ENVIRONMENTAL TECTONICS CORP
Form 10-Q
January 08, 2007

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 November 24, 2006

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 the past 90 days.

Yes No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act (Check one):

Large Accelerated Filer Accelerated Filer Non-accelerated Filer

Indicate by check mark whether the registrant is a shell company (as defined on Rule 12b-2 of the Exchange Act).

Yes No

The number of shares outstanding of the registrant s common stock as of December 29, 2006 is: 9,026,958.

PART I FINANCIAL INFORMATION

Item 1. Financial Statements

Environmental Tectonics Corporation

Consolidated Statements of Operations

(unaudited)

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

	Thirteen Weeks Ended		Thirty-nine Weeks Ended	
	November 24, 2006	November 25, 2005	November 24, 2006	November 25, 2005
Net sales	**$4,718**	$6,206	**$13,622**	$18,376
Cost of goods sold	**3,688**	4,839	**11,084**	14,274
Gross profit	**1,030**	1,367	**2,538**	4,102
Operating expenses:				
Selling and administrative	**2,568**	2,267	**6,945**	7,142
Research and development	**43**	86	**529**	247
	2,611	2,353	**7,474**	7,389
Operating loss	**(1,581)**	(986)	**(4,936)**	(3,287)
Other expenses:				
Interest expense, net	**291**	321	**857**	1,265
Other, net	**(43)**	10	**(36)**	110
	248	331	**821**	1,375
Loss before income taxes	**(1,829)**	(1,317)	**(5,757)**	(4,662)
Provision for income taxes	**4**	4	**13**	4
Loss before minority interest	**(1,833)**	(1,321)	**(5,770)**	(4,666)
Income attributable to minority interest	**33**	6	**16**	4
Net loss	**$(1,866)**	$(1,327)	**$(5,786)**	$(4,670)

Per share information:				
Loss applicable to common shareholders	**$(1,956)**	$(1,327)	**$(5,955)**	$(4,670)
Basic and diluted loss per share	**$(0.22)**	$(0.15)	**$(0.66)**	$(0.52)
Number of shares: basic and diluted	**9,027,000**	9,021,000	**9,031,000**	9,020,000

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

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Environmental Tectonics Corporation

Consolidated Balance Sheets

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

	November 24, 2006	February 24, 2006
	(unaudited)	
Assets		
Current assets:		
Cash and cash equivalents	**$4,002**	$3,566
Cash, restricted	**19**	16
Accounts receivable, net	**8,381**	6,021
Costs and estimated earnings in excess of billings on uncompleted long-term contracts	**4,679**	3,480
Inventories	**12,782**	10,734
Deferred tax asset	**1,558**	1,558
Prepaid expenses and other current assets	**428**	564
Total current assets	**31,849**	25,939
Property, plant and equipment, at cost, net of accumulated depreciation of $12,643 at November 24, 2006 and $12,134 at February 24, 2006	**4,099**	4,392
Software development costs, net of accumulated amortization of $10,773 at November 24, 2006 and $9,882 at February 24, 2006	**2,008**	2,832
Goodwill and intangibles	**455**	455
Other assets, net	**29**	49
Total assets	**$38,440**	$33,667
Liabilities and Stockholders Equity Liabilities		
Current liabilities		
Note payable	**$3,000**	$
Accounts payable trade	**1,818**	2,111
Billings in excess of costs and estimated earnings on uncompleted long-term contracts	**2,035**	1,118
Customer deposits	**1,401**	877
Accrued liabilities	**2,134**	2,013
Total current liabilities	**10,388**	6,119
Long-term debt:		
Subordinated debt	**8,709**	8,376

	8,709	8,376
Deferred income taxes	**1,558**	1,558
Total liabilities	**20,655**	16,053
Minority interest	**77**	61
Stockholders Equity		
Cumulative convertible preferred stock, $.05 par value, 15,000 shares authorized; 6,000 shares issued and outstanding at November 24, 2006	**6,000**	
Common stock; $.05 par value; 20,000,000 shares authorized; 9,026,958 and 9,024,804 shares issued and outstanding at November 24, 2006 and February 24, 2006, respectively	**451**	451
Capital contributed in excess of par value of common stock	**16,624**	16,584
Accumulated other comprehensive loss	**(179)**	(249)
Retained (deficit) earnings	**(5,188)**	767
Total stockholders equity	**17,708**	17,553
Total liabilities and stockholders equity	**$38,440**	$33,667

