method over the estimated useful lives of the assets. Upon disposition, the cost and related accumulated depreciation are removed from the accounts and any related gain or loss is reflected in earnings. Expenditures for repairs and improvements that significantly add to the productive capacity or extend the useful life of an asset are capitalized. Repair and maintenance charges are expensed as incurred. Property under a capital lease is capitalized and amortized over the lease terms.

The useful lives of property, plant and equipment for purposes of computing depreciation are:

Land Improvements

15-20 Years

Buildings and improvements

25-30 Years

Machinery and equipment

3-10 Years

Patterns, dies, and tools

3-5 Years

Furniture and fixtures

5-10 Years

### ***Valuation Assessment of Long-Lived Assets***

Management periodically evaluates long-lived assets for potential impairment and will record an impairment charge whenever events or changes in circumstances indicate the carrying amount of the assets may not be fully recoverable. As of January 31, 2004 and 2003, management does not believe that any assets are impaired.

### ***Capitalized Software Costs and Other Assets***

Capitalized software is recorded at cost less accumulated amortization. Production costs for computer software that is to be utilized as an integral part of a product is capitalized when both (a) technological feasibility is established for the software and (b) all research and development activities for the other components of the product have been completed. Amortization is charged to expense at the greater of the expected unit sales versus units sold or the straight line method for a period of three years from the date the product becomes available for general release to customers.

There were no software additions in fiscal 2004 or fiscal 2003. Total capitalized costs were \$825,000 at January 31, 2004 and January 31, 2003, respectively. Accumulated amortization amounted to \$825,000 and \$685,000 at January 31, 2004 and 2003, respectively.

### ***Income Taxes***

The Company accounts for income taxes in accordance with Statement of Financial Accounting Standards (SFAS) No. 109, Accounting for Income Taxes. Under this method, deferred tax liabilities and assets are determined based on the difference between the financial statement carrying amounts and tax bases of assets and liabilities using enacted tax rates in effect in the years in which the differences are expected to reverse. A valuation allowance is provided against the future benefit of deferred tax assets if it is determined that it is more likely than not that the future tax benefits associated with the deferred tax asset will not be realized.



### ***Revenue Recognition***

The Company generally recognizes revenue from sales of its products when the following have occurred: evidence of a sale arrangement exists; delivery has occurred or services have been rendered; the price to the buyer is fixed or determinable; and collectibility is reasonably assured.

The Company follows the percentage-of-completion method of accounting for one long-term engineering service contract. Under this method, contract revenue is computed as that percentage of estimated total revenue that costs incurred to date bear to total estimated costs, after giving effect to the most recent estimates of costs to complete. From time to time, the Company will record costs and estimated profits in excess of billings for certain of these contracts. Revisions in costs and revenue estimates are reflected in the period in which the revisions are determined. Provisions for estimated losses on uncompleted contracts are made in the period in which such losses are determined without regard to the percentage-of-completion.

Occasionally the Company enters into research and development contracts with customers. The Company accounts for such contracts on the basis of the lesser of non-refundable cash versus percentage of completion.

As a general matter, the terms specified in customer purchase orders determine whether the Company or the customer bears the obligation for payment of freight charges. While customers pay for freight in most transactions, the Company does occasionally pay freight charges on behalf of customers and bill all or a portion to customers. Freight revenue of \$8,000, \$10,000 and \$9,000 is included in revenues in the consolidated statement of operations for the years ended January 31, 2004, 2003 and 2002, respectively. Freight expense of \$117,000, \$115,000 and \$122,000 is included in cost of sales in the consolidated statement of operations for the years ended January 31, 2004, 2003 and 2002, respectively.

### ***Research and Development***

Research and development costs are expensed as incurred. Research and development expense that is included Selling, General and Administrative Expenses in the Consolidated Statement of Operations approximated \$167,000, \$745,000 and \$1,083,000, during the years ended January 31, 2004, 2003 and 2002, respectively. Research and development costs that are included in Selling, General and Administrative Expenses in the Consolidated Statement of Operations declined significantly as resources were devoted to the Joint Strike Fighter program, where expenditures are charged to Cost of Sales. The amount related to the Joint Strike Fighter program that was charged to cost of sales

in fiscal year 2004 was approximately \$527,000.

### *Environmental Expenditures*

The Company accrues for environmental expenses resulting from existing conditions that relate to past operations when the costs are probable and reasonably estimable. The following table outlines the Company's experience with such expenditures and the amount of the accrual that existed at the close of each fiscal year:

	<b>For the year ended January 31,</b>		
	<b>2004</b>	<b>2003</b>	<b>2002</b>
Environmental Expense (Income Statement)			\$
	\$ 52,000	\$ 122,000	23,000
Environmental Accrual (Balance Sheet)			\$
	\$ 38,000	\$ 38,000	10,000

### *Treasury Stock*

The Company accounts for the acquisition of treasury shares at cost. The Company has not reissued acquired shares. It has, however, used treasury shares to make matching contributions to the Company's 401(k) plan. For those transactions, the Company accounts for the contributions at fair value at the date of contribution.

### ***Computation of Earnings Per Share***

Basic earnings per share is computed using the weighted average number of shares of common stock outstanding. Diluted earnings per share is computed using the treasury stock method. There were no dilutive common stock equivalents outstanding during the years ended January 31, 2004, 2003, and 2002. Therefore, basic and diluted earnings per share are the same amount.

### ***Concentrations of Credit Risk***

Financial instruments which potentially subject the Company to concentrations of credit risk consist principally of cash and cash equivalents and receivables. As of January 31, 2004 and 2003, substantially all of the Company's cash balances were deposited with financial institutions who management has determined are of high credit quality.

During the normal course of business, the Company extends credit, without collateral, to customers conducting business in the aviation industry worldwide.

### ***Financial Instruments***

SFAS No. 107 Disclosures about Fair Value of Financial Instruments, requires disclosure of the fair value of certain financial instruments. Cash, accounts receivable, short-term borrowings, accounts payable and accrued liabilities are reflected in the financial statements at amounts which approximate fair value because of the short term maturity of these instruments. The carrying amount of long-term debt and notes payable at January 31, 2004 and 2003 approximates fair value as most instruments have adjustable rates which change frequently, while one instrument contains a fixed rate that approximates the Company's incremental borrowing rate.

