



To Our Shareholders:

This past year was an exciting year for your company. We introduced more new products and technology than ever in our past. Ours is a company of the future. In this letter, I will review our many accomplishments and our plans for the future.

Advanced Tactical Flight Simulation

In fiscal 2004, we unveiled the Authentic Tactical Flight Simulator for high performance tactical maneuvering jet aircraft -- Model ATFS-400-- with a First Flight Celebration last November. This is the world's first high fidelity tactical simulator integrated into a high performance human centrifuge. Flying in the ATFS-400, pilots and weapons systems officers learn to handle their aircraft and control their flight systems while simultaneously experiencing the physical stress of high G-forces in a tactical engagement as well as the mental stress of high fidelity threat simulation. To demonstrate the capability of the ATFS-400 we sponsored the "Orange Flag" event at ETC in January 2004. Orange Flag was an open competitive air combat exercise between fighter pilots from several nations as well as the US Air Force, Navy and Marine Corps. We installed the F/A-18 "Hornet" Tactical Aircraft Configuration (TAC) Module in the GFET II centrifuge. We then linked it interactively with the MIG 29 TAC Module installed in a non-motion "docking station". This week of one-on-one dogfights involving more than 50 pilots demonstrated, beyond question, that the ATFS technology works - and offers a risk-free way to introduce simulated tactical maneuvers at a cost advantage of twenty to one as compared with airborne training.

We have invested significantly in the development of ATFS and its supporting technologies. The ATFS-400 will revolutionize military flight training in the future. We already have seen interest from the U.S. Government and several foreign military organizations. The ATFS-400 will significantly reduce training costs, increase flight safety and improve pilot performance. When deployed with the U.S. operational forces, the ATFS-400 can save the U.S. Government over \$2 billion per year, minimize

human risk, preserve the high-value aircraft and give the air warriors more authentic experience. By investing in the ATFS-400 military air forces of allied nations around the world will gain the benefit of realistic risk-free training and the savings from using simulators, just as the commercial airlines have been doing for many years.

The potential tactical flight simulator market is both large and worldwide. ATFS-400 moves us into a unique position in the forefront of that market.

Aircrew Training Systems

The Aircrew Training Systems Division has made significant technical advancements in several of its products. ATS currently markets the following products:

Centrifuges

- G-LAB[®]
- G-FET II[™]
- ATFS100, 200, 300, 400

Spatial Disorientation Trainers

- GYROLAB[®] 1500 and GYROLAB 4000
- GYRO IPT II

Night Vision/Night Vision Goggle Training System (NVTS/NVGTS)

Ejection Seat Trainers

Altitude (Hypobaric) Chambers

Simulators

- GL-2500
- GYROFLIGHT and GYROFLIGHT HELO
- GAT II[®] and GAT[®] HELO
- ProTrainer[™]

Survival Training Systems

- Water Survival Training Systems
- Parachute Procedures Trainer (SIMFALL)
- Pilot Selection System

Significant product development has been made during this past year in the GYRO IPT II, the NVTS/NVGTS, and ProTrainer. The GYRO IPT II was redesigned to incorporate ETC's a proprietary Flight Motion System, a larger cockpit, and a wide field of view visual display. Software efforts produced a more powerful profile editor and a user-friendly user interface. The NVTS/NVGTS was refined to become a fully automated, computer based system. A powerful training session editor was



added to give customers the ability to modify the existing training sessions or to create new sessions

Sales for fiscal 2004 were strong in the GYRO IPT II, NVTS/NVGTS and GAT II product lines. GYRO IPT II sales and deliveries included Venezuela, Australia, Czech Republic and the United States Air Force. NVTS/NVGTS sales included the Egyptian Air Force and Indonesia. GAT II sales included Frederick Flight Center, University of North Dakota, U.S.A.F., and the Federal Aviation Administration Civil Aerospace Medical Institute (CAMI). Our Advanced Pilot Selection System was sold to the Egyptian Air Force.

We recently received an initial contract from NASA for work in the field of upset training. Upsets, the leading cause of transport aircraft fatalities, have been a key interest of ETC for several years. In spite of the seriousness of the problem, no authentic training has been available to the more than 200,000 professional pilots worldwide. ETC is uniquely positioned to help solve this with its authentic sustained motion simulators and knowledge base for authentically simulating extreme in-flight conditions. The NASA contract indicates their interest in proving the training concept and contacts are on-going and encouraging with the FAA as well.

Entertainment

Our Entertainment Group, EnTCo, has had a terrific year and is well positioned to take advantage of a rebound in the economy. Our customers are experiencing an increase in traffic at their parks, museums and zoos and this will undoubtedly lead to greater investment in new attractions. Given our investment in new rides and platforms, we anticipate making some major breakthroughs during fiscal 2005.

During fiscal 2004 we aggressively marketed our capabilities to the amusement/theme park, family entertainment center, museum, zoo, aquarium and shopping mall marketplaces worldwide. As a result of our marketing investments, we have experienced an exponential increase in new proposal activity.

Despite the sluggish travel and tourism industry, during fiscal 2004 we developed two new rides of our own, and we are now beginning to see the fruits of our labor. We have secured our first few orders for each of these exciting new products and the market reception has been overwhelming. At the time of this letter, we have installed the Wild Earth ride in two new venues with several more to be announced in fiscal 2005; meanwhile, we've secured orders for several Monster Roll Cage™ (Monster Truck Ride) that are to be delivered over fiscal years 2005 and 2006. Given the budgeting cycles associated with most of our clients, we anticipate even greater return on our investment in fiscal 2006 and beyond.

Simulation Division

In the area of Airport Driving Simulators, ETC Simulation experienced two significant events last fiscal year. The first was the acceptance and commissioning of the Minneapolis-St. Paul International Airport Driving Simulator which, because of the excellent relationship between the Metropolitan Airports Commission and ETC, will serve as a showcase for our training system and future marketing efforts. The second major event was the award to ETC by the Metropolitan Nashville Airport Authority for an Airport Driving Simulator, which established ETC as the leading supplier of this training system in the U.S. The Nashville contract calls for an additional, 3-display Desktop Driving Station, which will enable ETC to also appeal to smaller airports. The Desktop Driving Station will operate in an interactive team mode with the Driving Simulator Cab, enabling both drivers to maneuver in the same environment viewing each other's vehicles. This is another technological advance for ETC's Driving Simulators.

In the area of ETC's Advanced Disaster Management Simulator (ADMS), we made an important breakthrough this year in the U.K. Fire Service market with the receipt of a contract from the Warwickshire Fire and Rescue Service (WFRS) for an ADMS Desktop Unit that meets the requirements of the newly-adopted Integrated Personnel Development System (IPDS). This training system, due for commissioning in early fall of 2004, will be the only training system available that uses simulation to assess Fire Service personnel to the IPDS standards, opening up a tremendous market for ETC's ADMS product line.

ETC Simulation's goals for this fiscal year are to continue their growth and presence in the markets they serve. The overall strategy is to perform contracts that will continually advance the capabilities of the ADMS, both with new customers and with our already established customer base. Following commissioning of the ADMS-IPDS for Warwickshire, we will jointly (ETC and WFRS) obtain national certification of the ADMS as an accepted training/assessment system for the IPDS, thereby placing ETC in the prime position for the provision of ADMS-IPDS to the U.K.'s 69 regional fire services. ETC will continue to focus on the U.S. market for ADMS, particularly airports, state fire colleges, seaports, Homeland Defense and other government agencies.



Sterilizers

This past year ETC Sterilization Group completed the fabrication of five 100% Industrial Ethylene Oxide (EtO) sterilization systems. The units are various sizes ranging from 400 cu. ft. to 6,000 cu. ft. The 6,000 cu. ft. unit can accommodate 26 standard product-loaded pallets at one time.

The sterilizers feature ETC's unique Air Jacket Heating/Cooling (AJHC) System. AJHC technology not only helps to avoid the costly maintenance and repairs commonly associated with traditional water-jacketed vessels, it also maintains superior temperature distribution throughout the chamber, thus providing better overall performance and substantial energy savings. On these sterilizers we introduced ETC's custom-designed Pro-Genesis[®] Series 2000 PC/PLC Distributed Control System which is the most sophisticated sterilization control and data acquisition system in the world. These controls execute all process control and data retrieval. The system also utilizes a dedicated server that will retrieve, store and secure all cycle data insuring compliance with 21 CFR Part 11 requirements. This cutting edge control application utilizes fiber optics technology to safely access all required process and control data from the equipment suites. The use of fiber optics not only optimizes signal quality and safety, it also eliminates the need to install extensive and costly facility wiring and large, space-consuming intrinsic barrier boxes. These technologies continue to support ETC sterilizers as the leading supplier of (EtO) sterilization systems.

The demand for our steam sterilizers, CGMP steam sterilizers and field service support in the pharmaceutical, life sciences and biotech industries was consistent in fiscal 2004. We continue to differentiate ourselves through our ability in working closely with our customers to refine each unit while providing optimal field performance. We have added additional sales resources to further expand our market potential and overall sales objectives in fiscal 2005.

Biomedical

ETC's BioMedical Systems (BMS) Group has generated renewed interest in our BARAMED[®] monoplace hyperbaric chambers and hyperbaric product line. Sales included six monoplace chambers to international customers and a similar number to domestic customers this year. ETC is the only hyperbaric system company providing a computer-controlled chamber that allows for control, data acquisition and safety monitoring.

ETC has recently received contracts for three multiplace hyperbaric chambers. This procurement is through the U.S. Army Corps of Engineers and a company in the United States that is under contract with the Egyptian Navy. The contracts re-establishes ETC as a leader in the design and supply of multiplace hyperbaric chambers worldwide.

Testing and Simulation Systems (TSS)

Fiscal 2004 saw the second year of a major reorganization and staff enhancement for ETC's Testing & Simulation Division. Two years ago we made a commitment to invest in key experienced staff to expand and upgrade the capabilities of this group. As part of this investment, we hired seven highly experienced individuals with directly relevant backgrounds in sales, engineering, field installation and start up capabilities. They are all professionals committed to quality and customer service. None of our competition has as much experience in automotive testing as ETC. A key area of market focus is on the Original Equipment Manufacturer (OEM) and Tier 1 and Tier 2 automotive system and component manufacturers. We recently received orders from Mercedes Benz and Honda for 4-Post Drive-in Environmental Testing Chambers for "squeak and rattle" testing of vehicles under real-life conditions. ETC is working together on these projects with the two largest automotive servo-hydraulic simulation companies in the world, MTS and IST.

TSS has also received a follow-on order for the next two phases of an engine development facility for an IRL racing engine manufacturer. ETC is providing a turnkey project to supply environmentally conditioned air-to-test engines in three new Engine Development Dynamometer Test Cells. This order includes the move and installation of previously supplied ETC equipment including an Altitude Simulation System.

Additionally, TSS has recently received an order for an Environmental Test Chamber that will be used to test the M-1 tank transmission that will be running on a dynamometer. The Test Chamber will have the capability to simulate any environment found anywhere in the world.

TSS has teamed up with Horiba, the largest emissions testing supplier in the world, to provide a turnkey diesel engine emissions testing facility expansion, designed to meet the new EPA CY-2007 emissions regulations. The customer, a Japanese automotive manufacturer, has selected the team of Horiba and ETC for this first phase of their expansion in the Detroit area.



The TSS group has now positioned itself to be able to compete in the supply of test equipment, where the competition is from medium size companies rather than very small companies, thus enabling the group to achieve better margins. This change will now enable the group to team up with key suppliers to offer comprehensive solutions to the automotive testing market. This is evidenced by the above-mentioned orders received in partnership with MTS and IST. Similarly TSS group is in process of securing another such order from Nissan in partnership with AVL and one at Isuzu in partnership with Horriba.