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

Environmental Tectonics Corporation

Consolidated Statements of Cash Flows

(unaudited)

	Thirty-nine Weeks Ended	
	November 24, 2006	**November 25, 2005**
	(amounts in thousands)	
Cash flows from operating activities:		
Net loss	**$(5,786)**	$(4,670)
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation and amortization	**1,400**	2,012
Non-cash interest expense	**333**	282
Provision for losses on accounts receivable and inventories	**(307)**	129
Minority interest	**16**	3
Compensation cost	**37**	
Changes in operating assets and liabilities:		
Accounts receivable	**(1,771)**	536
Costs and estimated earnings in excess of billings on uncompleted long-term contracts	**(1,199)**	(210)
Inventories	**(2,330)**	(2,214)
Prepaid expenses and other current assets	**136**	(203)
Other assets	**20**	
Accounts payable	**(293)**	(754)
Billings in excess of costs and estimated earnings on uncompleted long-term contracts	**917**	209
Customer deposits	**524**	(1,542)
Other accrued liabilities	**121**	(1,109)
Net cash used in operating activities	**(8,182)**	(7,531)
Cash flows from investing activities:		
Acquisition of equipment	**(216)**	(264)
Capitalized software development costs	**(67)**	(442)
Net cash used in investing activities	**(283)**	(706)
Cash flows from financing activities:		
Proceeds from issuance of note payable	**3,000**	
Repayment of long-term bonds		(4,370)
Cash, restricted	**(3)**	4,618

Proceeds from issuance of preferred stock	**6,000**	
Dividends payable	**(169)**	
Proceeds from issuance of common stock / warrants	**3**	4
Net cash provided by financing activities	**8,831**	252
Effect of exchange rate changes on cash	**70**	58
Net increase (decrease) in cash and cash equivalents	**436**	(7,927)
Cash and cash equivalents at beginning of period	**3,566**	12,041
Cash and cash equivalents at end of period	**$4,002**	$4,114
Supplemental schedule of cash flow information:		
Interest paid	**$621**	$658
Income taxes paid	**$4**	$5

During the thirty-nine week period ending November 25, 2005, $361 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

(amounts in dollars, except where noted and share and per share information)

(unaudited)

1. Summary of Significant Accounting Policies

Basis of Presentation

The accompanying consolidated financial statements include the accounts of Environmental Tectonics Corporation (ETC Southampton), 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 significant inter-company accounts and transactions have been eliminated in consolidation. (Note: for reporting purposes, the consolidated entity is referred to as ETC or the Company).

The accompanying consolidated financial statements have been prepared by ETC pursuant to the rules and regulations of the Securities and Exchange Commission (SEC), and reflect all adjustments which, in the opinion of management, are necessary for a fair presentation of the results for the interim periods presented. All such adjustments are of a normal recurring nature.

Certain information in footnote disclosures normally included in financial statements prepared in conformity with accounting principles generally accepted in the United States of America has been condensed or omitted pursuant to such rules and regulations and the financial results for the periods presented may not be indicative of the full year s results, although the Company believes the disclosures are adequate to make the information presented not misleading. These financial statements should be read in conjunction with the financial statements and the notes thereto included in the Company s Annual Report on Form 10-K for the fiscal year ended February 24, 2006.

Use of Estimates

The preparation of the consolidated financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Inventories

Inventories are valued at the lower of cost or market using the first in, first out (FIFO) method and consist of the following (net of reserves of $1,314,000 at November 24, 2006 and $1,032,000 at February 24, 2006):

	November 24, 2006	February 24, 2006
	(amounts in thousands)	
Raw materials	$112	$158
Work in process	11,120	8,803
Finished goods	1,550	1,773
Total	$12,782	$10,734

Environmental Tectonics Corporation

Notes to Consolidated Financial Statements, continued

(amounts in dollars, except where noted and share and per share information)

(unaudited)

Revenue Recognition

The Company recognizes revenue using three methods:

On long-term contracts over $250,000 in value and six months in length, the percentage-of-completion (POC) method is applied based on costs incurred as a percentage of estimated total costs. This percentage is multiplied by the total estimated revenue under a contract to calculate the amount of revenue recognized in an accounting period. Revenue recognized on uncompleted long-term contracts in excess of amounts billed to customers is reflected as an asset. Amounts billed to customers in excess of revenue recognized on uncompleted long-term contracts are reflected as a liability. When it is estimated that a contract will result in a loss, the entire amount of the loss is accrued. The effect of revisions in cost and profit estimates for long-term contracts is reflected in the accounting period in which the Company learns the facts which require it to revise the cost and profit estimates. Contract progress billings are based upon contract provisions for customer advance payments, contract costs incurred, and completion of specified contract milestones. Contracts may provide for customer retainage of a portion of amounts billed until contract completion. Retainage is generally due within one year of completion of the contract. Revenue recognition under the POC method involves significant estimates.

Revenue for contracts under $250,000, or to be completed in less than six months, and where there are no post-shipment services included in the contract, is recognized on the date that the finished product is shipped to the customer. Revenue on contracts under $250,000, or to be completed in less than six months, and where post-shipment services (such as installation and customer acceptance) are required, is recognized following customer acceptance.

Revenue derived from the sale of parts and services is recognized on the date that either the part is shipped to the customer or the service is completed. Revenue for service contracts is recognized ratably over the life of the contract with related material costs expensed as incurred.

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

Environmental Tectonics Corporation

Notes to Consolidated Financial Statements, continued

(amounts in dollars, except where noted and share and per share information)

(unaudited)

Net loss per share

Basic loss per share is computed by dividing the net loss (the numerator) by the weighted average number of common shares outstanding (the denominator) during the period. Shares outstanding during the period and shares reacquired during the period are weighted for the portion of the period that they were outstanding. The computation of diluted loss per share is similar to the computation of basic loss per share except that the denominator is increased to include the number of additional common shares that would have been outstanding if the dilutive potential common shares had been issued (e.g., upon exercise of common stock options or warrants). Potentially dilutive common shares are not included in the computation of diluted loss per share if they are anti-dilutive. Net loss per share as reported for each period was not adjusted for potential common shares, as they are anti-dilutive. The following table illustrates the reconciliation of net loss from operations for fiscal 2007 to net loss applicable to common shareholders:

	Thirteen weeks ended November 24, 2006	**Thirty-nine weeks ended November 24, 2006**
	(amounts in thousands)	
Net loss, as reported	$1,866	$5,786
Plus: preferred stock dividends	90	169
Net loss applicable to common shareholders	$1,956	$5,955
Loss per share of common stock-basic and diluted:	$0.22	$0.66

At November 24, 2006, potentially dilutive common shares which were not included in the computation of diluted loss per share included the following:

A. Outstanding options to purchase the Company s common stock totaling 371,928 shares.

B. Convertible subordinated debt, with a face value of $10,000,000, which is convertible into shares of common stock at an exercise price of $6.05 per share, equating to 1,652,893 shares of common stock if fully converted. Upon each conversion of the subordinated note, the holder will 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 subordinated note were to be converted into shares of common stock, then warrants to purchase an additional 165,289 shares of common stock would be issued, bringing the total number of shares of common stock to be issued to 1,818,182.

C. Convertible preferred stock issued in fiscal 2007 totaling $6,000,000 which is convertible into 1,055,161 shares of common stock. The conversion price for $3,000,000 of the preferred stock is $4.95 per common share and the remaining $3,000,000 is convertible at $6.68 per common share.

None of these shares were included in the computation of diluted loss per share as the effect would be anti-dilutive.

Environmental Tectonics Corporation

Notes to Consolidated Financial Statements, continued

(amounts in dollars, except where noted and share and per share information)

(unaudited)

At November 25, 2005, potentially dilutive common shares which were not included in the computation of diluted loss per share included the following:

A. Outstanding options to purchase the Company s common stock totaling 247,939 shares.

B. Convertible subordinated debt with a face value of $10,000,000, which is convertible into shares of common stock at an exercise price of $6.05 per share, equating to 1,652,893 shares of common stock if fully converted. Upon each conversion of the subordinated note, the holder will 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 subordinated note were to be converted into shares of common stock, then warrants to purchase an additional 165,289 shares of common stock would be issued, bringing the total number of shares of common stock to be issued to 1,818,182.