### ***Segment Reporting***

As of January 31, 2004 management does not believe the Company has any reportable segments as defined in SFAS No. 131, Disclosure about Segments of an Enterprise and Related Information.

***Recent Accounting Pronouncements***

In November 2002, the FASB issued FIN 45, *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others (an interpretation of FAS No. 5, 57 and 107 and rescission of FASB Interpretation No. 34)*, which modifies the accounting and enhances the disclosure of certain types of guarantees. FIN 45 requires that upon issuance of certain guarantees, the guarantor must recognize a liability for the fair value of the obligation it assumes under the guarantee. FIN 45's provisions for the initial recognition and measurement are to be applied to guarantees issued or modified after December 31, 2002. The disclosure requirements are effective for financial statements of annual periods that end after December 15, 2002. The Company does not believe the adoption of FIN 45 has a material impact on its financial statements.

In January 2003, the FASB issued FIN No. 46, *Consolidation of Variable Interest Entities*, ("**FIN 46**"). FIN 46 clarifies the application of Accounting Research Bulletin No. 51, *Consolidated Financial Statements*, to certain entities in which equity investors do not have the characteristics of a controlling financial interest or do not have sufficient equity at risk for the entity to finance its activities without additional subordinated financial support from other parties. FIN 46 applies immediately to variable interest entities (**VIEs**) created after January 31, 2003, and to variable interest entities in which an enterprise obtains 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 Company has not identified any VIEs for which it is the primary beneficiary or has significant involvement.

In December 2003, the FASB issued FIN No. 46 (revised December 2003), *Consolidation of Variable Interest Entities* ("**FIN 46-R**") to address certain FIN 46 implementation issues. The effective dates and impact of FIN 46 and FIN 46-R are as follows:

(i)

For special purpose entities ( **SPEs** ) created prior to February 1, 2003, the Company must apply either the provisions of FIN 46 or early adopt the provisions of FIN 46-R at the end of the first interim or annual reporting period ending after December 15, 2003.

(ii)

For non-SPEs created prior to February 1, 2003, the Company is required to adopt FIN 46-R at the end of the first interim or annual reporting period ending after March 15, 2004.

(iii)

For all entities, regardless of whether a SPE, that were created subsequent to January 31, 2003, the provisions of FIN 46 were applicable for variable interests in entities obtained after January 31, 2003. The Company is required to adopt FIN 46-R at the end of the first interim or annual reporting period ending after March 31, 2004.

The adoption of the provisions applicable to SPEs and all other variable interests obtained after January 31, 2003 did not have a material impact on the Company's consolidated financial statements. The Company is currently evaluating the impact of adopting FIN 46-R applicable to non-SPE's created prior to February 1, 2003, but does not expect a material impact.

In May 2003, the FASB issued FAS No. 149, *Amendment of Statement No. 133 on Derivative Instruments and Hedging Activities*, ("**FAS 149** "). FAS 149 is effective for contracts entered into or modified after June 30, 2003 and for hedging relationships designated after June 30, 2003. FAS 149 amends and clarifies financial accounting and reporting for derivative instruments, including certain derivative instruments embedded in other contracts and for hedging activities. FAS 149 also amends FAS 133 for decisions made as part of the Derivatives Implementation Group process that effectively required amendments to FAS 133, in connection with other FASB projects dealing with financial instruments and in connection with implementation issues raised in relation to the application of the definition of a derivative. The adoption of FAS 149 did not have an impact on the Company's consolidated financial statements.

In May 2003, the FASB issued SFAS No. 150, *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity*, ("**FAS 150**"). FAS 150 is effective for 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. FAS 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 reclassify certain instruments previously classified as equity as a liability. The adoption of FAS 150 did not have an impact on the Company's consolidated financial statements.

In December 2003, the FASB issued SFAS No. 132 (revised 2003), *Employers' Disclosures about Pensions and Other Postretirement Benefits*, an amendment of SFAS No. 87, 88 and 106, and a revision of SFAS No. 132. The statement is effective for fiscal years and interim periods ending after December 15, 2003. This Statement revises employers' disclosures about pension plans and other postretirement benefit plans. It does not change the measurement or recognition of those plans required by SFAS No. 87, 88 and 106. The new rules require additional disclosures about the assets, obligations, cash flows, and net periodic benefit cost of defined benefit pension plans and other postretirement benefit plans. The Company currently does not have any pension or other postretirement benefit plans other than a qualified 410(k) plan and the adoption of this statement did not have an impact on the Company's consolidated financial statements.

## 2. Restatement of Prior Years Financial Statements

In September 2004, the Company announced that the United States Internal Revenue Service ( **IRS** ) had disallowed the Company's income tax refund claims of approximately \$873,000 for the tax years ended January 31, 1998 and 1999. The Company had erroneously recorded income taxes receivable for the tax effect of net operating loss carry backs to tax years for which the applicable statutes had expired. The Company has since filed an amended return for the tax year ended January 31, 2001 that has resulted in a refund of approximately \$301,000. Therefore, the remaining prior period adjustment to correct this error results in the reduction of income taxes receivable and retained earnings by approximately \$572,000 at January 31, 2000 and thereafter and an increase in income tax expense of approximately \$572,000 for the year ended January 31, 2000. This adjustment has been made to income tax receivable and retained earnings in each subsequent year. In addition, the correction of the erroneously recorded income taxes receivable also resulted in the restatement of the Company's deferred tax assets. However, the Company also recorded a deferred tax valuation allowance to the full extent of this restatement of deferred tax assets because it is not more likely than not that these deferred tax benefits will be realized in a subsequent period. This amendment does not affect earnings or cash flows in the Company's previously reported financial statements in the Company's Original 2004 Form 10-K.