TSS is expanding its market share in the international market, especially in the Far East and Europe. The opening up of a TSS group Europe office has enabled it access to not only EU countries, but also to Asian markets, where EU manufacturers are in the process of setting up new facilities.

ETC Turkey

ETC Turkey has supplied ETC's Alesta Disaster Management software to the Afyon Municipality in Turkey. This software is an extension of the ADMS Advanced Disaster Management Simulation software and allows the municipality to monitor disaster data and control resources on a real time basis. It is the first system of its kind in Turkey. We expect to be introducing this system to the other municipalities in Turkey in fiscal 2005. ETC Turkey has also received two grants from the Turkish government for the continuing development of Alesta and centrifuge based flight simulation.

ETC Poland

ETC Poland is a key factor in the implementation of ADMS software and flight simulation. They developed BattleSpace, flight models and the GeoSpecific software used on our ATFS-400 during the Orange Flag demonstration in January 2004. They, along with ETC Turkey, are developing the ETC core software that will be used in all of our simulation products. This core software has been a major investment of ETC over the last few years. This core software was first utilized late in fiscal 2004. We expect to see significant product improvements and cost savings in software development utilizing our core software going forward. ETC Poland is the major supplier of simulation products and technology to the Polish government. They are negotiating several significant simulation projects both in Poland and internationally.

Corporate Governance

Our Board members and senior staff were very busy in fiscal 2004. We created and adopted an Insider Trading Policy, a Whistleblower Policy, a Company Code of Ethics, and a Code of Ethics for the Chief Executive Officer and Senior Financial Officers. Additionally, we adopted three Board of Directors Committee Charters including an amended and restated Audit Committee Charter, a Compensation Committee Charter, and a Nominating and Governance Committee Charter. I want to issue a warm thank you to all the Board members who helped create these policies and especially recognize the efforts of Mr. Howard W. Kelley for his ongoing efforts ensuring ETC maintains compliant with continually changing government rules and regulations.

Unfortunately I must end this year's letter on a sad note. Cliff G. Russell, ETC's Vice-President and General Counsel for the past 11 years, passed away on July 26, 2004. Cliff was a prolific and tireless attorney of the highest moral integrity. He was a key member of our executive management staff and a personal friend. He will always be remembered.

William F. Mitchell
Chairman and CEO



Report of Independent Registered Public Accounting Firm

Board of Directors and
Shareholders of Environmental Tectonics Corporation

We have audited the accompanying consolidated balance sheets of Environmental Tectonics Corporation and Subsidiaries as of February 27, 2004 and February 28, 2003, and the related consolidated statements of operations, changes in stockholders' equity, and cash flows for each of the three fiscal years in the period ended February 27, 2004. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits 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 audits provide 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 Environmental Tectonics Corporation and Subsidiaries as of February 27, 2004 and February 28, 2003, and the consolidated results of its operations and its cash flows for each of the three fiscal years in the period ended February 27, 2004, in conformity with accounting principles generally accepted in the United States of America.

We have also audited the accompanying Schedule II of Environmental Tectonics Corporation and Subsidiaries as of February 27, 2004 and February 28, 2003 and for each of the three fiscal years in the period ended February 27, 2004. In our opinion, this schedule presents fairly, in all material respects, the information required to be set forth herein.

As discussed in Note 1 to the consolidated financial statements, the Company has recorded receivables in the amount of \$5.5 million related to claims made to or against the United States government and an international customer for contract costs incurred through February 27, 2004. The total net claims amount made is approximately \$26.9 million based on costs incurred through February 27, 2004, and is subject to negotiation, arbitration and audit by the United States government and the international customer.

As discussed in note 1 to the consolidated financial statements, the Company adopted Statement of Financial Accounting Standards No. 142, Goodwill and Other Intangible Assets, on February 23, 2002.

Grant Thornton LLP

/s/ Grant Thornton LLP
Philadelphia, Pennsylvania
April 28, 2004



FINANCIAL REVIEW

(\$ in thousands, except share and per share data)

Fiscal Year End	2004	2003	2002	2001	2000
Net sales	\$25,995	\$43,123	\$32,527	\$32,452	\$34,920
Gross profit	9,943	14,198	11,465	13,075	12,798
Operating income	131	4,116	2,873	4,122	5,327
Net (loss)/ income	(793)	2,493	1,741	2,021	2,873
(Loss)/earnings per common share:					
Basic	(.11)	.35	.24	.29	.40
Diluted	(.11)	.33	.23	.27	.36
Working capital	29,907	31,216	30,683	25,070	16,306
Long-term obligations	12,157	12,643	16,688	12,778	4,455
Total assets	48,696	47,698	48,482	40,705	31,897
Total stockholders' equity	25,054	25,907	20,782	18,796	16,245
Weighted average common shares:					
Basic	7,163,000	7,153,000	7,143,000	7,087,000	6,604,000
Diluted	7,163,000	7,497,000	7,499,000	7,499,000	7,319,000

All earnings per share and share amounts have been restated to reflect a 2-for-1 stock split effective May 28, 1999. No cash dividends have ever been paid on the Company's common stock, and the Company is prohibited from declaring any cash dividends on its common stock under the terms of its existing credit facilities.



Forward-Looking Statements

This Annual Report on Form 10-K includes forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. These forward-looking statements are based on the Company's current expectations and projections about future events. These forward-looking statements are subject to known and unknown risks, uncertainties and assumptions about the Company and its subsidiaries that may cause actual results, levels of activity, performance or achievements to be materially different from any future results, levels of activity, performance or achievements expressed or implied by such forward-looking statements.

These forward-looking statements include statements with respect to the Company's vision, mission, strategies, goals, beliefs, plans, objectives, expectations, anticipations, estimates, intentions, financial condition, results of operations, future performance and business of the company, including but not limited to, (i) projections of revenues, costs of raw materials, income or loss, earnings or loss per share, capital expenditures, growth prospects, dividends, capital structure, other financial items and the effects of currency fluctuations, (ii) statements of our plans and objectives of the Company or its management or Board of Directors, including the introduction of new products, or estimates or predictions of actions of customers, suppliers, competitors or regulatory authorities, (iii) statements of future economic performance, (iv) statements of assumptions and other statements about the Company or its business, and (v) statements preceded by, followed by or that include the words, "may," "could," "should," "looking forward," "would," "believe," "expect," "anticipate," "estimate," "intend," "plan," or the negative of such terms or similar expressions. These forward-looking statements involve risks and uncertainties which are subject to change based on various important factors. Some of these risks and uncertainties, in whole or in part, are beyond the Company's control. Factors that might cause or contribute to such a material difference include, but are not limited to, those discussed in the Company's Annual Report on Form 10-K, in the section entitled "Risks Particular to Our Business." Shareholders are urged to review these risks carefully prior to making an investment in the Company's common stock. The Company cautions that the foregoing list of important factors is not exclusive. The Company does not undertake to update any forward-looking statement, whether written or oral, that may be made from time to time by or on behalf of the Company.

Management's Discussion & Analysis of Financial Condition & Results of Operations

Overview

We are principally engaged in the design, manufacture and sale of software driven products used to create and monitor

the physiological effects of motion on humans and equipment and to control, modify, simulate and measure environmental conditions. These products include aircrew training systems, entertainment products, sterilizers, environmental and hyperbaric chambers and other products that involve similar manufacturing techniques and engineering technologies.

The following factors had an adverse impact on our performance for the fiscal year ended February 27, 2004:

- Unfavorable global economic and political conditions;
- Completion in the prior period of a major entertainment contract;
- Increased product development costs;
- Integration costs of new personnel in environmental business;
- Higher costs of capital;
- Customer induced shipping delays.

During fiscal 2004, our sales efforts were hampered by continuing unfavorable global economic and political conditions. We saw many of our potential new contracts delayed by budget constraints and delays of our customers located throughout the world. This was especially true in our Aircrew Training Systems business, where most of the sales are to international customers. Sales in our entertainment business declined as a result of the completion in fiscal 2003 of our contract with Walt Disney World for the amusement ride Mission:Space for Epcot Center in Florida. Disputes related to this contract, which was reduced in scope and prematurely terminated by the customer, are the subject of current litigation. In fiscal 2004, our entertainment business did not replace this business with new projects to offset the decrease in revenues from fiscal 2003. In fiscal 2005, our entertainment business has started several new projects that will result in increased revenues over fiscal 2004. However, we do not at this point have sales backlog in this segment of our business to ensure that revenues from our entertainment business will return to the levels we experienced in fiscal 2003. We believe that our entertainment business remains one of the areas where we will continue to experience growth in our business.

In many of our product lines, especially sterilizers and environmental products, we must wait for new building or major plant expansion construction to finalize our contracts. Delays in construction schedules lead to delays in our ability to ship and install what are basically complete devices. Fiscal 2004 saw numerous examples of these and other customer delays, including government paperwork complications and procedural issues. In the environmental line, we made a significant investment in new personnel, hiring the key former employees from a competitor, although under a legal settlement we were restricted from any major sales effort until January 1, 2004. Since the restriction has been lifted, we have seen an increase in new business generated by the new sales employees. Additionally, given the highly technical skills of the new service and installation staff, we anticipate an increase in efficiency that will result in faster, less



costly installations of environmental equipment.

Fiscal 2004 also saw the culmination of over 30 years of our work with aeromedical technology with the introduction of our Authentic Tactical Flight Simulator ("ATFS") and significant enhancements to our GAT and Gyro-IPT family of flight trainers. The evolution of these exciting and state-of-the-art technologies is an important step in our goal of integrating flight and aeromedical training in a simulator device. This technology allows a fighter pilot to practice tactical air combat maneuvers such as dodging enemy missiles, ground fire and aircraft obstacles while experiencing the real life environment of a high-G Force fighter aircraft. These flight trainers provide a low cost and extremely less risky alternative to actual air flight. We believe that armed forces agencies of various governments will appreciate the efficiency of these technologies, especially in this time of fiscal conservatism and budgetary constraints throughout the world.

One of the greatest challenges we face is adequately capitalizing our business. Many of our projects are capital intensive and our business requires us to have a substantial amount of available capital in order to increase our sales. As a result of our February 2003 financing, we received a sufficient amount of capital to allow us to operate and continue to grow our business. However, in fiscal 2004, as a result of this refinancing, our costs of capital, namely interest payments on our subordinated debt, increased dramatically over fiscal 2003. Our liquidity and capitalization improved in fiscal 2004 when we reached a final settlement on a long-standing contract dispute with an international customer pursuant to which we received \$10.5 million subsequent to February 27, 2004. This settlement contributed approximately \$2.3 million to our pre-tax income for fiscal 2004. Subsequent to fiscal year end, PNC Bank advised us that it was considering certain changes to the revolving credit facility including reducing the total facility and requiring us to cash collateralize some or all of the facility. As of the filing date of this Annual Report on Form 10-K, these discussions were still ongoing. In the event that PNC Bank takes these actions, we may need to obtain additional sources of capital in order to continue growing our business. We believe that we will be able to locate such additional sources of capital and that any such action by PNC Bank will not have a long-term material adverse effect on our business.

In addition, we face the following challenges and business goals in order to make fiscal 2005 a successful year:

- Sell through all the products we technologically enhanced in fiscal 2004. During fiscal 2004 we invested heavily in enhancing functionality and product capability of three ATS products: - our centrifuge-based flight simulator - our General Aviation Trainer (GAT) and - our Gyro-IPT. Repeat sales of these state-of-the-art simulators will allow us to recoup non-recurring engineering and design effort.
- Continue to evolve Advanced Tactical Flight Simulation (ATFS). Our challenge will be to find funding to continue this

critical development objective, either through U.S. government grants or a customer order.