None of these shares were included in the computation of diluted loss per share as the effect would be anti-dilutive.

Share-Based Compensation

The Company adopted Statement of Financial Accounting Standard (SFAS) No. 123(R) effective February 25, 2006. SFAS No. 123(R) requires the Company to recognize expense related to the fair value of stock-based compensation awards, including employee stock options. Prior to the adoption of SFAS No. 123(R), the Company accounted for stock options using the intrinsic value method of APB Opinion No. 25, and it did not recognize compensation expense in its income statement for options granted that had an exercise price equal to the market value of the underlying common stock on the date of grant. The Company also provided certain pro forma disclosures for stock option awards as if the fair value-based approach of SFAS No. 123(R) had been applied.

The Company has elected to use the modified prospective transition method as permitted by SFAS No. 123(R) and therefore has not restated its financial results for prior periods. Under this transition method, the Company will apply the provisions of SFAS No. 123(R) to new awards and to awards modified, repurchased or cancelled after February 24, 2006. Additionally, for unvested awards granted prior to the effective date of the Company s adoption of SFAS No. 123(R), the Company recognizes compensation expense in the same manner as was used in its income statement or for pro-forma disclosures prior to the effective date of its adoption of SFAS No. 123(R).

The cost for stock option employee compensation was $22,000 and $37,000, respectively, for the thirteen and thirty-nine week periods ending November 24, 2006.

As of November 24, 2006, the remaining prospective pre-tax cost of unvested stock option employee compensation was $186,000, which will be expensed on a pro-rata basis going forward.

Environmental Tectonics Corporation

Notes to Consolidated Financial Statements, continued

(amounts in dollars, except where noted and share and per share information)

(unaudited)

The following table illustrates the effect on net loss and net loss per common share as if the Company had applied the fair value recognition provisions of SFAS No. 123(R) to stock option employee compensation for the thirteen and thirty-nine week periods ended November 25, 2005:

	Thirteen weeks ended November 25, 2005	**Thirty-nine weeks ended November 25, 2005**
	(amounts in thousands)	
Net loss, as reported	$1,327	$4,670
Plus: stock-based compensation costs determined under fair market value based methods for all awards	7	22
Net loss, pro forma	$1,334	$4,692
Loss per share of common stock-basic and diluted:		
As reported	$0.15	$0.52
Pro forma	$0.15	$0.52

During the thirteen and thirty-nine weeks ended November 24, 2006, options to purchase a total of 44,639 shares of the Company s common stock were granted. There were no grants of stock options during the thirty-nine weeks ended November 25, 2005.

2. Accounts Receivable:

The components of accounts receivable at November 24, 2006 and February 24, 2006 are as follows:

	November 24, 2006	**Feb. 24, 2006**
	(amounts in thousands)	
U.S. Government receivables billed and unbilled contract costs subject to negotiation	$3,142	$3,346
U.S. commercial receivables billed	1,173	2,297
International receivables billed	4,442	1,343
	8,757	6,986

Less allowance for doubtful accounts	(376)	(965)
	$8,381	$6,021

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

Unbilled contract costs subject to negotiation as of November 24, 2006 and February 24, 2006, 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. 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 submitted a written rebuttal to the draft 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 updated the claim for additional costs expended on claimable items since the original submission and converted the claim to a complaint, which was filed in the Court of Federal Claims in July 2005. This claim is currently in the discovery phase, including the mutual exchange of documents. Depositions are expected to last through the end of January 2007. Assuming no further delays, the case is scheduled to go to trial in July 2007.

Environmental Tectonics Corporation

Notes to Consolidated Financial Statements, continued

(amounts in dollars, except where noted and share and per share information)

(unaudited)

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 been that most claims are initially denied in part or in full by the contracting officer (or no decision is forthcoming, which is then taken to be a deemed denial) which then forces the Company to seek relief in a court of law.

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

International receivables billed:

International receivables billed include $315,000 and $700,000, respectively, at November 24, 2006 and February 24, 2006, 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 a 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 had 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.