The following table presents the impact of this adjustment on our previously reported balance sheets as of January 31, 2004 and 2003:

	2004		2003	
	Previously Reported	as Restated	Previously Reported	as Restated
<b>BALANCE SHEET:</b>				
Income taxes receivable				
	\$			
	1,842,000	\$ 1,270,000	\$ 207,000	\$ 207,000
Deferred income taxes				
	619,000	559,000	476,000	416,000
Total current assets				
	14,904,000	14,272,000	11,033,000	10,973,000
Income taxes receivable				
	-	-	1,854,000	1,282,000

Deferred income taxes

	-	38,000	-	16,000
Total Assets				
	\$			
	18,985,000	\$18,391,000	\$17,269,000	\$16,653,000
Total shareholders' equity				
	\$			
	9,515,000	\$ 8,943,000	\$ 8,973,000	\$ 8,401,000
Total liabilities and shareholders' equity				
	\$			
	18,985,000	\$18,391,000	\$17,269,000	\$16,653,000

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**3. Receivables**

Receivables at January 31, 2004 and 2003 consisted of the following:

	<b>2004</b>	<b>2003</b>
Trade	\$ 4,048,000	\$ 3,962,000
Officers and employees	- 4,048,000	2,000 3,964,000
Less: allowance for doubtful accounts	(152,000)	(372,000)
	\$ 3,896,000	\$ 3,592,000

The decrease in the allowance for doubtful accounts in fiscal year 2004 is primarily due to the partial write off of one customer account from whom collection of that portion of the account balance became remote during fiscal 2004.

During fiscal 2003, the Company secured one long-term fixed-price contract for the development of instrumentation for the Joint Strike Fighter program. Costs and estimated earnings on this contract as of the years ended January 31, 2004 and 2003 are as follows:

	<b>2004</b>	<b>2003</b>
Costs incurred to date	\$ 7,553,000	\$ 2,534,000
Estimated earnings	1,333,000	447,000
	8,886,000	2,981,000
Less billings to date	(7,488,000)	(2,485,000)

Costs and estimated profits in excess of billings

\$	\$
1,398,000	496,000

#### 4. Inventories

Inventories at January 31, 2004 and 2003 consisted of the following:

	<b>2004</b>	<b>2003</b>
Raw materials	\$ 3,756,000	\$ 2,322,000
Work in process	1,719,000	2,545,000
Finished goods	208,000	715,000
	\$ 5,683,000	\$ 5,582,000

#### 5. Property, Plant and Equipment

Property, Plant and Equipment at January 31, 2004 and 2003 consisted of the following:

	<b>2004</b>	<b>2003</b>
Land and improvements	\$ 464,000	\$ 464,000
Building and improvements	3,815,000	3,709,000
Machinery and equipment	5,045,000	4,913,000

Patterns, dies and tools		
	382,000	409,000
Furniture and fixtures		
	1,306,000	1,342,000
	11,012,000	10,837,000
Less accumulated depreciation and amortization		
	(7,058,000 )	(6,619,000 )
	\$	\$
	3,954,000	4,218,000

Depreciation expense was \$683,000, \$638,000 and \$600,000 for the years ended January 31, 2004, 2003 and 2002, respectively. The Company utilizes the straight-line method when accounting for depreciation. Certain components of property, plant and equipment are pledged as collateral for debt obligations (**Note 8**).

**6. Accrued Expenses**

Accrued expenses as of January 31, 2004 and 2003 were approximately \$2,343,000 and \$2,100,000, respectively. A substantial portion of these expenses are related to amounts owed to subcontractors who participate in the Company's product development programs, as shown below:

	<b>2004</b>	<b>2003</b>
Product development programs	\$ 1,497,000	\$ 1,415,000
Other accrued expenses	846,000 \$	685,000 \$
	<b>2,343,000</b>	<b>2,100,000</b>

**7. Income Taxes**

Income tax expense (benefit) for the years ended January 31, 2004, January 31, 2003 and January 31, 2002 consisted of:

	<b>2004</b>	<b>2003</b>	<b>2002</b>
Current			
	\$	\$	\$
Federal	(259,000)	138,000	138,000
State	(41,000)	71,000	21,000
	(300,000)	209,000	159,000
Deferred:			
Federal	(143,000)	(204,000)	(120,000)
State	(22,000)	(27,000)	(18,000)
	(165,000)	(231,000)	(138,000)
	\$	\$	\$
	(465,000)	(22,000)	21,000

The following table illustrates the difference between the statutory income tax rates applicable to the Company versus the effective tax (benefit) rate:

	<b>2004</b>	<b>2003</b>	<b>2002</b>
Federal tax rate	34.0%	34.0%	34.0%
Increase in taxes resulting from:			
State income taxes, net of federal tax benefit	3.3%	3.3%	3.3%
Other-primarily non-deductible expenses	41.0%	2.2%	1.7%
Deferred tax asset valuation adjustment	-684.1%	-9.0%	-36.1%
Research and experimentation credit	1.9%	-32.7%	0.0%
Effective tax rate	-603.9%	-2.2%	2.9%

As of January 31, 2004, the current income tax receivable of \$207,000 at January 31, 2003 related to the research and experimentation credit was collected. During fiscal year 2004, the Company filed amended tax returns for the fiscal years ended January 31, 1998, 1999, 2000, 2001 and 2002 subsequent to the restatement of its results and the consequent reduction in taxable income for the fiscal years 1999, 2000, 2001 and 2002 as disclosed in the Company's Annual Report on Form 10-K for the fiscal year ended January 31, 2003. As of November 30, 2004, the Company has received refunds of approximately \$914,000 related to the amended tax returns for the fiscal years ended January 31, 2000, 2001 and 2002. In June 2004, the United States Internal Revenue Service disallowed the refund requests for \$873,000 that were related to net operating loss carrybacks for fiscal years 1998 and 1999 due to noncompliance with the statutory timing requirements for such requests, resulting in this amendment to the Company's financial statements. The Company has since filed an amended return for the tax year ended January 31, 2001 that resulted in a refund of approximately \$301,000. The Company intends to continue working with its tax advisors to determine if any potential additional deferred tax benefits that result from this change can be realized in any periods subsequent to January 31, 2000, including any future periods.