- Re-engineer the products in our ATS group to remain competitive. The initial development and engineering required to integrate the latest technology into existing products is a costly process. We need to follow through to evaluate and eliminate duplicate processes, materials, etc., in order to remain cost competitive.
- Standardize the environmental line of products. Estimating the engineering effort and production costs of custom products is risky and often significantly under budgeted. To alleviate some of the variables in the process, we need to, as much as is possible given the technology and application, develop and sell standard modular-based offerings with a range of functionality.
- Expand the entertainment line by repeat sales and the introduction of story line enhancements. Fiscal 2004 saw the introduction of a new amusement ride directed towards the location-based entertainment and educational markets. Initial reaction from customers has been very favorable with multiple units sold. In fiscal 2005, we need to aggressively pursue the large venues of zoos and museums and to expand our story line based offerings.
- Expand the South American market. In the mid-1980's we sold many altitude chambers and other ATS products in South America. Since then, deteriorating political and economic conditions have severely restricted international business with most countries in this continent. In fiscal 2004, we received the first new significant order from this area since many years ago. We need to find creative financing alternatives for our customers in this area if we are to properly cultivate this market.
- Settle at least one major claim. At February 27, 2004, we had two significant claims outstanding totaling \$5.5 million. To the extent we can settle either or both of these claims, we may receive significant cash payments that will improve our liquidity position and allow us to grow our business.

Revenue Recognition

We currently market our products and services primarily through our sales offices and employees. In addition, we also utilize the services of approximately 100 independent sales agents and organizations in seeking foreign orders for our products. We generally customize our products using our proprietary software based on specifications provided by our customers. Many of these products are capital intensive and take more than one year to manufacture and deliver to the customer. In the ATS segment, we sell our Aircrew Training Devices to military and commercial airline operators both in the United States and internationally. We sell our Entertainment products to amusement parks,



zoos and museums. We sell our Disaster Management Simulation products to state and local governments. In our Industrial Group, we sell our sterilizers to pharmaceutical and medical device manufacturers. We sell our Environmental systems primarily to commercial automobile manufacturers and heating, ventilation and air conditioning (HVAC) manufacturers and our Hyperbaric products to the military (mainly larger chambers) and hospitals and clinics (mainly monoplace chambers). To a lesser degree, we provide upgrade, maintenance and repair services for our products and for products manufactured by other parties.

The Company recognizes revenue using three methods:

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

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

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

In accordance with accounting principles generally accepted in the United States 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 esti-

mate the amount of additional contract revenue. However, revenue recorded on a contract claim cannot exceed the incurred contract costs related to that claim. Claims are subject to negotiation, arbitration and audit by the customer or governmental agency.

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

Critical Accounting Policies

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

Critical accounting policies are defined as those that reflect significant judgments and uncertainties, and potentially result in materially different results under different assumptions and conditions. The Company believes that its critical accounting policies include those described below. For a detailed discussion on the application of these and other accounting policies, see Note 1 to the Consolidated Financial Statements, Summary of Significant Accounting Policies.

Revenue Recognition on Long-Term Contracts

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

The Company accounts for some its largest contracts,



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

Accounts Receivable

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

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. 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.

Results of Operations

Fiscal 2004 versus Fiscal 2003

The Company had a net loss of \$793,000 or \$.11 per share (diluted) in 2004 versus net income of \$2,493,000 or \$.33 per share (diluted) in fiscal 2003. Operating income was \$131,000, a decrease of \$3,985,000 or 96.8% over 2003. This decrease was primarily the result of reduced gross profits due to lower sales volume, primarily in domestic entertainment sales, partially offset by lower research and development expenses.

Sales (\$000 except for %)

	Domestic		Government		International		Total	
	\$	%	\$	%	\$	%	\$	%
Fiscal Year 2004	8,856	34.1	1,717	6.6	15,422	59.3	25,995	100.0
Fiscal Year 2003	23,692	54.9	4,626	10.8	14,805	34.3	43,123	100.0

Total sales in fiscal 2004 were \$25,995,000, a decrease of \$17,128,000 or 39.7% over 2003, representing decreases in entertainment (\$16,998,000), hyperbaric (\$1,519,000) and environmental (\$1,701,000). Entertainment suffered from the completion in fiscal 2003 of a large project. Hyperbaric sales reflected reduced effort on a large US government submarine decompression chamber project. Environmental sales were down in the current period as fiscal 2003 reflected significant sales for large chamber projects in China. Providing partial offsets were increased sales for domestic sterilizers (up \$1,662,000) and higher International Aircrew Training Systems (up \$1,702,000) primarily for International Logistics Services (equipment upgrades and maintenance on various aeromedical equipment). Geographically, domestic sales were down \$14,835,000 or 62.6%, and represented 34.1% of total sales, down from 54.9% in fiscal 2003, primarily reflecting decreased entertainment activity. U.S. government sales decreased to \$1,717,000, as compared to \$4,626,000 in fiscal 2003, and represented 6.6% of total sales, down from 10.8% of total sales in fiscal 2003. International sales, including those from the Company's foreign subsidiaries, were up \$616,000 or 4.2%, and represented 59.3% of total sales, up from 34.3% in fiscal 2003, primarily reflecting an increase in ATS sales. Throughout the Company's history, most of the sales for Aircrew Training products have been made to international customers.

Customers representing 10% or more of sales in fiscal 2004 were the Royal Malaysian Air Force, \$2,874,000 or 11.1%, and the United Kingdom Ministry of Defense, \$2,840,000 or 10.9%. In fiscal 2004, international sales totaling at least \$500,000 per country were made to customers in Malaysia, the United Kingdom, Indonesia, Venezuela, Egypt, Nigeria, Thailand, China and Norway. Fluctuations in sales to international countries from year to year primarily reflect percentage of completion revenue recognition on the level and stage of development and production on multi-year long-term contracts. Open orders for the Royal Malaysian Air Force and a foreign customer constituted 19.4% and 20.0% respectively of the Company's backlog at February 27, 2004. For a discussion of the



additional risks associated with our international operations, see "Risks Related to Our Business-There are certain risks inherent in our international business activities, which constitute a significant portion of our business," in our Annual Report on Form 10-K.

Segment Sales (\$000 except for %)

	Aircrew Training Systems		Industrial Group		Total	
	\$	%	\$	%	\$	%
Fiscal 2004	15,880	61.1	10,115	38.9	25,995	100.0
Fiscal 2003	31,612	73.3	11,511	26.7	43,123	100.0

On a segment basis, sales of the Company's ATS products, which create and monitor the physiological effects of motion (including spatial disorientation and centrifugal forces) on humans and equipment for medical, training, research and entertainment markets, were \$15,880,000 in fiscal 2004, a decrease of \$15,732,000, or 49.8% over fiscal 2003. Sales of these products accounted for 61.1% of the Company's sales compared to 73.3% in fiscal 2003. The decrease in ATS product sales primarily reflected the completion in the prior period of a major entertainment contract. Sales in the Company's other segment, the Industrial Group, which designs and produces chambers that create environments that are used for sterilization, research and medical applications, decreased \$1,396,000 to \$10,115,000, a decrease of 12.1%, and constituted 38.9% of the Company's total sales compared to 26.7% in fiscal 2003.

Significant claims outstanding at February 27, 2004 included a claim with the U.S. Navy for a submarine decompression chamber (\$2.9 million recorded) and a claim with an international customer (\$2.6 million recorded). Significant claims outstanding at February 28, 2003 included \$2.1 million for the aforementioned U.S. Navy claim and \$9.5 million for two claims with an international customer. Effective February 27, 2004 the Company reached an agreement totaling \$10.5 million on one of these international claims, thus resolving all outstanding amounts related to this claim. Although recorded as a current asset in the financial statements, all claim revenues may not be received in full during fiscal 2005. For a more complete discussion of outstanding claims, see "Note 2. Accounts Receivable" to our consolidated financial statements in the Annual Report to Stockholders following.

Gross profit for fiscal 2004 decreased by \$4,255,000 or 30.0% from fiscal 2003 reflecting the aforementioned sales decrease which was partially offset by a 5.3 percentage point increase in the rate as a percentage of sales. Product development costs, both to enhance functionality of existing products and to develop product extensions, negatively impacted gross profit as these costs are primarily charged directly to the cost of sales for specific orders. Increased rates were evidenced in all business groups except environmental and entertainment, but the primary positive impact came from the ATS group primarily reflecting the aforementioned settlement of an international claim.

Operating income for fiscal 2004 was \$131,000, a decrease of \$3,985,000 or 96.8% over fiscal 2003. On a segment basis, ATS had an operating income of \$1,231,000, a decrease of \$3,748,000 or 75.3% from fiscal 2003, while the Industrial Group had an operating loss of \$248,000 in fiscal 2004 compared to an operating income of \$52,000 in fiscal 2003. These segment operating results were offset, in part, by unallocated corporate expenses of \$852,000, a decrease of \$63,000 from fiscal 2003.

The decrease in operating income for the ATS segment in fiscal 2004 reflected the aforementioned sales decrease partially offset by higher gross margins as a percentage of sales. The segment also experienced higher selling and marketing expenses including commissions.

The Industrial Group segment's decrease in operating income in fiscal 2004 reflected the aforementioned slight reduction in sales coupled with a 2.9 percentage point drop in the gross profit rate as a percentage of sales partially offset by reduced selling and marketing expenses.

Selling and administrative expenses were flat between the two periods as increases in legal and accounting costs and sales commissions were offset by reduced claims expenses. Approximately 41% of selling and administrative costs in the current fiscal were related to legal and accounting fees, claim costs and sales commissions. As a percentage of sales, selling and administrative expenses were 36.4% in fiscal 2004 compared to 21.9% in fiscal 2003.

Research and development expenses decreased \$278,000 or 43.7% in fiscal 2004 as compared to fiscal 2003. This decrease reflected government grants in our Turkish subsidiary under a government research award for work on our multi-axis centrifuge tactical flight simulator. Most of the Company's research efforts, which were and continue to be a significant cost of its business, are included in cost of sales for applied research for specific contracts, as well as research for feasibility and technology updates. Capitalized software development costs for fiscal 2004 were \$1,716,000 compared to \$1,193,000 in fiscal 2003. Amortization of software costs, which was charged to cost of sales, was \$851,000 and \$653,000 for fiscal 2004 and fiscal 2003, respectively.



Interest expense (net of interest income) increased \$1,088,000 or 210.0% in fiscal 2004 from fiscal 2003 reflecting higher average borrowings at higher rates and increased amortization of both deferred finance expenses from the Company's February 2003 refinancing and subordinated debt discount associated with the Company's subordinated debt. Letter of credit and other income/expenses decreased \$208,000 or 61.5% in fiscal 2004 over fiscal 2003 reflecting reduced letter of credit fees on a lower balance and the net receipt of insurance proceeds for a stolen simulator.

Given the Company's pre-tax loss for the fiscal period and the impact of some large permanent book/tax differences for some accounts, the Company experienced a domestic tax benefit based on an effective rate of 55.4% and a consolidated rate of 50.5%. Part of the reduction in the effective rate reflected the impact of research and experimentation tax credit refunds. The Company intends to continue to use research and experimentation tax credits, if applicable, to reduce its federal income tax.

