ENVIRONMENTAL TECTONICS CORP
Form 10-Q
October 11, 2005

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

FORM 10-Q
FOR QUARTERLY REPORT UNDER SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended August 26, 2005

Commission File No. 1-10655

ENVIRONMENTAL TECTONICS CORPORATION

(Exact name of registrant as specified in its charter)

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

County Line Industrial Park
Southampton, Pennsylvania 18966
(Address of principal executive offices)
(Zip Code)

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

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

Yes __x__ No ____

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

Yes ____ No __x__

The number of shares outstanding of the registrant's common stock as of September 30, 2005 is: 9,020,976.

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PART I FINANCIAL INFORMATION

Item 1. Financial Statements

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

	Thirteen Weeks Ended		Twenty-six Weeks Ended	
	August 26, 2005	August 27, 2004	August 26, 2005	August 27, 2004
Net sales	**$ 6,255**	$ 6,523	**$ 12,170**	$ 12,698
Cost of goods sold	**5,002**	5,502	**9,435**	10,683
Gross profit	**1,253**	1,021	**2,735**	2,015
Operating expenses:				
Selling and administrative	**2,248**	3,121	**4,875**	5,551
Research and development	**154**	292	**161**	501
	2,402	3,413	**5,036**	6,052
Operating loss	**(1,149)**	(2,392)	**(2,301)**	(4,037)
Other expenses:				
Interest expense, net	**394**	387	**944**	731
Other, net	**76**	40	**100**	125
	470	427	**1,044**	856
Loss before income taxes	**(1,619)**	(2,819)	**(3,345)**	(4,893)
Benefit from income taxes		(835)		(1,450)
Loss before minority interest	**(1,619)**	(1,984)	**(3,345)**	(3,443)
Loss (income) attributable to minority interest	**(1)**		**2**	(2)
Net loss	**$ (1,620)**	$ (1,984)	**$ (3,343)**	$ (3,445)
Per share information:				
Loss applicable to common shareholders	**$ (1,620)**	$ (1,984)	**$ (3,343)**	$ (3,445)
Basic and diluted loss per share	**$ (0.18)**	$ (0.26)	**$ (0.37)**	$ (0.45)
Number of shares: basic and diluted	**9,020,000**	7,641,000	**9,020,000**	7,590,000

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

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Environmental Tectonics Corporation
Consolidated Balance Sheets

	August 26, 2005	February 25, 2005
	(unaudited) (amounts in thousands, except share information)	
Assets		
Current assets:		
Cash and cash equivalents	**$ 5,529**	$ 12,041
Restricted cash	**61**	4,680
Accounts receivable, net	**7,732**	8,018
Costs and estimated earnings in excess of billings on uncompleted long-term contracts	**5,389**	3,333
Inventories	**8,462**	7,928
Deferred tax asset	**1,786**	1,786
Prepaid expenses and other current assets	**1,978**	1,668
Total current assets	**30,937**	39,454
Property, plant and equipment, at cost, net of accumulated depreciation of $11,859 at August 26, 2005 and $11,491 at February 25, 2005	**4,572**	4,331
Software development costs, net of accumulated amortization of $9,260 at August 26, 2005 and $8,658 at February 25, 2005	**3,311**	3,567
Goodwill and intangibles	**477**	477
Other assets, net		80
Total assets	**$ 39,297**	$ 47,909
Liabilities and Stockholders' Equity		
Liabilities		
Current liabilities:		
Current portion of long-term debt	**$ -**	$ 275
Accounts payable trade	**1,660**	2,893
Billings in excess of costs and estimated earnings on uncompleted long-term contracts	**4,248**	1,533
Customer deposits	**975**	2,247
Accrued liabilities	**1,396**	2,688
Total current liabilities	**8,279**	9,636
Long-term debt, less current portion:		
Long-term bonds, net		4,095
Subordinated debt	**8,176**	7,992
	8,176	12,087
Deferred income taxes	**1,786**	1,786