The tax effects of temporary differences that give rise to significant portions of the deferred tax assets and deferred tax liabilities at January 31, 2004 and 2003 are as follows:

	<b>2004</b> <b>as restated</b>	<b>2003</b> <b>as restated</b>
Current deferred tax assets:		
Accounts receivable	\$ 57,000	\$ 139,000
Inventories		
Vacation and sick pay accrual	1,141,000	1,610,000
Net operating loss carry forward	124,000	120,000
Other	147,000	-
Valuation Allowance	64,000	51,000
	(974,000)	(1,504,000)
Total current deferred tax assets	\$ 559,000	\$ 416,000
Non-current deferred tax assets		
Property, plant and equipment, principally due to differences in Depreciation and capitalized interest		
	38,000	16,000
Total non-current deferred tax assets		
	38,000	16,000
Net deferred tax asset	\$ 597,000	\$ 432,000

At January 31, 2004, the Company has a net operating loss carry forward of approximately \$400,000, as restated.

This carry forward will expire January 31, 2024. The Company has determined that a valuation allowance is required against the deferred tax assets as it is not more likely than not that the Company will realize all of the future benefits of the deferred tax assets. As of January 31, 2003 and 2004, the Company had a restated valuation allowance of \$1,504,000 and \$974,000, respectively, against its then-existing deferred tax assets.

The Company accounts for income taxes in accordance with Statement of Financial Accounting Standards (SFAS) No. 109, Accounting for Income Taxes. Under this method, deferred tax liabilities and assets are determined based on the difference between the financial statement carrying amounts and tax bases of assets and liabilities using enacted tax rates in effect in the years in which the differences are expected to reverse.

### 8. Long-Term Debt, Notes Payable and Revolving Credit Facility

Long-term debt and notes payable at January 31, 2004 and 2003 consisted of the following:

	2004	2003
Note payable	\$ 717,000	\$ 871,000
Industrial development revenue bonds	668,000	742,000
Mortgage note payable	391,000	464,000
Note payable, equipment	205,000	493,000
Note payable, II	353,000	724,000
Capitalized Leases	82,000	117,000
	2,416,000	3,411,000
Less current maturity	1,497,000	1,121,000
Long-term debt and notes payable, less current maturity	\$ 919,000	\$ 2,290,000



The amount of long-term debt and notes payable maturing in each of the fiscal years 2005, 2006, 2007, 2008, 2009 and thereafter is as follows:

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**Maturity Schedule of Long Term Debt and Notes Payable<sup>(1)</sup>**

2005		\$
	1,497,000	
2006		
	148,000	
2007		
	148,000	
2008		
	148,000	
2009		
	148,000	
thereafter		
	327,000	
Total		\$
	2,416,000	

(1)

This maturity schedule and the debt table described above reflect the repayment obligations as of January 31, 2004, but the financial statements reflect current maturities based upon the new debt agreements that were established in February 2004, as described below and in Note 13.

On February 25, 2004, the Company completed a refinancing of its debt obligations by securing new credit facilities with Wachovia Bank, N.A. ( **Wachovia Refinancing** ) The new facilities total \$5.7 million, and include a 15 year term loan of \$3.0 million that is collateralized by the Company's real estate in Clearwater, Florida, a revolving credit facility of \$2.5 million, and a seven year equipment loan of \$0.2 million. The entire debt also is secured by a lien on other Company and Avionics' assets and by a Deed of Trust on Avionics' real estate in Earlysville, Virginia. The 15 year term loan has repayment obligations of \$200,000 per year. As of the date of this report, the seven year equipment loan remained unutilized. These facilities replace all of the Company's debt that was previously held by First Commercial Bank and SunTrust Bank, N.A.

The interest rate on the new credit facility is one-month LIBOR plus 300 basis points. Certain loan covenants have been revised and now include a debt coverage ratio (defined as earnings before interest and taxes plus depreciation and amortization minus dividends, withdrawals and non-cash income divided by the sum of current maturities of long term debt and capital and synthetic lease obligations plus interest) that is greater than or equal to 1.25 to 1.00 and a leverage ratio (defined as total liabilities divided tangible net worth) not to exceed 1.30 to 1.00.

### ***Note Payable***

The note payable was payable in monthly installments beginning in October 1998 through April 30, 2004 including interest at the Prime Rate (4.00% at January 31, 2004) as a result of covenant violations for which waiver had previously been obtained. Prior to the covenant violations, interest accrued at a rate equal to the 90-day average of the 90-day treasury bill plus 2.75% (4.39% and 4.64% at January 31, 2003 and 2002 respectively). The note payable was collateralized by accounts receivable, inventory and general intangibles (including patents, trademarks, copyrights, trade secrets, inventions and designs). See *Covenants* below for a description of covenants that the Company was subject to in connection with this note payable.

### ***Industrial Development Revenue Bonds***

The industrial development revenue bonds held by SunTrust Bank, N.A. were payable in quarterly principal installments of approximately \$19,000 until December 2012, plus quarterly interest payments. As of January 31, 2004, the interest rate was 3.55%. During 2004 and 2003, these interest payments averaged \$6,500 and \$8,200, respectively, per quarter. The bonds were collateralized by property, plant and equipment located in Clearwater, Florida. The pledged collateral had a carrying value of approximately \$1,226,000 at January 31, 2004. The mortgage and underlying bonds could have been redeemed in whole at the principal amount plus accrued interest on the 10th, 15th, or 20th anniversary date of the mortgage and underlying bonds. If the tax exempt status of the bond were to be revoked or impaired or the maximum corporate tax rate of the holder increased, certain portions could have become immediately payable or the interest rate could have been increased. In addition, the outstanding balance of \$668,000 was subject to accelerated maturity upon a material, adverse change in financial condition or operation which in the opinion of the Trustee materially affects the borrower's ability to repay the obligation as defined in the loan agreement. See *Covenants* below for a description of covenants that the Company was subject to in connection with the Industrial Development Revenue Bond.

### ***Mortgage Note Payable***

The mortgage note was payable in monthly installments through May 2009, including interest at 7.5% through May 1999 and prime plus 1 percent thereafter. The note was collateralized by substantially all property, plant and equipment of Avionics Specialties, Inc. The collateralized property had a carrying value of approximately \$1,110,000 at January 31, 2004. See *Covenants* below for a description of covenants that the Company was subject to in connection with this mortgage note.