During the second quarter of fiscal 2003, the Company reached a settlement with Inland Revenue in Great Britain which resulted in an additional tax assessment of \$15,000. Additionally, during fiscal 2004 the Company successfully concluded an Internal Revenue Service routine audit of the Company's fiscal 2000 tax filing with no additional liability.

Fiscal 2003 versus Fiscal 2002

The Company had net income of \$2,493,000 or \$.33 per share (diluted) in 2003 versus net income of \$1,741,000 or \$.23 per share (diluted) in fiscal 2002. Operating income was \$4,116,000, an increase of \$1,243,000 or 43.3% over 2002. This increase was primarily the result of increased gross profits due to higher sales volumes, partially offset by higher general and administrative expenses and research and development expenses.

Total sales in fiscal 2003 were \$43,123,000, an increase of \$10,596,000 or 32.6% over fiscal 2002, representing increases in all segments except hyperbaric. Primary contributors were additional international revenues for Aircrew Training Systems (ATS) (increased by \$5,404,000) which benefited from a human centrifuge project in Southeast Asia, higher government sales for ATS (increased \$2,099,000) reflecting the impact of the settlement with the U.S. Navy on the centrifuge contract and hyperbaric sales for a large U.S. Navy submarine rescue project, higher domestic sterilizer sales (increased by \$1,245,000), and additional sales for domestic entertainment (increased by \$1,409,000) which was involved in full production of a large project. Geographically, domestic sales were up \$2,468,000 or 11.6%, and represented 54.9% of total sales, down from 65.2% in fiscal 2002, primarily reflecting sterilizer and entertainment activity. U.S. government sales increased to \$4,626,000, as compared to \$1,194,000 in fiscal 2002, and represented 10.8% of total sales, up from 3.7% of total sales in fiscal 2002. International sales, including those from

the Company's foreign subsidiaries, were up \$4,695,000 or 46.4%, and represented 34.3% of total sales, up from 31.1% in fiscal 2002, primarily reflecting an increase in ATS sales. Throughout the Company's history, most of the sales for Aircrew Training products have been made to international customers.

Customers representing 10% or more of sales in fiscal 2003 were the Walt Disney Company, \$17,268,000 or 40.0%, and the Royal Malaysian Air Force, \$7,203,000 or 16.7%. In fiscal 2003, international sales totaling at least \$500,000 per country were made to customers in Malaysia, Thailand and China. Fluctuations in sales to international countries from year to year primarily reflect percentage of completion revenue recognition on the level and stage of development and production on multi-year long-term contracts. Open orders for the Royal Malaysian Air Force and a domestic sterilizer customer constituted 27.6% and 11.8% respectively of the Company's backlog at February 28, 2003. For a discussion of the additional risks associated with our international operations, see "Risks Related to Our Business-There are certain risks inherent in our international business activities, which constitute a significant portion of our business," in our Annual Report on Form 10-K.

On a segment basis, sales of the Company's ATS products, which create and monitor the physiological effects of motion (including spatial disorientation and centrifugal forces) on humans and equipment for medical, training, research and entertainment markets, were \$31,612,000 in fiscal 2003, an increase of \$8,983,000, or 39.7% over fiscal 2002. Sales of these products accounted for 73.3% of the Company's sales compared to 69.6% in fiscal 2002. Sales in the Company's other segment, the Industrial Group, which designs and produces chambers that create environments that are used for sterilization, research and medical applications, increased \$1,613,000 to \$11,511,000, an increase of 16.3%, and constituted 26.7% of the Company's total sales compared to 30.4% in fiscal 2002.

Significant claims outstanding at February 28, 2003 included a new claim with the U.S. Navy (\$2.1 million recorded) and two claims with an international customer (\$9.6 million recorded). On May 9, 2002, the Company reached a final settlement agreement totaling approximately \$6.9 million with the U.S. Navy for a claim on a centrifuge contract completed in 1996 to resolve all outstanding amounts related to this claim. The outstanding claims with the international customer are both in arbitration. Although recorded as a current asset in the financial statements, all claim revenues may not be received in full during fiscal 2004.

Gross profit for fiscal 2003 increased by \$2,733,000 or 23.8% from fiscal 2002 as the increased sales volume was only partially offset by a 2.3 percentage point reduction in the rate as a percentage of sales. Reduced rates as a percentage of sales were primarily evidenced in international environmental, government hyperbaric and domestic simulation. Acting as a partial offset was an increase in gross profit dollars and rate as a percentage of sales for Aircrew Training Systems.



Operating income for fiscal 2003 was \$4,116,000, an increase of \$1,243,000 or 43.3% over fiscal 2002. On a segment basis, ATS had an operating income of \$4,979,000, an increase of \$2,348,000 or 89.2% from fiscal 2002, while the Industrial Group had an operating income of \$52,000 in fiscal 2003 compared to an operating income of \$1,347,000 in fiscal 2002. These segment operating incomes were offset, in part, by unallocated corporate expenses of \$915,000, a decrease of \$190,000 from fiscal 2002.

The improvement in operating income for the ATS segment in fiscal 2003 was due to increased international sales at a higher gross profit rate as a percentage of revenues partially offset by higher general and administrative expenses including commissions.

The Industrial Group segment's decrease in operating income in fiscal 2003 reflected increased sales offset by a 13.2 percentage point reduction in the gross profit rate as a percentage of sales and additional general and administrative expenses. Both the environmental and hyperbaric product lines experienced reduced gross profit percentages.

Selling and administrative expenses increased \$1,454,000 or 18.2% in fiscal 2003 as compared to fiscal 2002 primarily reflecting increased commissions on the sales increase and increased claims expenses associated with the Company's ongoing claims activity. As a percentage of sales, selling and administrative expenses were 21.9% in fiscal 2003 compared to 24.6% in fiscal 2002.

Research and development expenses increased slightly, up \$36,000 or 6.0% in fiscal 2003 as compared to fiscal 2002, reflecting slightly higher activity at the Company's Turkish branch. Most of the Company's research efforts, which were and continue to be a significant cost of its business, are included in cost of sales for applied research for specific contracts, as well as research for feasibility and technology updates. Capitalized software development costs for fiscal 2003 were \$1,193,000 compared to \$989,000 in fiscal 2002. Amortization of software costs, which was charged to cost of sales, was \$653,000 and \$496,000 for fiscal 2003 and fiscal 2002, respectively.

Interest expense (net of interest income) decreased \$576,000 or 52.7% in fiscal 2003 from fiscal 2002 reflecting reduced average borrowings at lower rates and reduced amortization of deferred finance expenses. During fiscal 2002, deferred finance costs associated with the Company's refinancing in March 1997, which debt was subsequently paid off in March 2000, were charged off. Letter of credit and other expenses increased \$194,000 or 134.7% in fiscal 2003 over fiscal 2002, principally due to increased banking fees associated with the Company's former lender.

The Company's provision for taxes in fiscal 2003 was calculated based on a consolidated rate of 24.7%, primarily

reflecting the impact of research and experimentation tax credit refunds. The Company intends to continue to use research and experimentation tax credits, if applicable, to reduce its federal income tax.

During the second quarter of fiscal 2003, the Company reached a settlement with Inland Revenue in Great Britain which resulted in an additional tax assessment of \$15,000. Additionally, the Internal Revenue Service is currently performing a routine audit of the Company's fiscal 2000 tax filing. The Company is currently not able to assess whether any additional tax liability will result from the audit, although at this point the Company believes that any additional taxes, if any, will be immaterial.

Liquidity and Capital Resources

During fiscal 2004, the Company used \$2,864,000 of cash to support operating activities. Cash usages included the net operating loss, increases in current assets, most notably receivables, inventories and prepaids and a decrease in billings in excess of costs and estimated earnings on uncompleted long-term contracts. Acting as partial offsets were non-cash expenses such as depreciation and amortization and increases in current liability accounts, primarily accounts payable, customer deposits and other accrued liabilities. The primary impact on cash usage was an increase in an international receivable to reflect a \$10.5 million claim settlement that was subsequently paid to us in March 2004, a build-up in inventories reflecting pre-engineering costs on the Authentic Tactical Flight Simulator and customer induced delays on shipping completed products.

The Company's investing activities used \$1,695,000 in fiscal 2004 and consisted of purchases of capital equipment (\$475,000) and capitalized software (\$1,220,000). Given the nature of the Company's market and products, the continued development of generic control and core software and software tools is a critical objective of management.

The Company's financing activities generated \$1,780,000 of cash during fiscal 2004. This primarily reflected a significant decrease in restricted cash to cash collateralize international letters of credit (reflecting both the nature and amount of new contracts, outstanding international letters of credit decreased \$2,277,000 during the fiscal year) which was only partially offset by net repayments under the Company's bank facility. (See "Note 6. Long-Term Obligations and Credit Arrangements" to the Consolidated Financial Statements.)

The Company has historically financed operations through a combination of cash generated from operations, equity offerings and bank debt. On February 19, 2003, the Company completed a refinancing of its indebtedness with PNC Bank, National Association and H.F. Lenfest in the aggregate amount of \$29,800,000. The Company used a portion of the proceeds from the financing to satisfy its existing debt obligations to



Wachovia Bank, the Company's former lender, and to permit PNC Bank to issue a letter of credit to support outstanding bonds issued by Company. The transaction resulted in net proceeds (after transaction expenses and repayment of existing debt) to the Company of approximately \$3,600,000. The net proceeds have been used by the Company for working capital purposes, and general corporate purposes directly related to growth.

In accordance with the terms of an amendment dated April 30, 2003, the PNC Bank facility was increased and, as of the date of this Annual Report on Form 10-K, includes: (i) a revolving credit facility in the maximum aggregate principal amount of \$14,800,000 to be used for the Company's working capital and general corporate purposes, including capital expenditures, with a sublimit for issuances of letters of credit in the maximum amount of \$10,300,000, and (ii) a standby letter of credit in the amount of \$5,025,410 as credit support for the Company's bonds.

The terms and conditions of the revolving loan and the line of credit are set forth in a Credit Agreement, as amended, between the Company and PNC Bank. Availability under the facility is determined each month based on a borrowing base consisting of a portion of the Company's receivables, inventory and costs and estimated earnings in excess of billings, net of billings in excess of costs and estimated earnings on uncompleted long-term contracts. As of February 27, 2004, availability under the \$14,800,000 revolving facility was \$7,567,000.

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

Subsequent to fiscal year end, PNC Bank advised the Company that it was considering certain changes to the revolving credit facility including reducing the total facility and requiring the Company to cash collateralize some or all of the facility. As of the filing date of this Form 10-K, these discussions were still ongoing. In the event that PNC Bank takes these actions, we may need to obtain additional sources of capital in order to continue growing our business. We believe that we will be able to locate such additional sources of capital and that any such action by PNC Bank will not have a long-term material adverse effect on our business.

As of April 30, 2004 the Company had used approximately \$5,426,000 of the facility for international letters of credit and as collateral for a portion of the PNC Bank letter of credit that serves as collateral for the Company's long-term bonds.

In connection with the financing provided by Mr. Lenfest, the Company entered into a Convertible Note and Warrant Purchase Agreement with Mr. Lenfest, pursuant to which the Company issued to Mr. Lenfest (i) a senior subordinated convertible promissory note in the original principal amount of \$10,000,000 and (ii) warrants to purchase 803,048 shares of the Company's common stock. Upon the occurrence of certain events, the Company will be obligated to issue additional warrants to Mr. Lenfest. The note accrues interest at the rate of 10% per annum and matures on February 18, 2009. The note entitles Mr. Lenfest to convert all or a portion of the outstanding principal of, and accrued and unpaid interest on, the note into shares of common stock at a conversion price of \$6.05 per share. The warrants may be exercised into shares of common stock at an exercise price equal to the lesser of \$4.00 per share or two-thirds of the average of the high and low sale prices of the common stock for the 25 consecutive trading days immediately preceding the date of exercise.