On June 16, 2003, the Company filed for arbitration in Thailand seeking recovery of the $700,000 open balance on this contract. On March 23, 2006, the arbitration panel awarded the Company $314,813 plus interest from March 1, 2006 as full settlement of this dispute. Although this award is final with the arbitration panel, the RTAF has filed a motion in the Thai court to void the award, citing that the award was illegal and thus against the public order and unfair to the RTAF. On August 9, 2006, the Company filed its defense to this motion with the court. In September 2006, at a pre-trial session the court ordered the parties to produce witnesses to testify. This testimony has been scheduled for August and September 2007.

Environmental Tectonics Corporation

Notes to Consolidated Financial Statements, continued

(amounts in dollars, except where noted and share and per share information)

(unaudited)

If the RTAF loses on its motion but does not honor the decision, the award will have to be enforced through the court system in Thailand, a process which may be time consuming and costly. The assets of the RTAF are not subject to attachment. At this point, the Company is not able to determine the ultimate outcome of this dispute. However, the Company has established sufficient receivable reserves so that any resolution will not have a material impact on the Company s financial position or its results of operations.

Historically, the Company has had positive experience with regard to its contract claims in that recoveries have exceeded the carrying value of claims. Although the claim with the U.S. Government was filed in the Court of Federal Appeals whereas prior claims have been filed with the Armed Services Board of Contract Appeals (ASBCA), the litigation has followed a consistent process and time frame as prior claims. The dispute with the RTAF has been outstanding for over 10 years, although the arbitration award occurred on March 23, 2006.

There is no assurance that the Company will always have positive experience with regard to recoveries for its contract claims.

3. Stockholders Equity

The components of stockholders equity at November 24, 2006 and February 24, 2006 were as follows (amounts in thousands, except share information):

		Common Stock					
	Preferred Stock	**Shares**	**Amount**	**Additional Paid in Capital**	**Accumulated Other Comp. Loss**	**Retained Earnings (Deficit)**	**Total**
Balance at February 24, 2006		9,024,804	$ 451	$ 16,584	$ (249)	$ 767	$ 17,553
Net loss for the thirty-nine weeks ended November 24, 2006						(5,786)	(5,786)
Foreign currency translation adjustment					70		70
Total comprehensive loss							(5,716)
Preferred stock	6,000						6,000
Dividends on preferred stock						(169)	(169)
Compensation cost				37			37

Other shares issued		2,154		3			3
Balance at November 24, 2006	$ 6,000	9,026,958	$ 451	$ 16,624	$ (179)	$ (5,188)	$ 17,708

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Environmental Tectonics Corporation

Notes to Consolidated Financial Statements, continued

(amounts in dollars, except where noted and share and per share information)

(unaudited)

4. Long-Term Obligations and Credit Arrangements:

The following table lists the long-term debt and other long-term obligations of the Company as of November 24, 2006:

	Payments Due by Period				
	Total	**Less Than 1 Year**	**1-3 Years**	**4-5 Years**	**After 5 Years**
	(in thousands)				
Long-term debt, including current maturities	$8,709	$	$8,709	$	$
Operating leases	567	32	338	197	
Total	$9,276	$32	$9,047	$197	$

Long-term debt is reported net of unamortized discount of $1,291,000 on the Company s subordinated debt.

As part of the Company s credit agreement (the PNC Agreement) with PNC Bank, National Association (PNC Bank), at February 24, 2006 the Company was required to maintain a minimum tangible net worth (defined as total assets minus intangible assets minus all liabilities) (Tangible Net Worth) at the end of each fiscal quarter and fiscal year of $12,000,000. This was reduced to $9,000,000 under the November 16, 2006 Letter Agreement (see a full description below.)

As part of the Company s subordinated debt agreement, at the end of each fiscal quarter and fiscal year, the Company must meet three financial covenants: (a) a maximum Leverage Ratio (defined as the ratio of total debt to annualized earnings before interest, taxes, depreciation and amortization (EBITDA) of 4.03 times; (b) a minimum Fixed Charge Ratio (defined as the ratio of the annualized sum of EBITDA minus expenditures for capital equipment and capitalized software to annualized fixed charges (interest payments, income taxes paid, and any cash dividends) of 1.06 times, and (c) a minimum Tangible Net Worth Ratio, which adjusts quarterly, based on net income and common stock proceeds.