### ***Note Payable, Equipment***

During September 1999, the Company converted its equipment revolving credit facility into a note payable. The note payable was payable in monthly installments beginning in September 1999 through September 2004 including interest at 8.05%. The note payable was collateralized by all machinery and equipment at the Clearwater location. See *Covenants* below for a description of covenants that the Company was subject to in connection with this note payable.

### ***Note Payable, II***

During July 2000, the Company converted \$1,800,000 of its Revolving Credit Facility (described below) into a long term note payable. This note bore interest at the Prime Rate (4.00% at January 31, 2004) as a result of covenant violations for which waiver had previously been obtained. Prior to the covenant violations, interest accrued at a rate equal to the trailing 90 day average of the 90 day Treasury bill rate on the last day of each of the Company's fiscal calendar quarters plus 2.75% (4.39% and 4.64% at January 31, 2003 and 2002, respectively). This note was payable in thirty-seven monthly principal installments of \$37,103, plus accrued interest, with the outstanding principal balance due on or before April 30, 2004. This note was collateralized by the Company's receivables, inventory and general intangibles (including patents, trademarks, copyrights, trade secrets, inventions and designs). See *Covenants* below for a description of covenants that the Company was subject to in connection with this note payable.

### ***Revolving Credit Facility***

During July 2000, the Company obtained a revolving credit facility in the amount of \$1,000,000 to replace the prior facility that matured in June 2000. This note originally was due and payable on demand, and if no demand was made, was due and payable May 30, 2001. The Company extended the revolving credit facility under the same terms in 2002. The revolving credit facility matured in May 2003, and the Company obtained an extension of the facility until

April 30, 2004. In connection with the covenant violations and the extension of the maturity date as discussed below, the interest rate on this facility was increased to the Prime Rate, which was 4.00% at January 31, 2004. Prior to the covenant violations, starting on October 31, 2000 the interest rate on this facility was the trailing 90 day average of the 90 day Treasury bill rate on the last day of each of the Company's fiscal calendar quarters plus 2.75%. This credit facility was fully drawn at January 31, 2004. The average interest rate under this facility for the year ended January 31, 2004 was 3.90%, and was 4.99% for the year ended January 31, 2003. The revolving credit facility agreement was collateralized by receivables, inventory and general intangibles (including patents, trademarks, copyrights, trade secrets, inventions and designs), and was subject to the same covenants as the Company's Note Payable and Note Payable, II.

### *Covenants*

The Company's long-term debt agreements with First Commercial Bank, which include the Note Payable, the Note Payable, Equipment, and the Note Payable II above, include certain restrictive covenants, including the requirement to maintain a debt to tangible net worth ratio not to exceed 1.0:1, a current ratio of not less than 2.0:1 and a long-term debt service coverage of 1.25:1. A covenant waiver dated October 30, 2003 suspended measurement of Company performance against the covenants until February 1, 2004. As stated above and in Note 13 below, the Company repaid this debt upon refinancing its debt obligations in February 2004.

The Company's long-term debt agreements with SunTrust, which include the Industrial Development Revenue Bonds and the Mortgage Note Payable above, include certain restrictive covenants, including the requirement to maintain a debt to tangible net worth ratio that does not exceed 1.0:1, a current ratio of not less than 2.5:1, a quick ratio of not less than 0.75:1, working capital of not less than \$4.0 million and a minimum net worth of \$6.0 million. A covenant waiver dated October 30, 2003 eliminated the aforementioned covenant restrictions and replaced them with a Debt Service Coverage Requirement of not less than 1.50:1 and a Maximum Total Liabilities to Tangible Net Worth Requirement that does not exceed 1.0:1. At January 31, 2004, the Company was in violation of both measures.

However, as stated above and in Note 13 below, the Company repaid this debt obligation upon refinancing its debt in February 2004.

## **9. Major Customer Information**

Direct and indirect sales to U.S. Government agencies, when combined, represented 10% or more of net sales and amounted to approximately \$16,153,000, \$10,575,000 and \$6,798,000 for the years ended January 31, 2004, 2003 and 2002, respectively. Of these amounts, approximately \$4,604,000, \$2,711,000 and \$2,357,000 were sales directly to U.S. Government agencies for the fiscal years ended January 31, 2004, 2003 and 2002, respectively. The remaining amounts represent sales to commercial customers that are for government applications.

Sales to Lockheed and Boeing each represented 10% or more of net sales and amounted to 25% and 11% respectively, for the year ended January 31, 2004. For the year ended January 31, 2003, sales to Lockheed and Boeing each represented 10% or more of net sales, or 17% and 12%, respectively. Sales to Boeing represented 10% of net sales for the year ended January 31, 2002. Included in these amounts are sales of products that are sold by each company to the U.S. Government. Foreign sales for the years ended January 31, 2004, 2003 and 2002 represented 10% or more of net sales and amounted to approximately \$4,100,000, \$4,315,000 and \$7,379,000, respectively. Substantially all foreign sales contracts are payable in U.S. dollars. No other customer sales totaled greater than 10% of net sales for years ended January 31, 2004, 2003 or 2002.

Receivables at January 31, 2004 included approximately \$432,000, \$1,755,000 and \$618,000 due from the U.S. Government, two domestic commercial customers and foreign customers, respectively. Receivables at January 31, 2003 included approximately \$504,000, \$1,760,000 and \$652,000 due from the U.S. Government, two domestic commercial customers and foreign customers, respectively. No other customers represented greater than 10 percent of receivables at January 31, 2004 or 2003.

## **10. Benefit Plans**

Effective February 1, 1993, the Company adopted a tax-deferred savings plan which covers substantially all employees of the Company. Under the plan, participants may elect to contribute up to 15% of pre-tax earnings. The Company will fund a 100% matching contribution, up to 3% of the participant's yearly compensation. Such matching contributions will be made in cash or Common Stock of the Company. Additional contributions may be made at the Company's discretion. For the year ended January 31, 2004, the Company contributed cash of approximately \$186,000. For the year ended January 31, 2003, the Company contributed 7,674 shares (approximately \$177,000) of treasury stock. For the year ended January 31, 2002, the Company contributed cash of approximately \$177,000.