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

Prior to the consummation of the refinancing, Advanced Technology Asset Management, LLC ("ATAM") (formerly ETC Asset Management, LLC), a shareholder of the Company and a holder of warrants to purchase 332,820 shares of the Company's common stock, consented to the transactions contemplated under the Credit Agreement and the financing provided by Mr. Lenfest, including the below market issuance of warrants to Mr. Lenfest. As a result of its consent, ATAM waived, solely in connection with such issuance, the anti-dilution rights contained in its warrant. In exchange for ATAM's consent, the Company issued to ATAM warrants to purchase an additional 105,000 shares of common stock. Except for the number of shares issuable upon exercise of the warrants, the new ATAM warrants have substantially the same terms as the warrants issued to Mr. Lenfest. In March, 2004, ATAM exercised all its warrants and received a total of 437,820 shares of common stock of the Company. The Company received proceeds of \$586,410 from the exercise of these warrants.

The Company believes that cash generated from operating activities (including claim settlements) as well as future availability under its credit agreement will be sufficient to meet its future obligations through at least May 31, 2005. However, as was noted above, the Company is in discussions with PNC Bank concerning the Company's revolving credit facility.

In reference to the Company's outstanding claims with both the U.S. Navy and an international customer, to the extent the Company is unsuccessful in further recovery of contract costs, such an event could have a material adverse effect on the Company's liquidity and results



of operations. Historically, the Company has had a favorable experience in that recoveries have exceeded recorded claims, including significant settlement agreements in fiscal 2003 and 2004. (See Note 2 to the Consolidated Financial Statements, Accounts Receivable).

The following table presents our contractual cash flow commitments on long-term debt and operating leases. See Notes 6 and 7 to the consolidated financial statements for additional information on our long-term debt and operating leases.

Payments Due by Period (in thousands)

	Total	Less Than 1 Year	1-3 Years (in thousands)	4-5 Years	After 5 Years
Long-term debt, including current maturities*	\$12,474	\$317	\$ 946	\$11,211	-
Operating leases	<u>384</u>	<u>159</u>	<u>225</u>	<u>-</u>	<u>-</u>
Total	12,858	\$476	\$1,171	\$11,211	-

* Long-term debt is reported net of unamortized discount of \$2,334 on the company's subordinated debt. See "Note 6. Long-Term Obligations and Credit Arrangements" to the Consolidated Financial Statements.

The Company's sales backlog at February 27, 2004 and February 28, 2003, for work to be performed and revenue to be recognized under written agreements after such dates, was \$16,914,000 and \$21,454,000, respectively. This decline primarily reflected continued production and corresponding percentage of completion revenue recognition in the current fiscal year on two significant contracts. In addition, the Company's training, maintenance and upgrade contracts backlog at February 27, 2004 and February 28, 2003, for work to be performed and revenue to be recognized after such dates under written agreements, was approximately \$2,637,000 and \$3,931,000, respectively. Of the February 27, 2004 backlog, approximately \$14,417,000 was under contracts for ATS and maintenance support including \$3,798,000 for the Royal Malaysian Air Force. Approximately 89% of the February 27, 2004 backlog is expected to be completed prior to February 25, 2005.

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

Off-Balance Sheet Arrangements

There were no off-balance sheet arrangements during the fiscal year ended February 27, 2004 that have or are reasonably likely to have a current or future effect on our financial condition, changes in financial condition, revenues or expenses, results of operations, liquidity, capital expenditures or capital resources that is material to the Company's investors.

Recent Accounting Pronouncements

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

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

Accounting for Costs Associated with Exit or Disposal Activities:

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



Accounting and Disclosure Requirements for Guarantees:

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

Consolidation of Variable Interest Entities:

In January 2003, the FASB issued FASB Interpretation 46 (FIN 46), Consolidation of Variable Interest Entities. FIN 46 clarifies the application of Accounting Research Bulletin 51, Consolidated Financial Statements, for certain entities that do not have sufficient equity at risk for the entity to finance its activities without additional subordinated financial support from other parties or in which equity investors do not have the characteristics of a controlling financial interest ("variable interest entities"). Variable interest entities within the scope of FIN 46 will be required to be consolidated by their primary beneficiary. The primary beneficiary of a variable interest entity is determined to be the party that absorbs a majority of the entity's expected losses, receives a majority of its expected returns, or both. FIN 46 applies immediately to variable interest entities created after January 31, 2003, and to variable interest entities in which an enterprise acquires an interest after that date. It applies in the first fiscal year or interim period beginning after June 15, 2003, to variable interest entities in which an enterprise holds a variable interest that it acquired before February 1, 2003. The adoption of this statement did not have a significant impact on the Company's consolidated financial position, results of operations, or cash flows since the Company currently has no VIEs. In December 2003, the FASB issued FIN 46R with respect to VIEs created before January 31, 2003, which, among other things, revised the implementation date to the first fiscal year or interim period ending after March 15, 2004, with the exception of Special Purpose Entities (SPE). The consolidation requirements apply to all SPEs in the first fiscal year or interim period ending after December 15, 2003. The Company adopted the provision of FIN 46R effective February 27, 2004, and such adoption did not have a material impact on the consolidated financial statements since the Company currently has no SPEs.

Accounting for Certain Financial Instruments:

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

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

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

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

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

Market for the Registrant's Common Stock and Related Security Holder Matters

The Company's common stock is traded on the American Stock Exchange under the symbol "ETC." As of May 14, 2004, the Company had 281 shareholders of record.



The following table sets forth the quarterly ranges of high and low sale prices for shares of the common stock for the periods indicated.

	<u>Sale Prices</u>	
	<u>High</u>	<u>Low</u>
Fiscal 2004		
First Quarter	\$6.00	\$5.00
Second Quarter	6.10	5.00
Third Quarter	8.70	6.08
Fourth Quarter	9.95	7.00
Fiscal 2003		
First Quarter	\$9.15	\$6.20
Second Quarter	7.85	6.00
Third Quarter	6.45	5.80
Fourth Quarter	6.40	5.86

On May 14, 2004, the closing price of the Company's common stock was \$8.59. The Company has never paid any cash dividends on its common stock and does not anticipate that any cash dividends will be declared or paid in the foreseeable future. The Company's current credit facilities prohibit the payment of any dividends by the Company without the lender's prior written consent.

Equity Compensation Plan Information

<u>Plan Category</u>	<u>Number of securities to be issued upon exercise of outstanding options, warrants and rights</u>	<u>Weighted-average exercise price of outstanding options, warrants and rights</u>	<u>Number of securities remaining available for future issuance under equity compensation plans (excluding securities reflected in column (a))</u>
	(a)	(b)	(c)
Equity compensation plans approved by security holders	376,002	\$7.21	623,998
Equity compensation plans not approved by security holders	-	N/A	209,058
Total	376,002	\$7.21	833,056

The following plans have not been approved by our stockholders:

Employee Stock Purchase Plan

The Company has an Employee Stock Purchase Plan which was adopted by the Board of Directors on November 3, 1987. All employees meeting service requirements, except officers, directors and 10% stockholders, are eligible to voluntarily purchase common stock through payroll deductions up to 10% of salary. The Company makes a matching contribution of 20% of the employee's contribution.



Consolidated Balance Sheets (\$ in thousands, except share data)

	February 27, 2004	February 28, 2003
ASSETS		
Cash and cash equivalents	\$ 1,366	\$ 4,305
Cash equivalents restricted for letters of credit	784	3,189
Accounts receivable, net	19,233	16,193
Costs and estimated earnings in excess of billings on uncompleted long-term contracts	5,333	5,441
Inventories	9,843	8,494
Deferred tax asset	1,337	689
Prepaid expenses and other current assets	1,949	983
Total current assets	39,845	39,294
Property, plant and equipment, net	4,886	5,086
Software development costs, net of accumulated amortization of \$7,494 and \$6,819 in 2004 and 2003, respectively	3,089	2,224
Goodwill	477	477
Other assets, net	399	617
Total assets	\$48,696	\$47,698
LIABILITIES		
Current portion of long-term obligations	\$ 317	\$ 281
Accounts payable - trade	2,431	1,778
Billings in excess of costs and estimated earnings on uncompleted long-term contracts	945	1,463
Customer deposits	3,657	3,000
Other accrued liabilities	2,588	1,556
Total current liabilities	9,938	8,078
Long-term obligations, less current portion:		
Credit facility payable to banks	30	600
Long term bonds	4,370	4,645
Subordinated debt	7,666	7,391
Capitalized lease obligations	91	7
	12,157	12,643
Deferred tax liability	1,502	1,022
Total liabilities	\$23,597	\$ 21,743
Minority Interest	45	48
STOCKHOLDERS' EQUITY		
Common stock - authorized 20,000,000 shares, \$.05 par value; 7,176,552 and 7,157,239 shares issued and outstanding in 2004 and 2003, respectively	\$ 359	\$ 358
Capital contributed in excess of par value of common stock	9,430	9,331
Accumulated other comprehensive loss	(329)	(169)
Retained earnings	15,594	16,387
Total stockholders' equity	\$25,054	\$25,907
Total liabilities and stockholders' equity	\$48,696	\$47,698

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


Consolidated Statements of Operations (\$ in thousands, except share data)

	52 Weeks Ended February 27, 2004	53 Weeks Ended February 28, 2003	52 Weeks Ended February 22, 2002
Net sales	\$25,995	\$43,123	\$32,527
Cost of goods sold	16,052	28,925	21,062
Gross profit	9,943	14,198	11,465
Operating expenses:			
Selling and administrative	9,454	9,446	7,992
Research and development	358	636	600
	9,812	10,082	8,592
Operating income	131	4,116	2,873
Other expenses:			
Interest expense (net)	1,606	518	1,094
Letter of credit fees	127	154	102
Other, net	3	184	42
	1,736	856	1,238
(Loss)/Income before (benefit from)/provision for income taxes and minority interest	(1,605)	3,260	1,635
(Benefit from) provision for income taxes	(810)	805	(93)
(Loss)/income before minority interest	(795)	2,455	1,728
Loss attributable to minority interest	(2)	(38)	(13)
Net (loss)/income	\$ (793)	\$ 2,493	\$ 1,741
Per share information: (Loss)/earnings per common share:			
Basic	\$ (.11)	\$.35	\$.24
Diluted	\$ (.11)	\$.33	\$.23
(Loss)/income applicable to common stockholders	\$ (793)	\$ 2,493	\$ 1,741
Weighted average common shares:			
Basic	7,163,000	7,153,000	7,143,000
Diluted	7,163,000	7,497,000	7,499,000

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

Environmental Tectonics Corporation 2004 Annual Shareholder's Report





Consolidated Statements of Cash Flows (\$ in thousands)