Total liabilities	**18,241**	23,509
Minority interest	**43**	45
Stockholders' Equity		
Common stock: $.05 par value; 20,000,000 shares authorized; 9,020,976 and 9,019,376 issued and outstanding at August 26, 2005 and February 25, 2005, respectively	**451**	450
Capital contributed in excess of par value of common stock	**16,564**	16,561
Accumulated other comprehensive loss	**(140)**	(137)
Retained earnings	**4,138**	7,481
Total stockholders' equity	**21,013**	24,355
Total liabilities and stockholders' equity	**$ 39,297**	$ 47,909

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

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Environmental Tectonics Corporation
Consolidated Statements of Cash Flows
(unaudited)

	Twenty-six Weeks Ended	
	August 26, 2005	**August 27, 2004**
	(amounts in thousands)	
Cash flows from operating activities:		
Net loss	**$ (3,343)**	$ (3,445)
Adjustments to reconcile net loss to net cash provided by/(used in) operating activities:		
Depreciation and amortization	**1,364**	925
Non-cash interest expense	**184**	156
Provision for losses on accounts receivable and inventories	**90**	76
Minority interest	**(2)**	2
Changes in operating assets and liabilities:		
Accounts receivable	**139**	10,152
Costs and estimated earnings in excess of billings on uncompleted long-term contracts	**(2,056)**	(788)
Inventories	**(838)**	1,129
Prepaid expenses and other assets	**(624)**	(1,392)
Accounts payable	**(1,233)**	445
Billings in excess of costs and estimated earnings on uncompleted long-term contracts	**2,715**	1,180
Customer deposits	**(1,272)**	(1,837)
Other accrued liabilities	**(1,292)**	(604)
Net cash (used in)/provided by operating activities	**(6,168)**	5,999
Cash flows from investing activities:		
Acquisition of equipment	**(248)**	(92)
Capitalized software development costs	**(346)**	(842)
Net cash used in investing activities	**(594)**	(934)
Cash flows from financing activities:		
Payments under credit facility	—	(30)
Repayment of long-term bonds	**(4,370)**	(275)
Decrease/(increase) in restricted cash	**4,619**	(5,399)
Proceeds from issuance of common stock / warrants	**4**	749
Net cash provided by/(used in) financing activities	**253**	(4,955)
Effect of exchange rate changes on cash	**(3)**	96

Net (decrease)/increase in cash and cash equivalents	**(6,512)**	206
Cash and cash equivalents at beginning of period	**12,041**	1,366
Cash and cash equivalents at end of period	**$ 5,529**	$ 1,572
Supplemental schedule of cash flow information:		
Interest paid	**$ 460**	$ 444
Income taxes paid	**$ 4**	$ 4

During the twenty-six week periods ending August 26, 2005 and August 27, 2004, $361 and $593, respectively, was reclassified from inventory to fixed assets.

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

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Environmental Tectonics Corporation
Notes to Consolidated Financial Statements

1. **Basis of Presentation**

The accompanying consolidated financial statements include the accounts of Environmental Tectonics Corporation ("ETC" or the "Company"), Entertainment Technology Corporation (“EnTCo”), ETC International Corporation and ETC-Delaware, its wholly-owned subsidiaries, ETC Europe, its 99% owned subsidiary and ETC-PZL Aerospace Industries, Ltd. ("ETC-PZL"), its 95% owned subsidiary. All material inter-company accounts and transactions have been eliminated in consolidation. The company’s fiscal year is the 52- or 53-week annual accounting period ending the last Friday in February.

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

Certain information in footnote disclosures normally included in financial statements prepared in conformity with accounting principles generally accepted in the United States of America has been condensed or omitted pursuant to such rules and regulations and the financial results for the periods presented may not be indicative of the full year’s results, although the Company believes the disclosures are adequate to make the information presented not misleading. These financial statements should be read in conjunction with the financial statements and the notes thereto included in the Company's Annual Report on Form 10-K/A for the year ended February 25, 2005.