William Parker was employed by the Company for 34 years, most recently as its President, until his retirement in 1997. During fiscal 2004, 2003 and 2002, the Company was, and it continues to be, a party to a Supplemental Pension Plan agreement with William C. Parker pursuant to which Mr. Parker receives monthly pension payments from the Company of \$4,166.67. Amounts expensed under this plan were \$137,000, \$6,000 and \$11,000 in 2004, 2003 and 2002, respectively. In May 2003, the Company and Mr. Parker executed a new Supplemental Pension Plan agreement, which became effective as of January 1, 2004, which extends the existing Supplemental Pension Plan, and pursuant to which Mr. Parker will continue to receive monthly payments of \$4,166.67 through December 2006. The extension resulted in a charge to income and an additional liability of \$134,000 during the fourth quarter of fiscal 2004. The new agreement is subject to renewal upon agreement by both parties.

## 11. Related Party Transactions

J. Mervyn Nabors, a former Director of the Company, is the beneficial owner of approximately 31.7% of the Company's issued and outstanding Common Stock, and was employed by the Company in numerous positions from 1962 until 1984 and as President and Chief Executive Officer from 1996 until November 2002. During fiscal 2003, Mr. Nabors was employed by the Company pursuant to an employment arrangement which provided for a minimum base salary of at least \$250,000, plus an automobile allowance, health insurance and other benefits, although Mr. Nabors' base salary for fiscal 2003 was \$300,000. On May 20, 2003, the Company terminated such employment and entered into a Consulting Agreement with Mr. Nabors. Pursuant to the terms of the Consulting Agreement, Mr. Nabors has agreed to serve the Company as a consultant with respect to matters specifically assigned by the Company's President, and the Company has agreed to pay Mr. Nabors a consulting fee of \$120,000 per year for one year. The Consulting Agreement also provides Mr. Nabors with an automobile allowance of \$18,000 per year, health insurance and retirement benefits similar to those provided to employees of the Company. The term of the Consulting Agreement is for one year, unless earlier terminated pursuant to its terms, including a determination by the Company's Board of Directors to terminate the Consulting Agreement, with or without cause. In the event of a termination by the Board of Directors without cause, Mr. Nabors would be entitled to the unpaid balance of the consulting fee and the other benefits under the Consulting Agreement. The Company forecasts very limited use of Mr. Nabors' services for the term of this agreement, and, accordingly, has elected to accrue the full amount of the contract in May 2003.

During fiscal 2003, Mr. Nabors' wife was employed by the Company in a marketing capacity and received compensation of approximately \$12,696 for her services.

At the time that he served on the Board of Directors, A. Todd Beard was Senior Vice President of First Commercial Bank, an entity from which the Company has borrowed an amount in excess of 5% of its total consolidated assets as of January 31, 2003.

Until October 2002, Eric J. McCracken was the Company's Executive Vice President and Chief Financial Officer. In October 2002, Mr. McCracken resigned from the Board and his positions as Executive Vice President and Chief Financial Officer. Subsequent to his resignation, the Company and Mr. McCracken entered into a Consulting Agreement, pursuant to which Mr. McCracken was paid a \$10,000 retainer and was to be paid on an hourly basis for consulting services specifically assigned by the Company. No such services were assigned, and the Company has since terminated this Consulting Agreement.

Until his resignation from the Board of Directors in October 2002, Daniel J. Garwacki was a party to an oral consulting arrangement with the Company. Pursuant to that oral consulting arrangement, Mr. Garwacki performed consulting services specifically assigned by Mr. Nabors, who was the President at that time, and was compensated on a periodic basis at rates agreed upon on a matter by matter basis between Mr. Garwacki and the Company. Mr.



Garwacki received compensation of \$178,250 for his consulting services during fiscal year 2003.

Subsequent to his resignation, the Company and Mr. Garwacki entered into a written Consulting Agreement, pursuant to which Mr. Garwacki was to be paid on an hourly basis for consulting services specifically assigned by the Company. No such services were assigned, and the Company has since terminated this Consulting Agreement. During fiscal 2002 and 2003, the Company made payments of approximately \$45,155 and \$20,985, respectively, to Dynamic Business Consultants, an entity related to Mr. Garwacki, for consulting services.

## **12. Commitments and Contingencies**

In accordance with a consent agreement with the Department of Environmental Protection signed by the Company in 1993, the Company's environmental consultant has developed an interim remedial action plan to contain and remediate certain contamination on and underlying the Company's property. During 1997, the Company recorded a provision of approximately \$175,000 related to the estimated costs to be incurred under this plan. As of January 31, 2000, the Company had utilized all amounts originally recorded in other accrued expenses, and phase-one remediation had been completed.

During the third quarter of 2001, management determined the post-remediation monitoring expense related to the environmental clean up of 1993 would cost approximately \$125,000. This amount was accrued and expensed during the third quarter of 2001. As of January 31, 2003, all existing reserve balances had been utilized. An assessment by Company management in conjunction with its environmental consultants has determined that the Company's future exposure with respect to this post-remediation monitoring expense is approximately \$38,000, for which a reserve has been established.

At January 31, 2004, the Company was committed to future purchases of approximately \$7,680,000 for materials and services as well as a development contract. These purchase commitments are supported by firm underlying contracts with customers and contain provisions permitting the Company to terminate such purchase commitments in the event the underlying contracts should be terminated or discontinued.