	52 Weeks Ended February 27, 2004	53 Weeks Ended February 28, 2003	52 Weeks Ended February 22, 2002
Cash flows from operating activities:			
Net(loss)/income	\$(793)	\$2,493	\$1,741
Adjustments to reconcile net (loss)/income to net cash (used in)			
/provided by operating activities			
Depreciation and amortization	1,847	1,401	1,475
Deferred financing costs	275	-	-
(Decrease)/increase in allowance for accounts receivable and inventory	(149)	(19)	111
Loss attributable to minority interest	(2)	(38)	(13)
Deferred income taxes (benefit)	(168)	313	(39)
Changes in operating assets and liabilities:			
(Increase) decrease in assets			
Accounts receivable	(2,973)	3,590	(3,083)
Costs and estimated earnings in excess of billings on uncompleted			
Long-term contracts	108	3,950	204
Inventories	(1,763)	(2,091)	(2,645)
Prepaid expenses and other current assets	(720)	62	(530)
Other assets	(103)	32	(136)
Increase (decrease) in liabilities:			
Accounts payable	653	(1,660)	1,509
Billings in excess of costs and estimated earnings on uncompleted			
Long-term contracts	(518)	964	(1,213)
Customer deposits	657	(684)	2,241
Accrued income taxes	(247)	(731)	(23)
Other accrued liabilities	1,032	(2)	(319)
Net cash (used in)/provided by operating activities	(2,864)	7,580	(720)
Cash flows from investing activities:			
Acquisition of equipment	(475)	(215)	(649)
Software development costs	(1,220)	(569)	(989)
Net cash used in investing activities	(1,695)	(784)	(1,638)
Cash flows from financing activities:			
Borrowings under credit facility	2,514	26,396	10,899
Payments under credit facility	(3,084)	(37,551)	(6,708)
Payments on long-term bonds	(275)	(275)	(275)
Proceeds from subordinated debt	-	7,391	-
Deferred financing costs	-	(719)	-
Increase/(decrease) in restricted cash	2,405	(2,620)	(25)
Net increase/(decrease) in other long-term obligations	120	(6)	(368)
Proceeds from issuance of common stock/warrants	100	2,629	191
Net cash provided by/(used in) financing activities	1,780	(4,755)	3,714
Effect of exchange rates on cash	(160)	3	54
Net (decrease)/increase in cash and cash equivalents	(2,939)	2,044	1,410
Cash and cash equivalents at beginning of year	4,305	2,261	851
Cash and cash equivalents at end of year	\$1,366	\$4,305	\$2,261
Supplemental schedule of cash flow information:			
Interest paid	\$ 854	\$ 480	\$ 766
Income taxes paid	\$ 78	\$1,720	\$ 582

Supplemental information on non-cash operating and investing activities:

During the year ended February 27, 2004, the Company reclassified \$496 from inventory to capitalized software.

During the year ended February 28, 2003, the Company reclassified \$226 from inventory to property, plant and equipment and \$624 from inventory to capitalized software.

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

Environmental Tectonics Corporation 2004 Annual Shareholder's Report





Notes to Consolidated Financial Statements
(\$ in thousands, except share data)

1. Summary of Significant Accounting Policies
(Continued):

passes at shipment. Revenue on those types of contracts where post-shipment services (such as installation and acceptance) are required is recognized upon customer acceptance. Revenue for service contracts is recognized ratably over the life of the contract with related material costs expensed as incurred.

In December 1999, the Securities and Exchange Commission issued Staff Accounting Bulletin No. 101, Revenue Recognition in Financial Statements (SAB 101) which addresses certain criteria for revenue recognition. SAB 101, as amended by SAB 101A and SAB 101B, outlines the criteria that must be met to recognize revenue and provides guidance for disclosures related to revenue recognition policies. The Company implemented the applicable provisions of SAB 101 for the fiscal year ending February 23, 2001, with no material impact on the Company's results of operations.

In September 2000, the Emerging Issues Task Force reached a consensus on Issue 00-10, "Accounting for Shipping and Handling Fees and Costs" (Issue 00-10). Issue 00-10 requires that all amounts billed to customers related to shipping and handling be classified as revenues. In addition, Issue 00-10 specifies that the classification of shipping and handling costs is an accounting policy decision that should be disclosed pursuant to APB 22, "Disclosure of Accounting Policies". The Company's product costs include amounts for shipping and handling. Therefore, the Company charges its customers shipping and handling fees at the time the products are shipped or when its services are performed. The cost of shipping products to the customer is recognized at the time the products are shipped to the customer and is included in cost of goods sold. Adoption of this consensus opinion had no effect on the Company's current and previous classifications.

Cash and Cash Equivalents:

Cash and cash equivalents include short-term deposits at market interest rates with original maturities of three months or less. The Company maintains cash balances at several financial institutions located in the Northeast United States and at some locations internationally. Accounts in each domestic institution are insured by the Federal Deposit Insurance Corporation up to \$100. During each fiscal year, the Company periodically has cash and cash equivalents in excess of insured amounts. However, significant portions of the Company's funds are with one financial institution, which has had no experience of significant customer losses to date.

Inventories:

Inventories are valued at the lower of cost or market. Cost is determined principally by the first-in, first-out method. The costs of finished goods and work-in-process inventories include material, direct engineering, manufacturing labor and overhead components. The Company periodically reviews the net realizable value of the inventory and, if necessary, writes down the recorded costs.

Depreciation of Property, Plant and Equipment:

Property, plant and equipment are depreciated over their estimated useful lives by the straight-line method for financial reporting purposes. Accelerated depreciation methods are used for tax purposes. Upon sale or retirement of property, plant and equipment, the costs and related accumulated depreciation are eliminated from the accounts. Any resulting gains or losses are included in the determination of net income.

Amortization of Goodwill:

Goodwill of \$662 was recorded in fiscal 1999 for the Company's 65% ownership purchase of ETC-PZL Aerospace Industries, SP. Z O.O. On September 27, 2000, the Company purchased an additional 30% ownership for \$300 cash, bringing the Company's total ownership to 95%. This transaction resulted in a reduction in goodwill of \$101. Amortization expense was \$0, \$0, and \$17 in fiscal years 2004, 2003 and 2002, respectively, and accumulated amortization was \$113 as of February 27, 2004 and February 28, 2003.

On February 23, 2002, we adopted SFAS No. 142 "Goodwill and Intangible Assets" (SFAS No. 142). SFAS No. 142 includes requirements to annually test goodwill and indefinite lived intangible assets for impairment rather than amortize them. Accordingly, we no longer amortize goodwill, thereby eliminating an annual amortization charge of approximately \$29. We have completed documentation of our transitional goodwill impairment tests and have not recorded any transitional goodwill impairment loss as a result of our adoption of SFAS No. 142. Additionally, we did not record any transitional intangible asset impairment loss upon adoption of SFAS No. 142.

Reported net income, exclusive of amortization expense that is related to goodwill that is no longer being amortized, would have been:

Fiscal year ended

	February 2004	February 2003	February 2002
Reported net(loss)/earnings	\$(793)	\$2,493	\$1,741
Goodwill amortization	-	-	17
Adjusted net(loss)/earnings	\$(793)	\$2,493	\$1,758



Notes to Consolidated Financial Statements
(\$ in thousands, except share data)

1. Summary of Significant Accounting Policies
(Continued):

Basic(loss)/earnings per share:

Reported net(loss) earnings	\$(0.11)	\$0.35	\$0.24
Goodwill amortization	-	-	.01
Adjusted net(loss)/earnings	\$(0.11)	\$0.35	\$0.25

Diluted(loss)/earnings per share:

Reported net(loss)/earnings	\$(0.11)	\$0.33	\$0.23
Goodwill amortization	-	-	-
Adjusted net(loss)/earnings	\$(0.11)	\$0.33	\$0.23

Capitalized Software Development Costs:

The Company capitalizes the qualifying costs of developing software contained in certain products. Capitalization of costs requires that technological feasibility has been established. When the software is fully documented and tested, capitalization of development costs cease and amortization commences on a straight-line basis over a period ranging from 36 to 60 months, depending upon the life of the product, which, at a minimum, approximates estimated sales. Realization of capitalized software costs is subject to the Company's ability to market the related product in the future and generate cash flows to support future operations. Capitalized software costs totaled \$1,716 and \$1,193, respectively, for the fiscal years ended February 27, 2004 and February 28, 2003. Related software amortization totaled \$851, \$653 and \$496, respectively, for fiscal 2004, 2003 and 2002.

Research and Development:

Research and development expenses are charged to operations as incurred. During fiscal 2004, 2003 and 2002, the Company incurred research and development costs of approximately \$358, \$636 and \$600, respectively.

Amortization of Deferred Financing Costs:

During fiscal 2002, all remaining capitalized costs relating to the March 1997 financing of the Company were expensed. Capitalized costs relating to the Company's bond issuance on March 15, 2000 and costs associated with the February 2003 PNC/Lenfest financing are being amortized over the relevant term. Amortization expense relating to deferred financing costs was \$321, \$75 and \$293 in fiscal 2004, 2003 and 2002, respectively (see "Note 6. Long-Term Obligations and Credit Arrangements" to Consolidated Financial Statements).

Subordinated Debt Discount

During fiscal 2003, the Company had recorded

\$2,609 in additional paid-in capital representing an allocation of the proceeds from the convertible debt element of its financing with PNC and Lenfest. This allocation represents the value assigned to the beneficial conversion option of the Lenfest promissory 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 was \$275 in fiscal 2004 and \$0 in fiscal 2003.

Income Taxes:

The Company accounts for income taxes using the liability method, which reflects the impact of temporary differences between values recorded for assets and liabilities for financial reporting purposes and values utilized for measurement in accordance with applicable tax laws.

Long-Lived Assets:

The Company followed the provisions of Statement of Financial Accounting Standards (SFAS) No. 121, "Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of," which provided guidance on when to recognize and how to measure impairment losses of long-lived assets and certain identifiable intangibles, and how to value long-lived assets to be disposed of. This involved a review of goodwill and other intangibles to assess recoverability from future operations using undiscounted future cash flows. Any impairments were recognized in operating results to the extent that carrying value exceeded fair value, which was determined based on the net present value of estimated future cash flows. Effective February 22, 2002, the Company adopted SFAS No. 144, "Impairment or Disposal of Long-Lived Assets" which requires additional impairment testing for long-lived assets.

Stock Options:

The Company accounts for stock options under the alternate provisions of SFAS No. 123 (discussed below), "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 No. 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.



Notes to Consolidated Financial Statements (\$ in thousands, except share data)

1. Summary of Significant Accounting Policies (Continued):

At February 28, 2004, the Company has one stock-based employee compensation plan, which is described more fully in Note 10 to Consolidated Financial Statements. The Company accounts for those plans under the recognition and measurement principles of APB Opinion No. 25, Accounting for Stock Issued to Employees, and related Interpretations. No stock-based employee compensation cost is reflected in net income, as all options granted under this plan had an exercise price equal to the market value of the underlying common stock on the date of grant. The following table illustrates the effect on net income and earnings per share if the company had applied the fair value recognition provisions of FASB Statement No. 123, Accounting for Stock-Based Compensation, to stock-based employee compensation.

	<u>Fiscal Year Ended</u>		
	<u>February 27, 2004</u>	<u>February 28, 2003</u>	<u>February 22, 2002</u>
Net (loss)/income, as reported	\$(793)	\$2,493	\$1,741
Deduct: Total stock-based employee compensation expense determined under fair value based method for all awards, net of related tax effects	(27)	(275)	(456)
<u>Pro forma net (loss)/income</u>	<u>\$(820)</u>	<u>\$2,218</u>	<u>\$1,285</u>
(Loss)/earnings per share:			
Basic-as reported	\$(0.11)	\$.35	\$.24
Basic-pro forma	\$(0.11)	\$.31	\$.18
Diluted-as reported	\$(0.11)	\$.33	\$.23
Diluted-pro forma	\$(0.11)	\$.30	\$.17

The fair value of each option grant is estimated on the date of grant using the Black-Scholes options-pricing model with the following weighted average assumptions used for grants in fiscal 2002: expected volatility of 30.1%; risk-free interest rate of 5.01%; and an expected life of 10 years. There were no grants in fiscal 2003 and fiscal 2004.