At November 24, 2006, the Company failed to meet the covenants contained in the subordinated debt agreement but has obtained a waiver of such violations from the subordinated lender. This waiver applies to all periods through November 25, 2007. Except as specified, the waiver does not constitute a modification or alteration of any other terms or conditions in the respective agreements, or a release of any of the lender s rights or remedies, all of which are reserved, nor does it release the Company or any guarantor from any of its duties, obligations, covenants or agreements including the consequences of any event of default, except as specified.

Refinancing

The Company has historically financed operations through a combination of cash generated from operations, equity offerings, subordinated borrowings and bank debt. On February 19, 2003, the Company refinanced its outstanding indebtedness (the Refinancing). The Refinancing was effected through the issuance of subordinated, convertible notes to H.F. Gerry Lenfest (referred to as Mr. Lenfest throughout the remainder of this Quarterly Report on Form 10-Q), an individual, and entering into the PNC Agreement. The total proceeds from the Refinancing were $29,800,000.

Bank Credit and Facility

Since its inception, the PNC Agreement has undergone numerous amendments. As of November 24, 2006, the facility total was $5,000,000 and use of this amount was restricted to the issuance of international letters of credit. This line was secured by all assets of the Company as well as a $5,000,000 personal guarantee by Mr. Lenfest.

Environmental Tectonics Corporation

Notes to Consolidated Financial Statements, continued

(amounts in dollars, except where noted and share and per share information)

(unaudited)

On June 28, 2006, the Company signed an amendment to the PNC Agreement which (i) extended the agreement s termination date to the earlier of June 30, 2007 or such date to which the Company and PNC Bank have agreed in writing, (ii) terminated the Security Agreement and Mortgage, thereby releasing the Company s assets as collateral for the facility, (iii) adjusted the Tangible Net Worth covenant to a minimum of $9,000,000, and (iv) made other changes to the PNC Agreement.

On November 16, 2006, the Company entered into a Letter Agreement with PNC Bank. This Letter Agreement amended, restated and replaced the existing PNC Credit Agreement. Pursuant to such agreement, PNC Bank (i) terminated ETC s Credit Agreement dated as of February 18, 2003 (ii) re-approved the Company s $5 million Line of Credit for Letters of Credit, and (iii) re-affirmed the Tangible Net Worth covenant (as defined in the Agreement) to a be a minimum of $9,000,000. The $5 million Line of Credit for Letters of Credit will continue to be guaranteed by Mr. Lenfest, the holder of the Company s subordinated debt and a party to the Company s Preferred Stock Purchase Agreement, which is described below.

As of November 24, 2006, the Company had used approximately $3,208,000 of the availability under the PNC Agreement for international letters of credit.

Equity Line

On April 7, 2006, the Company entered into a Preferred Stock Purchase Agreement (the Equity Agreement) with Mr. Lenfest, a Director, significant shareholder and holder of the Company s subordinated debt. The Equity Agreement permits ETC to unilaterally draw down up to $15 million prior to October 2007 in exchange for shares of the Company s newly-created Series B Cumulative Convertible Preferred Stock (Preferred Stock). The Preferred Stock provides for a dividend equal to six percent per annum. After three years, the Preferred Stock will be convertible, at Mr. Lenfest s request, into ETC common shares at a conversion price (the Conversion Price) which will be set on the day of each draw down. The Conversion Price will be equal to the closing price of the Company s common stock on the trading day immediately preceding the day in which the draw down occurs, subject to a floor price of $4.95 per common share. Drawdowns are not permitted on any day when the Conversion Price would be less than this floor price. On the sixth anniversary of the Equity Agreement, any issued and outstanding Preferred Stock will be mandatorily converted into ETC common stock at each set Conversion Price. The Equity Agreement also allows for the Company to redeem any outstanding Preferred Stock any time within the six-year term of the Equity Agreement. The Preferred Stock is entitled to vote with the ETC common stock on an as converted basis.