The Company entered into various operating leases in fiscal year 2002 and fiscal year 2003 to lease certain equipment. No new leases occurred during fiscal year 2004. Total rental expense was approximately \$412,000, \$329,000 and \$48,000 for the years ended January 31, 2004, 2003 and 2002, respectively. The future minimum rental payments under leases that have initial or remaining non-cancelable lease terms in excess of one year at January 31, 2004 are as follows:

**Minimum Lease Payments**

	<u>Operating Leases</u>
2005	\$
	398,000
2006	
	398,000
2007	
	350,000
2008	
	70,000
Total Minimum Lease Payments	\$
	1,216,000

The Company was the subject of a Formal Order of Investigation issued by the U.S. Securities and Exchange Commission (the SEC) on May 13, 2003 with respect to potential violations of the federal securities laws in connection with the accounting misstatements and contributing causes disclosed by the Company in press releases dated March 17 and May 22, 2003 and further discussed in the Company's annual report for the fiscal year ended January 31, 2003 and the subsequent quarterly reports on Form 10-Q, which the Company brought to the attention of

the SEC in conjunction with management's internal investigation, and other potential issues. The Company received a letter from the SEC dated October 27, 2004 advising the Company that the SEC had concluded its investigation and that no enforcement action has been recommended to the Commission as to the Company.

On July 30, 2003, the Company received a deficiency letter from the American Stock Exchange ( **Amex** ) informing the Company that it was not in compliance with the Amex continued listing standards. The deficiency letter cited, among other things, the Company's disclosures regarding underlying causes of its financial misstatements and the late filing of the Company's 2003 Form 10-K and the Form 10-Q for the quarter ended April 30, 2003. On August 20, 2003, the Company provided a response, which included a plan to achieve compliance with applicable Amex rules. On September 24, 2003, the Company submitted an amended compliance plan to the Amex, which included an undertaking by the Company to file its 2003 Form 10-K no later than October 31, 2003 and to file both its April 30 and July 31, 2003 Forms 10-Q no later than November 15, 2003. On October 8, 2003, the Amex accepted the Company's compliance plan, as amended, and informed the Company that its listing on the Amex would be continued with the understanding that the Company would implement its compliance plan within the timeframe specified in the plan.

On September 25, 2003 (prior to the October 8, 2003 Amex acceptance of the Company's compliance plan), the Amex halted trading in the Company's Common Stock due to the lack of current financial information concerning the Company. Trading in the Company's Common Stock was resumed by the Amex on November 25, 2003, after the October 31, 2003 filing of the Company's 2003 Form 10-K and the November 20, 2003 filing of its Forms 10-Q for April 30 and July 31, 2003.

A claim had been asserted by Miriam Frank, on behalf of the estate of the Company's former President and Chairman Herbert J. Frank, for indemnification with respect to fines paid and legal expenses incurred by Mr. Frank in connection with an investigation by the United States government of the unauthorized use of foreign-manufactured components in aircraft clocks manufactured and sold by the Company (the **Government Action** ) and for which Mrs. Frank claims the Company was obligated to indemnify Mr. Frank. In May 2004, the Company negotiated a settlement whereby the Company paid Mrs. Frank \$35,000 in exchange for a release from any and all future claims that could arise from this matter.

The settlement with former Aerosonic President and Chief Executive Officer David Goldman resulted in a collection of approximately \$150,000 during the third quarter of the fiscal year ended January 31, 2003. The final resolution of Mr. Goldman's Chapter 7 liquidation, along with that of his company, Mil-Spec Finishers, Inc., may result in a minimal settlement in favor of the Company.

On November 12, 2003, a class action lawsuit was filed in the United States District Court for the Middle District of Florida by Sebastian P. Gaeta, individually and on behalf of all other similarly situated (the **Gaeta Suit**), against the Company, PricewaterhouseCoopers LLP, the Company's former independent registered certified public accounting firm, J. Mervyn Nabors, a former director and former President and CEO of the Company, Eric J. McCracken, a former Chief Financial Officer of the Company, and Michael T. Reed, a former Controller of the Company. The action alleges violations of Sections 10(b) and 20(a) of the Securities Exchange Act of 1934 (the **Exchange Act**) and Rule 10b-5 promulgated under that act, including, among other things, that the Company made materially false statements concerning the Company's financial condition and its future prospects. The plaintiff alleges that he suffered damages as the result of his purchase and sale of the Company's Common Stock during the asserted Class Period from November 13, 1998 through March 17, 2003. The action seeks compensatory and other damages, and costs and expenses associated with the litigation.

Shortly after the Gaeta Suit was filed, two other putative class actions (the "**Pratsch Suit**" and "**Suarez Suit**") were filed against the same defendants as in the Gaeta Suit and predicated upon alleged violations of the same securities laws, asserting that plaintiffs purchased the Company's stock at artificially inflated prices during the Class Period and have been damaged thereby. The Pratsch Suit and Suarez Suit assert a Class Period from May 3, 1999 through March 17, 2003. At a February 27, 2004 hearing, plaintiffs in the Suarez Suit voluntarily withdrew their complaint. On February 27, 2004, the Court entered an order consolidating the Gaeta Suit and Pratsch Suit into one case entitled "In re Aerosonic Corporation Securities Litigation," appointing Lead Plaintiffs (the "Miville Group"), and approving the selection of Lead Plaintiffs' Counsel (Berger & Montague P.C.). On April 27, 2004, Lead Plaintiffs filed an amended and consolidated class action complaint that alleges violations of Sections 10(b) and 20(a) of the Exchange Act and Rule 10b-5 including, among other things, that the Company made materially false statements concerning the Company's financial condition and its future prospects. The amended complaint also added as a defendant Andrew Nordstrud, a former employee of the company. On June 28, 2004, the Company responded to the amended complaint by filing a motion to dismiss, and each of the other defendants also moved to dismiss the amended complaint. On August 27, 2004, Lead Plaintiffs filed a memorandum of law as a comprehensive opposition to the motion to dismiss.

The outcome of the consolidated class action lawsuit cannot be adequately determined, and the impact upon the Company cannot be assessed, at this time. Any resolution of such litigation could have a material adverse effect upon the Company's financial position, results of operations, and cash flow.

The Company's Board of Directors has approved Employment Agreements between the Company and four of its executive officers: David A. Baldini, Gary E. Colbert, P. Mark Perkins and Carmelo Russo. The Employment Agreements became effective on May 14, 2003, each for a three-year period of time, which is automatically renewed at the end of such period for another term of three years unless either party gives 180 days notice of termination.