Advertising Costs:

The Company expenses advertising costs, which include trade shows, as incurred. Advertising expense was \$324, \$464 and \$438 in fiscal 2004, 2003, and 2002, respectively.



Notes to Consolidated Financial Statements (\$ in thousands, except share data)

1. Summary of Significant Accounting Policies (Continued)

Earnings Per Common Share:

The Company has adopted SFAS No. 128, "Earnings Per Share." This standard requires presentation of basic and diluted earnings per share together with disclosure describing the computation of the per share amounts. Basic earnings per share excludes dilution and is computed by dividing income available to common shareholders by the weighted average common shares outstanding for the period. Diluted earnings per share reflects the potential dilution that could occur if securities or other contracts to issue common stock were exercised and converted into common stock or resulted in the issuance of common stock that then shared in the earnings of the entity.

The following table illustrates the reconciliations of the numerators and denominators of the basic and diluted earnings per share computations.

Fiscal Year ended February 27, 2004

	<u>Loss (\$000)</u> (numerator)	Weighted average shares (denominator)	Per share <u>amount</u>
Net loss	\$793		
Basic loss per share			
Loss applicable to common stockholders	<u>\$793</u>	<u>7,163,000</u>	<u>\$.11</u>
Effective of dilutive securities			
Stock options		-	
Convertible Debt		-	
Stock warrants		-	
Diluted loss per share			
Loss applicable to common stockholders plus effect of dilutive securities	<u>\$793</u>	<u>7,163,000</u>	<u>\$.11</u>

At February 27, 2004, there were stock options to purchase the Company's common stock totaling 376,002 shares that were not included in the computation of diluted loss 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 of common stock if fully converted. Upon each conversion of the subordinated note, the holder would be entitled to receive a warrant to purchase additional shares of common stock equal to ten percent of the shares issued pursuant to such conversion. If the entire face value of the subordinated note is converted into shares of common stock, then warrants to purchase an additional 165,289 shares of common stock will be issued, bringing the total shares of common stock to be issued to 1,818,182. Additionally, at February 27, 2004, there were outstanding warrants to purchase the Company's stock totaling 1,240,868 shares. None of these shares were included in the computation of diluted earnings per share as the effect would be anti-dilutive.

Fiscal Year ended February 28, 2003

	<u>Income (\$000)</u> (numerator)	Weighted average shares (denominator)	Per share <u>amount</u>
Net income	\$2,493		
Basic earnings per share			
Income available to common stockholders	<u>\$2,493</u>	<u>7,153,000</u>	<u>\$.35</u>


Notes to Consolidated Financial Statements (\$ in thousands, except share data)
1. Summary of Significant Accounting Policies (Continued):

Effective of dilutive securities			
Stock options		22,717	
Convertible Debt		4,151	
Stock warrants		<u>317,407</u>	
Diluted earnings per share			
Income available to common stockholders plus			
effect of dilutive securities	<u>\$2,493</u>	<u>7,497,275</u>	<u>\$.33</u>

At February 28, 2003, options to purchase the Company's common stock totaling 421,614 shares were outstanding, 341,314 of which were not included in the computation of diluted earnings per share as the effect of such inclusion would be anti-dilutive.

	<u>Fiscal Year ended February 22, 2002</u>		
	<u>Income (\$000)</u>	<u>Weighted average shares</u>	<u>Per share amount</u>
	<u>(numerator)</u>	<u>(denominator)</u>	
Net income	\$1,741		
Basic earnings per share			
Income available to common stockholders	<u>\$1,741</u>	<u>7,142,946</u>	<u>\$.24</u>
Effective of dilutive securities			
Stock options		44,180	
Stock warrants		311,460	
Diluted earnings per share			
Income available to common stockholders plus			
effect of dilutive securities	<u>\$1,741</u>	<u>7,498,586</u>	<u>\$.23</u>

At February 22, 2002, options to purchase the Company's common stock totaling 448,514 shares were outstanding, 313,750 of which were not included in the computation of diluted earnings per share as the effect of such inclusion would be anti-dilutive.

2. Accounts Receivable:

The components of accounts receivable at February 27, 2004 and February 28, 2003 are as follows:

	<u>2004</u>	<u>2003</u>
U.S. government receivables billed and unbilled contract costs subject to negotiation	<u>\$ 3,128</u>	<u>\$ 2,719</u>
U.S. commercial receivables billed	<u>1,508</u>	<u>2,002</u>
International receivables billed and unbilled contract costs subject to negotiation	<u>14,976</u>	<u>11,918</u>
	<u>19,612</u>	<u>16,639</u>
Less allowance for doubtful accounts	<u>(379)</u>	<u>(446)</u>
	<u>\$19,233</u>	<u>\$16,193</u>

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

Unbilled contract costs subject to negotiation as of February 27, 2004 represent claims made against the U.S. government under a contract for a submarine decompression chamber project. These costs, totaling \$2,899, were recorded beginning in fiscal 2002,



Notes to Consolidated Financial Statements (\$ in thousands, except share data)

2. Accounts Receivable (Continued):

and include \$1,691 recorded during fiscal 2003 and \$833 recorded during fiscal 2004. 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. The U.S. Government has agreed to issue a final decision on September 15, 2004. The Company considers the recorded costs to be realizable due to the fact that they relate to customer caused delays, errors and changes in specifications and designs, disputed liquidated damages and other out of scope items. Subsequent to fiscal year end, the Company submitted a supplement to the claim incorporating additional cost items. During the fiscal 2004 third quarter, the U.S. Government, citing failure to deliver product within contract terms, began assessing liquidated damages by offsetting progress payments due the Company under the contract. Subsequent to fiscal 2004 year end, citing "substantial material progress" on the project, the U.S. Government agreed to release all outstanding invoice payments which had previously been withheld for liquidated damages. 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, in accordance with 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 to cover a delay through the extended delivery period.

International receivables billed and unbilled contract costs subject to negotiation:

The Royal Thai Air Force:

In October 1993, the Royal Thai Air Force (RTAF) notified the Company that the RTAF was terminating a certain \$4,600 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 the termination, the RTAF made a call on a \$230 performance bond, as well as a draw on an approximately \$1,100 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 remain as per 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 the testing 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 representing the amount due on the performance bond.

The open balance of \$700 at February 27, 2004 and February 28, 2003 due on the contract represents the total net exposure to the Company on this contract. As of February 27, 2004, the Company has authorized its Thai attorneys to commence and prosecute arbitration proceedings, and it is anticipated that this will occur in the near future. However, since the circumstances that caused a delay are commonly considered "force majeure" events, and since the contract under question allows for consideration of "force majeure" events, the Company believes that the open balance related to this contract is collectible and will continue to treat this balance as collectible until a final unappealable legal decision is rendered by a competent Thai tribunal. The Company has enjoyed a favorable relationship with the RTAF. It currently has both maintenance and upgrade contracts with the RTAF for the trainers that are the subject of the dispute, and it is not anticipated that the initiation of legal action against the RTAF will have any material adverse impact on future sales to the RTAF. A date for arbitration has not been set as of yet, although the parties are currently in the process of choosing their individual arbitrators. As of the date of this Annual Report on Form 10-K, the Company is not able to determine what, if any, impact the extended completion and payment period will have upon the receipt of the total amount due.

International customer:

Unbilled contract costs subject to negotiation as of February 27, 2004 included a claim (\$2,600 recorded) made against an international customer for a contract covering 1997 to the present. Claim costs have been incurred in connection with customer caused delays, errors in specifications and designs, and other out-of-scope items and exchange losses and may not be received in full during fiscal 2005. In conformity with accounting principles generally accepted in the United States, revenue recorded by the Company from a claim does not exceed the incurred contract costs related to the claim. The Company and the customer are currently in the arbitration process. The Company has filed its "Points of Claim" to which the customer has replied and also the customer has filed a counterclaim, which the Company expects to respond to shortly. Additionally, the discovery process is continuing. The customer, citing failure to deliver product within contract terms, has assessed liquidated



Notes to Consolidated Financial Statements (\$ in thousands, except share data)

2. Accounts Receivable (Continued):

damages totaling approximately \$400 on the contract. The Company disputes the basis for these liquidated damages and is vigorously contesting them. However, following generally accepted accounting principles, the Company has reduced contract values and corresponding revenues by approximately \$400.

Effective February 27, 2004, the Company reached an agreement totaling \$10.5 million with the same international customer on another claim of which \$6.8 million was included in unbilled contract costs subject to negotiation as of February 28, 2003, thus resolving all outstanding amounts related to this claim.

Claim bookings and settlements in fiscal 2004 increased operating income by \$1,802. Claim bookings in fiscal 2003 and 2002 decreased operating income by \$675 and \$661 respectively. All amounts are net of associated manufacturing costs and legal expenses.

Net claims receivables were \$5,508 and \$11,700 at February 27, 2004 and February 28, 2003, respectively.

3. Costs and Estimated Earnings on Uncompleted Contracts:

Unbilled costs

Amounts not billed or yet billable totaled \$16,638 at February 27, 2004. Under most of the Company's contracts, invoices are issued upon the attainment of certain contract milestones, for example upon receipt of order, upon engineering drawing submittal, upon design acceptance, or upon shipment. Service contracts are billed monthly or quarterly. Parts and service are billed as shipped or completed.

The following is a summary of long-term contracts in progress at February 27, 2004 and February 28, 2003:

	<u>2004</u>	<u>2003</u>
Costs incurred on uncompleted long-term contracts	\$28,802	\$23,941
Estimated earnings	<u>5,508</u>	<u>9,757</u>
	34,310	33,698
Less billings to date	<u>(29,922)</u>	<u>(29,720)</u>
	<u>\$ 4,388</u>	<u>\$ 3,978</u>
	<u>2004</u>	<u>2003</u>
Included in accompanying balance sheets under the following captions:		
Costs and estimated earnings in excess of billings on uncompleted long-term contracts	\$ 5,333	\$ 5,441
Billings in excess of costs and estimated earnings on uncompleted long-term contracts	<u>(945)</u>	<u>(1,463)</u>
	<u>\$ 4,388</u>	<u>\$ 3,978</u>

Included in billings in excess of costs and estimated earnings on uncompleted long-term contracts is a provision for anticipated losses on contracts of \$200 in fiscal 2004, 2003 and 2002.



Notes to Consolidated Financial Statements (\$ in thousands, except share data)

4. Inventories:

Inventories consist of the following:

	Raw Material	Work in Process	Finished Goods	Total
February 27, 2004	\$311	\$7,803	\$1,729	\$9,843
February 28, 2003	322	5,629	2,543	8,494

Inventory is presented above net of an allowance for obsolescence of \$564 and \$646 in fiscal 2004 and 2003, respectively.

5. Property, Plant and Equipment:

The following is a summary of property, plant and equipment, at cost, and estimated useful lives at February 27, 2004 and February 28, 2003:

	<u>2004</u>	<u>2003</u>	<u>Estimated useful lives</u>
Land	\$ 100	\$ 100	
Building and building additions	3,763	3,763	40 years
Machinery and equipment	9,019	8,611	3-5 years
Office furniture and equipment	1,195	1,195	10 years
Building improvements	<u>1,460</u>	<u>1,393</u>	5-10 years
	15,537	15,062	
Less accumulated depreciation	<u>(10,651)</u>	<u>(9,976)</u>	
Property, plant and equipment, net	<u>\$4,886</u>	<u>\$5,086</u>	

Depreciation expense for the fiscal years ended February 27, 2004, February 28, 2003 and February 22, 2002 was \$675, \$673 and \$668, respectively.