In connection with the execution of the Equity Agreement, in April 2006 the Company drew down $3 million by issuing 3,000 shares of Preferred Stock with a Conversion Price equal to $4.95 per share. Additionally, on July 31, 2006, the Company drew down an additional $3 million by issuing 3,000 shares of Preferred Stock at a Conversion Price equal to $6.68 per common share.

Environmental Tectonics Corporation

Notes to Consolidated Financial Statements, continued

(amounts in dollars, except where noted and share and per share information)

(unaudited)

Unsecured Promissory Note

On November 16, 2006, the Company executed an Unsecured Promissory Note (the Lenfest Note) in favor of H.F. Lenfest in the aggregate principal amount of $3,000,000. Pursuant to the terms of the Lenfest Note, ETC can borrow up to $3,000,000, in increments of $1,000,000, prior to the maturity date of October 6, 2007. On November 17, 2006, ETC borrowed $3,000,000. The Lenfest Note plus all accrued interest was repaid in full on December 13, 2006.

All outstanding and unpaid interest on the Lenfest Note is due and payable on the earlier of (i) October 6, 2007 or (ii) such date as ETC draws down funds sufficient to repay the amount due under the Lenfest Note pursuant to the Preferred Stock Purchase Agreement, dated as of April 6, 2006, between ETC and Mr. Lenfest.

Borrowings made pursuant to the Lenfest Note will bear interest at an annual rate of six (6%) percent with such interest beginning to accrue on the date of the funding of each loan and, to the extent not paid, compounding on the first day of each month.

The Lenfest Note provides for customary events of default including, but not limited to, the nonpayment of any amount payable when due, certain bankruptcy, insolvency or receivership events and the imposition of certain judgments. Upon the occurrence of an event of default, Mr. Lenfest has the right to accelerate the maturity date of the Lenfest Note and demand immediate payment of all amounts payable there under.

Subordinated Convertible Debt

In connection with the financing provided by PNC Bank on February 19, 2003, the Company entered into a Convertible Note and Warrant Purchase Agreement with Mr. Lenfest pursuant to which the Company issued to Mr. Lenfest (i) a senior subordinated convertible promissory note (the Senior Subordinated Note) in the original principal amount of $10,000,000 and (ii) warrants to purchase 803,048 shares of the Company s common stock. Upon the occurrence of certain events, the Company would be obligated to issue additional warrants to Mr. Lenfest. The Senior Subordinated Note accrues interest at the rate of 10% per annum (Mr. Lenfest has reduced the rate to 8% on a temporary basis for the period December 1, 2004 through November 30, 2006) and matures on February 18, 2009. At the Company s option, the quarterly interest payments may be deferred and added to the outstanding principal. The Senior Subordinated Note entitles Mr. Lenfest to convert all or a portion of the outstanding principal of, and accrued and unpaid interest on, the note into shares of common stock at a conversion price of $6.05 per share. The warrants were exercisable into shares of common stock at an exercise price equal to the lesser of $4.00 per share or two-thirds of the average of the high and low sale prices of the common stock for the 25 consecutive trading days immediately preceding the date of exercise.

The obligations of the Company to Mr. Lenfest under the Convertible Note and Warrant Purchase Agreement are secured by a second lien on all of the assets of the Company, junior in rights to any lien (if any is in place) in favor of PNC Bank, including all real property owned by the Company.

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Notes to Consolidated Financial Statements, continued

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Subordinated Convertible Debt Discount

In fiscal 2003, the Company recorded $2,609,000 in additional paid-in capital representing an allocation of the proceeds from the convertible debt element of its financing with PNC Bank and Mr. Lenfest. This allocation represented the value assigned to the beneficial conversion option of the Senior Subordinated Note and the value of the associated warrants. Such values were derived pursuant to an independent appraisal of these financial instruments obtained by the Company. Accreted interest expense related to the beneficial conversion option and the warrants were $116,000 and $333,000 for the thirteen and thirty-nine week periods ending November 24, 2006, respectively, and $384,000 in fiscal 2006.

As a condition of amending the PNC Agreement on August 24, 2004, Mr. Lenfest agreed to issue to PNC Bank on the Company s behalf a limited guarantee to secure up to $5,000,000 in principal amount of any letters of credit issued under the amended facility. In consideration for issuing this guarantee, Mr. Lenfest receives a fee of 0.75% per annum of the average amount of letters of credit outstanding, payable on a quarterly basis, and did receive a warrant to purchase 200,000 shares of common stock under the same terms and conditions as his warrant to purchase 803,048 shares of common stock.