From time to time the Company may be involved in certain claims and legal actions arising in the ordinary course of business. In the opinion of management, at this time there are no claims or legal actions that will have a material adverse effect on the Company's financial position, results of operations, or liquidity

### 13. Subsequent Events

On February 5, 2004, the Company sold its Engine Vibration Monitoring System ( **EVMS** ) product line inventory to Beran Instruments LTD., a UK Company. This sale, which also includes the US registered trademark **EVMS** , allows the company to concentrate on core technology developments in its other product lines. The sale of this product line inventory resulted in a gain that will be recognized during the first quarter of fiscal year 2005.

On February 25, 2004, the Company completed a refinancing of its debt obligations by securing new credit facilities with Wachovia Bank, N.A. ( **Wachovia Refinancing** ) The new facilities total \$5.7 million, and include a 15 year term loan of \$3.0 million that is collateralized by the Company's real estate in Clearwater, Florida, a revolving credit facility of \$2.5 million, and a seven year equipment loan of \$0.2 million. The 15 year term loan has repayment obligations of \$200,000 per year. As of the date of this report, the seven year equipment loan remained unutilized. The entire debt also is secured by a lien on other Company and Avionics assets and by a Deed of Trust on Avionics real estate in Earlysville, Virginia. These facilities replace all of the Company's debt that was previously held by First Commercial Bank and SunTrust Bank, N.A.

The interest rate on the new credit facility is one-month LIBOR plus 300 basis points. Certain loan covenants have been revised and now include a debt coverage ratio (defined as earnings before interest and taxes plus depreciation and amortization minus dividends, withdrawals and non-cash income divided by the sum of current maturities of long term debt and capital and synthetic lease obligations plus interest) that is greater than or equal to 1.25 to 1.00 and a leverage ratio (defined as total liabilities divided tangible net worth) not to exceed 1.30 to 1.00.

In June 2003, the Company had a small fire in its machine shop that resulted primarily in smoke damage to its machinery and equipment. The Company's machining processes were disrupted for approximately one month, after which production resumed. During the shutdown, the machine shop was restored to operating capacity. The costs for this restoration were borne by the Company's insurance carrier, except for a deductible of \$2,500. In addition to the restoration costs, the Company received reimbursement for business interruption expenses of approximately \$10,000, \$68,000 and \$139,000 in July 2003, October 2003 and January 2004, respectively. These reimbursements were recorded in the Company's financial statements in the periods when the reimbursements were received.

In March 2004, the Company retained the services of a business interruption specialist and then submitted a claim to its insurance carrier in April 2004 for the reimbursement of additional business interruption expenses that were identified as having been incurred as a result of the fire. In May 2004, after further negotiations, the Company and the insurance carrier reached a settlement whereby the Company would be reimbursed a total of approximately \$1,214,000 as a result of the business interruption. The Company received the remaining payment of approximately \$997,000 on May 25, 2004, which was included in the results of operations for the fiscal quarter ending July 30, 2004.

In addition to the subsequent events discussed in this Note 13, other subsequent events are also discussed under Note 12 above.

**14. Quarterly Data (unaudited):**

Set forth below are the Company's quarterly data for the years ended January 31, 2004 and 2003.

<b>Quarter Ended</b>			
<b>April 30</b>	<b>July 31</b>	<b>October 31</b>	<b>January 31</b> (1)

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2004

Net sales	\$	\$	\$	\$
	8,744,000	7,746,000	7,972,000	6,651,000
Gross profit				
	2,913,000	2,196,000	2,127,000	1,383,000
Income from operations				
	570,000	(298,000)	(286,000)	212,000
Net income				
	503,000	(342,000)	(301,000)	682,000
Earnings per share (EPS) basic				
	0.13	(0.09)	(0.08)	0.17
Earnings per share (EPS) diluted				
	0.13	(0.09)	(0.08)	0.17

2003

Net sales	\$	\$	\$	\$
	6,015,000	5,973,000	7,001,000	6,683,000
Gross profit				
	1,945,000	1,939,000	2,432,000	2,573,000
Income from operations				
	121,000	191,000	392,000	409,000
Net income				
	(72,000)	(37,000)	438,000	677,000
Earnings per share (EPS) basic				
	(0.02)	(0.01)	0.11	0.18
Earnings per share (EPS) diluted				
	(0.02)	(0.01)	0.11	0.18

(1) Results for the fiscal quarter ended January 31, 2004 include a reduction in audit fees from PricewaterhouseCoopers of approximately \$674,000.

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**Supplemental Schedule of Valuation Accounts***Allowance for Doubtful Accounts*

	<b>For the year ended January 31,</b>		
	<b>2004</b>	<b>2003</b>	<b>2002</b>
Beginning Reserve Balance			
	\$ 372,000	\$ 81,000	\$ 77,000
Amounts Written Off			
	(147,000)	-	-
Amounts Charged (Credited) to Operations			
	(73,000)	291,000	4,000
Ending Reserve Balance			
	\$ 152,000	\$ 372,000	\$ 81,000

*Warranty*

	<b>For the year ended January 31,</b>		
	<b>2004</b>	<b>2003</b>	<b>2002</b>
Beginning Reserve Balance			
	\$ 50,000	\$ 20,000	\$ 20,000
Amounts Charged (Credited) to Operations			
	100,000	30,000	-
Ending Reserve Balance			
	\$ 150,000	\$ 50,000	\$ 20,000

*Sales Returns*

	<b>For the year ended January 31,</b>		
	<b>2004</b>	<b>2003</b>	<b>2002</b>
Beginning Reserve Balance			
	\$ 75,000	\$ -	\$ -

Amounts Charged (Credited) to Operations

	-	75,000	-
Ending Reserve Balance			
	\$ 75,000	\$ 75,000	\$ -

*Deferred Tax Asset Valuation Allowance*

	<b>For the year ended January 31,</b>		
	<b>2004</b>	<b>2003</b>	<b>2002</b>
Beginning Reserve Balance, as restated			
	\$1,504,000	\$1,906,000	\$2,052,000
Amounts Charged (Credited) to Operations			
	(530,000)	(402,000)	(146,000)
Ending Reserve Balance, as restated			
	\$ 974,000	\$1,504,000	\$1,906,000