2. **Loss Per Share**

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

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Environmental Tectonics Corporation
Notes to Consolidated Financial Statements, continued

	Thirteen Weeks Ended August 26, 2005			Thirteen Weeks Ended August 27, 2004		
	Loss (Numerator)	Shares (Denominator)	Per Share Amount	Loss (Numerator)	Shares (Denominator)	Per Share Amount
	(amounts in thousands, except share and per share information)					
Basic EPS						
Net loss applicable to common stockholders	**$ (1,620)**	**9,020,000**	**$ (0.18)**	$ (1,984)	7,641,000	$ (0.26)
Effect of dilutive securities						
Options		—			—	
Warrants		—			—	
Diluted EPS						
Net loss applicable to common stockholders plus assumed conversions	**$ (1,620)**	**9,020,000**	**$ (0.18)**	$ (1,984)	7,641,000	$ (0.26)

	Twenty-six Weeks Ended August 26, 2005			Twenty-six Weeks Ended August 27, 2004		
	Loss (Numerator)	Shares (Denominator)	Per Share Amount	Loss (Numerator)	Shares (Denominator)	Per Share Amount
	(amounts in thousands, except share and per share information)					
Basic EPS						
Net loss applicable to common stockholders	**$ (3,343)**	**9,020,000**	**$ (0.37)**	$ (3,445)	7,590,000	$ (0.45)
Effect of dilutive securities						
Options		—			—	
Warrants		—			—	
Diluted EPS						
	$ (3,343)	**9,020,000**	**$ (0.37)**	$ (3,445)	7,590,000	$ (0.45)

Net loss applicable to common stockholders plus assumed conversions

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Environmental Tectonics Corporation
Notes to Consolidated Financial Statements, continued

At August 26, 2005 there were stock options to purchase the Company’s common stock totaling 274,562 shares, which were not included in the computation of diluted earnings per share, as the effect of such would be anti-dilutive. Additionally, there was subordinated debt with a face value of $10,000,000, which was convertible at an exercise price of $6.05 per share, equating to 1,652,893 shares if fully converted to common shares. Upon each conversion of the subordinated debt, the holder would be entitled to receive a warrant to purchase additional shares of common stock equal to ten percent of the shares issued pursuant to such conversion. If the entire face value of the Note representing the subordinated debt were to be converted into common shares, warrants for an additional 165,289 shares would be issued, bringing the total shares to be issued to 1,818,182. None of these shares have been included in the computation of diluted earnings per share for this reporting period as the effect would be anti-dilutive.

At August 27, 2004 there were stock options to purchase the Company’s common stock totaling 323,752 shares which were not included in the computation of diluted earnings per share, as the effect of such would be anti-dilutive. Additionally, there was subordinated debt with a face value of $10,000,000 which was convertible at an exercise price of $6.05 per share, equating to 1,652,893 shares if fully converted to common shares. Upon each conversion of the subordinated debt, the holder would be entitled to receive a warrant to purchase additional shares of common stock equal to ten percent of the shares issued pursuant to such conversion. If the entire face value of the Note representing the subordinated debt were to be converted into common shares, warrants for an additional 165,289 shares would be issued, bringing the total shares to be issued to 1,818,182. Additionally, at August 27, 2004, there were outstanding warrants to purchase the Company’s stock totaling 803,048 shares. None of these shares have been included in the computation of diluted earnings per share for this reporting period as the effect would be anti-dilutive.

3. **Stock Options**

The Company accounts for stock options under SFAS No. 123, “Accounting for Stock-Based Compensation,” as amended by SFAS No. 148, which contains a fair value-based method for valuing stock-based compensation that entities may use, which measures compensation cost at the grant date based on the fair value of the award. Compensation is then recognized over the service period, which is usually the vesting period. Alternatively, SFAS No. 123 permits entities to continue accounting for employee stock options and similar equity instruments under Accounting Principles Board (APB) Opinion 25, “Accounting for Stock Issued to Employees.” Entities that continue to account for stock options using APB Opinion 25 are required to make pro forma disclosures of net income and earnings per share, as if the fair value-based method of accounting defined in SFAS No. 123 had been applied. (See Note 9, Recent Accounting Pronouncements, “Accounting for Share Based Payments”, for a discussion of SFAS No. 123R.)