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

Long-Term Bonds

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

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

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Notes to Consolidated Financial Statements, continued

(amounts in dollars, except where noted and share and per share information)

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Liquidity

At any particular time, the Company s cash position is affected by the timing of cash receipts for milestone payments on open orders, product sales and maintenance services and its payments for inventory and operating expenses, including legal expenses, resulting in significant quarter-to-quarter, as well as within a quarter, fluctuations in the Company s cash balances. The Company faces increased liquidity risk if it does not receive cash flow from operating activities as planned. The Company s principal sources of liquidity are its cash balances, cash from operations and its promissory note and equity line with Mr. Lenfest. As of December 29, 2006, the Company had available a total of $9,000,000 under the promissory note and equity line with Mr. Lenfest and approximately $1,800,000 available under the Letter of Credit line with PNC. Given the Company s lack of an operating facility with PNC Bank and certain restrictions in the Equity Agreement, the Company may need to obtain additional sources of capital in order to continue growing and operating its business. This capital may be difficult to obtain and the cost of this additional capital is likely to be relatively high. However, because the Company has established businesses in many markets, significant fixed assets including a building, and other valuable business assets which can be used for security, the Company believes that it will be able to locate such additional capital and that the actions by PNC Bank will not have a long-term material adverse effect on its business.

The Company s plans project that its current cash resources, including cash on hand, its promissory note and equity line with Mr. Lenfest, and cash to be generated from operating activities should be adequate for at least the next twelve months. The Company s plans assume customer acceptances and subsequent collections from a few large customers, as well as cash receipts on new bookings.

In reference to the Company s outstanding claims with the U.S. Navy, to the extent the Company is unsuccessful in recovering a significant portion of recorded claim contract costs, and to the extent that significant additional legal expenses are required to bring the dispute to resolution, such events could have a material adverse effect on the Company s liquidity and results of operations. Historically, the Company has had favorable experience in that recoveries have exceeded recorded claims, including significant settlement agreements in fiscal 2003, 2004 and 2005. (See Note 2 to the Consolidated Financial Statements, Accounts Receivable).

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5. Segment Information:

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

	ATS	**Industrial Group**	**Total**
	(amounts in thousands)		
Thirteen weeks ended November 24, 2006			
Net Sales	**$2,533**	**$2,185**	**$4,718**
Interest Expense	**217**	**74**	**291**
Depreciation and Amortization	**214**	**238**	**452**
Operating Loss	**(847)**	**(497)**	**(1,344)**
Income Tax	**4**		**4**
Goodwill and Intangibles	**455**		**455**
Identifiable Assets	**22,577**	**6,629**	**29,206**
Expenditures For Segment Assets	**29**	**1**	**30**
Thirteen weeks ended November 25, 2005			
Net Sales	$3,605	$2,601	$6,206
Interest Expense	223	98	321
Depreciation and Amortization	244	189	433
Operating Loss	(467)	(285)	(752)
Goodwill and Intangibles	477		477
Identifiable Assets	16,245	7,177	23,422
Expenditures For Segment Assets	18	7	25

	Thirteen weeks ended November	**Thirteen weeks ended November**

	24, 2006	**25, 2005**
Reconciliation to consolidated amounts		
Segment Assets	$29,206	$23,422
Corporate Assets	9,234	12,178
Total Assets	$38,440	$35,600
Segment operating loss	$(1,344)	$(752)
Less interest expense	(291)	(321)
Less income tax	(4)	
Total loss for segments	(1,639)	(1,073)
Corporate home office expenses	(237)	(234)
Interest and other expenses	43	(10)
Income tax		(4)
Minority interest	(33)	(6)
Net loss	$(1,866)	$(1,327)

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	ATS	Industrial Group	Total
	(amounts in thousands)		
Thirty-nine weeks ended November 24, 2006			
Net Sales	**$7,951**	**$5,671**	**$13,622**
Interest Expense	**635**	**222**	**857**
Depreciation and Amortization			