At August 26, 2005, the Company had one stock-based employee compensation plan. The Company accounts for this plan under the recognition and measurement principles of APB Opinion 25, “Accounting for Stock Issued to Employees,” and related interpretations. Stock-based employee compensation costs are not reflected in results of operations, as all options granted under the plan had an exercise price equal to the market value of the underlying common stock on the date of grant. The pro-forma effect of stock-based compensation as calculated under the fair value-based method is immaterial for all periods presented.

There were no grants of stock options during the twenty-six weeks ended August 26, 2005 or August 27, 2004.

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Environmental Tectonics Corporation
Notes to Consolidated Financial Statements, continued

4. **Accounts Receivable**

The components of accounts receivable are as follows:

	August 26, 2005	February 25, 2005
	(amounts in thousands)	
U.S. Government receivables billed and unbilled contract costs subject to negotiation	**$ 3,805**	$ 3,202
U.S. commercial receivables billed	**2,610**	2,331
International receivables, including receivables of consolidated foreign subsidiaries and billed and unbilled contract costs subject to negotiation	**1,950**	2,971
	8,365	8,504
Less allowance for doubtful accounts	**(633)**	(486)
	$ 7,732	$ 8,018

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

Unbilled contract costs subject to negotiation as of August 26, 2005 and February 25, 2005 respectively, represent claims made against the U.S. Government under a contract for a submarine rescue decompression chamber project. These costs totaling $3,004,000 were recorded beginning in fiscal year 2002 and include $105,000 recorded during fiscal year 2005. In November 2003, the U.S. Government completed an audit of the claim, rejecting most of the items due to audit or engineering reasons. The Company was not provided a copy of the Government’s Technical Report that questioned approximately half of the claim costs. The Company has submitted a written rebuttal to the draft report and has formally requested a copy of the Technical Report. On July 22, 2004, the U.S. Government’s contracting officer issued a final decision on the claim, denying the claim in full. The Company has updated the claim for additional costs expended on claimable items since the original submission and has converted the claim to a complaint, which was filed in the Court of Federal Claims in July 2005. Additionally, the Company is reviewing the costs on the project for additional claim items, which would be filed in a supplemental claim, if required.

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

The Company considers the recorded costs to be realizable due to the fact that the costs relate to customer caused delays, errors and changes in specifications and designs, disputed liquidated damages and other out of scope items. The U.S. Navy has until November 2005 to respond to this claim. The U.S. Government, citing failure to deliver the product within contract terms, has assessed liquidated damages but has not offset or withheld any progress payments due to the Company under the contract. The Company disputes the basis for these liquidated damages, noting that applicable U.S. Government purchasing regulations allow for a waiver of these charges if the delay is beyond the control and not due to the fault or negligence of the Company. However, following accounting principles generally accepted in the United States of America, the Company has reduced contract values and corresponding revenue recognition for an estimated amount of $330,000 to cover a delay through the extended delivery period.

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Environmental Tectonics Corporation
Notes to Consolidated Financial Statements, continued

International receivables billed and unbilled contract costs subject to negotiation:

International receivables billed include $700,000 at August 26, 2005 and February 25, 2005, respectively, related to a contract with the Royal Thai Air Force (RTAF).

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

The open balance of $700,000 due on the contract represents the total gross exposure to the Company on this contract. On June 16, 2003, the Company filed for arbitration in Thailand seeking recovery of the open balance of $700,000 due on this contract. On October 8, 2003, the Thai government filed their defense with the Thai Arbitration Institute (TAI). Arbitration was conducted before a panel of three arbitrators in Bangkok, Thailand in August 2005. A decision on the dispute may be issued as early as November 2005.

Since the circumstances that caused a delay are commonly considered force majeure events, and since the contract under question allows for consideration of force majeure events, the Company believes that the open balance related to this contract is collectible and will continue to treat this balance as collectible until a final unappealable legal decision is rendered by a competent Thai tribunal. The Company continues to enjoy a favorable relationship with the RTAF. It currently has both maintenance and upgrade contracts with the RTAF for trainers that are the subject of the dispute and has sold a significant amount of additional equipment to the RTAF since this dispute began. Thus, we do not feel the initiation of legal action against the RTAF has affected our ability to obtain additional contracts with the RTAF. At this point, the Company is not able to determine what, if any, impact the extended completion period will ultimately have upon the receipt of final payment.

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