6. Long-Term Obligations and Credit Arrangements:

Long-term obligations at February 27, 2004 and February 28, 2003 consist of the following:

	<u>2004</u>	<u>2003</u>
Credit facility payable to banks	\$ 30	\$ 600
Long Term Bonds	4,645	4,920
Subordinated debt, net of unamortized discount of \$2,334 and \$2,609 for 2004 and 2003, respectively	7,666	7,391
Term loans payable, accruing interest at between 9% and 9.9% collateralized by priority liens on certain equipment	6	13
Capitalized lease obligations	<u>127</u>	<u>-</u>
	12,474	12,924
Less current portion	<u>(317)</u>	<u>(281)</u>
	<u>\$12,157</u>	<u>\$12,643</u>

The amounts of future long-term obligations maturing in each of the next five fiscal years are as follows:

2005	\$ 317
2006	343
2007	314
2008	289
2009 and thereafter	<u>11,211</u>
Total future obligations	<u>\$12,474</u>



Notes to Consolidated Financial Statements(\$ in thousands, except share data)

6. Long-Term Obligations and Credit Arrangements (Continued):

The approximate average loan balance, maximum aggregate borrowings outstanding at any month-end payable under the credit facility and subordinated debt during the fiscal years, and weighted average interest rate computed by the day's outstanding method as of February 27, 2004 and February 28, 2003 are as follows:

	<u>2004</u>	<u>2003</u>
Approximate average loan balance	10,401	8,219
Maximum aggregate	11,200	11,445
Weighted average interest rate	8.45%*	4.37%

* The weighted average interest rate calculation for fiscal 2004 reflects the impact of the \$10,000 senior subordinated debt obtained as part of the February 19, 2003 financing.

The Company established a senior credit facility with PNC Bank, National Association on February 19, 2003 and amended the facility on April 30, 2003. The PNC facility includes: (i) a revolving credit facility in the maximum aggregate principal amount of \$14,800 to be used for the Company's working capital and general corporate purposes, including capital expenditures, with a sublimit for issuances of letters of credit in the maximum amount of \$10,300, and (ii) a standby letter of credit in the amount of \$5,025 as credit support for the Company's bonds.

Interest is charged on direct borrowings at the bank's prime rate plus 0.75% for a base rate loan or for a Eurodollar loan, LIBOR plus 3.25% or adjusted LIBOR in 2003 and 2002. The interest rates ranged from 4.75% to 5.00% during fiscal 2004 and from 4.00% to 5.00% during fiscal 2003.

The terms and conditions of the revolving loan and the line of credit are set forth in a credit agreement between the Company and PNC. Availability under the facility is determined each month based on a borrowing base consisting of a portion of the company's receivables, inventory and costs and estimated earnings in excess of billings net of billings in excess of costs and estimated earnings on uncompleted long-term contracts. As of February 27, 2004, availability under the \$14,800 revolving facility was \$7,567 all of which was available for borrowing.

As part of our Bank and Subordinated agreements, the Company must also meet certain financial covenants including a Leverage Ratio, a Fixed Charge Ratio, a Tangible Net Worth Ratio, and maintain a full year profit. As of year end the Company failed to meet all of these covenants and has obtained waivers from both of its lenders.

The PNC credit facility is secured by (i) the grant of a first and prior security interest in all of the personal property of the Company, Entertainment Technology Corporation ("Entertainment"), and ETC Delaware, Inc. ("ETC Delaware"), each a wholly-owned subsidiary of the Company, in favor of PNC; (ii) the Company's grant of a first and prior security interest in all of the Company's accounts, deposits and all other negotiable and non-negotiable instruments owned by the Company in favor of PNC; (iii) the Company's grant of a first and prior mortgage on all of the Company's real property in favor of PNC; and (iv) the Company's grant of a first and prior security interest in all of the Company's rights to (a) all of the shares of capital stock of each of Entertainment and ETC Delaware and (b) 65% of the shares of capital stock owned by the company of each of its foreign subsidiaries in favor of PNC. In addition, the PNC credit agreement requires that Entertainment and ETC Delaware guarantee the Company's obligations under the PNC facility.

Subsequent to fiscal year end, PNC advised the Company that it was considering certain changes to the revolving credit facility including reducing the total facility and requiring the Company to cash collateralize some or all of the facility. As of the filing date of this Annual Report on Form 10-K, these discussions were still ongoing. As of April 30, 2004, the Company had utilized approximately \$5,426 of the facility for international letters of credit and as collateral for a portion of the long-term bonds. (Reference the Liquidity and Capital Resources Section of the Annual Report to Stockholders attached as Exhibit 13 to this Annual Report on Form 10-K.)

Also on February 19, 2003, the Company entered into a Convertible Note and Warrant Purchase Agreement with H.F. Lenfest ("Lenfest") for \$10,000 face value of senior subordinated debt. The note accrues interest at the rate of 10% per annum and matures on February 18, 2009. The note allows Lenfest to convert all or part of the outstanding principal thereunder into shares of common stock at a conversion price of \$6.05 per share.



Notes to Consolidated Financial Statements (\$ in thousands, except share data)

6. Long-Term Obligations and Credit Arrangements (Continued):

The promissory note allows for quarterly interest payments in arrears with the principal due on February 18, 2009. At the Company's option, the quarterly interest payments may be deferred and added to the outstanding principal. At Lenfest's option, any deferred interest amounts may be converted into shares of common stock under the same terms and conditions as the convertible note.

The Company has obtained a valuation from an independent valuation firm of the convertible note and the associated warrant. Based on the results of this valuation, at February 28, 2003, \$1,400 of value had been assigned to the beneficial conversion feature of the convertible note and \$1,209 had been assigned to the value of the associated warrants. Both of these amounts have been credited to additional paid-in capital as of February 28, 2003. Accreted interest expense related to the note and warrants was \$275 in fiscal 2004.

The Company used a portion of the proceeds from the financing to satisfy its existing obligations to Wachovia Bank, the Company's former lender, and to permit PNC to issue a letter of credit to support the Company's bonds.

The Company's letter of credit limit under the revolving credit facility is \$10,300, subject to borrowing base availability. The balance outstanding under these facilities at February 27, 2004 was \$4,083. Fees on letters of credit outstanding were 1.75% at February 27, 2004 and February 28, 2003.

On March 15, 2000, the Company issued approximately \$5,500 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 advance taken on the Company's revolving credit facility and to finance construction of an addition to the Company's main plant in Southampton, Pennsylvania. The bonds are secured by a \$5,000 irrevocable direct pay Letter of Credit issued by the Company's main lender which expires on March 15, 2005 and which is secured by all assets of the Company. The bonds carry a maturity date of April 1, 2020, bear a variable interest rate which adjusts each week to a rate required to remarket the bonds at full principal value (currently at 1.20% on May 12, 2004) with a cap of 17%, and are subject to mandatory redemption of \$275 per year for 19 years and \$245 for the 20th year.

The carrying value of these financial instruments approximates their fair values at February 27, 2004.

7. Leases:

Operating Leases

The Company leases certain premises and office equipment under operating leases, which expire over the next five years. Future minimum rental payments required under noncancellable operating leases having a remaining term expiring after one fiscal year as of February 27, 2004 are \$159 in 2005; \$125 in 2006; \$86 in 2007; \$14 in 2008; and \$0 in 2009 and thereafter.

Total rental expense for all operating leases for the fiscal years ended February 27, 2004, February 28, 2003 and February 22, 2002 was \$241, \$255 and \$197, respectively.

8. Income Taxes:

The components of the provision for income taxes are as follows:

	<u>52 Weeks Ended February 27, 2004</u>	<u>53 Weeks Ended February 28, 2003</u>	<u>52 Weeks Ended February 22, 2002</u>
Currently payable:			
Federal	\$(738)	\$285	\$ 42
State	-	188	134
Foreign taxes	<u>96</u>	<u>19</u>	<u>(230)</u>
	<u>(642)</u>	<u>492</u>	<u>(54)</u>
Deferred:			
Federal	(101)	282	(36)
State	(67)	31	(3)
	<u>(168)</u>	<u>313</u>	<u>(39)</u>
	<u>\$(810)</u>	<u>\$805</u>	<u>\$(93)</u>



Notes to Consolidated Financial Statements (\$ in thousands, except share data)

8. Income Taxes (Continued):

A reconciliation of the statutory federal income tax rate to the effective tax rate is as follows:

	<u>52 Weeks Ended</u> <u>February 27, 2004</u>	53 Weeks Ended <u>February 28, 2003</u>	52 Weeks Ended <u>February 22, 2002</u>
Statutory income tax	(34.0)%	34.0	34.0%
State income tax, net of federal tax benefit	(4.1)	3.7	5.4
Benefit of foreign sales corporation And extraterritorial income	(9.1)	(4.5)	(3.4)
Research and experimentation tax credit refunds attributable to open tax years	(0.0)	(0.0)	(37.8)
Research and experimentation and Other tax credits	(9.2)	(5.0)	(9.2)
Benefit of foreign and foreign-source Income or loss	(0.0)	(0.0)	(1.0)
Other, net	<u>6.0</u>	<u>(3.5)</u>	<u>6.4</u>
	<u>(50.4)%</u>	<u>24.7%</u>	<u>(5.6)%</u>

The tax effects of the primary temporary differences are as follows:

	<u>2004</u>	<u>2003</u>	<u>2002</u>
Deferred tax assets:			
Net products liability settlement	-	75	75
Vacation reserve	44	44	58
Inventory reserve	212	244	275
Receivable reserve	8	168	139
Warranty reserve	142	47	46
Net operating loss and credits	302	-	-
Other, net	<u>629</u>	<u>111</u>	<u>122</u>
Total current deferred tax asset	<u>\$1,337</u>	<u>\$689</u>	<u>\$715</u>
Deferred tax liabilities:			
Amortization of capitalized software	<u>\$1,166</u>	<u>\$724</u>	<u>\$488</u>
Depreciation	<u>336</u>	<u>298</u>	<u>247</u>
Total noncurrent deferred tax liability	<u>\$1,502</u>	<u>\$1,022</u>	<u>\$735</u>



Notes to Consolidated Financial Statements (\$ in thousands, except share data)

9. Business Segment Information:

The Company primarily manufactures, under contract, various types of high-technology equipment which 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 produces devices which create and monitor the physiological effects of motion, including spatial disorientation and centrifugal forces for medical, training, research and entertainment markets. The Industrial Group business produce chambers that create environments that are used for sterilization, research and medical applications. The following segment information reflects the accrual basis of accounting:

	ATS	Industrial Group	Total
Fiscal 2004			
Net sales	\$15,880	\$10,115	\$25,995
Interest expense	1,293	313	1,606
Depreciation and amortization	881	966	1,847
Operating income/(loss)	1,231	(248)	983
Income tax provision/(benefit)	62	(318)	(256)
Goodwill	477	-	477
Identifiable assets	30,002	7,496	37,498
Expenditures for segment assets	380	95	475
Fiscal 2003			
Net Sales	\$31,612	\$11,511	\$43,123
Interest expense	423	95	518
Depreciation and amortization	1,136	265	1,401
Operating income	4,979	52	5,031
Income tax provision/(benefit)	1,139	(11)	1,128
Goodwill	477	-	477
Identifiable assets	26,481	6,348	32,829
Expenditures for segment assets	406	35	441
Fiscal 2002			
Net Sales	\$22,629	\$9,898	\$32,527
Interest expense	950	144	1,094
Depreciation and amortization	1,041	434	1,475
Operating income	2,631	1,347	3,978
Income tax provision	164	118	282
Goodwill	477	-	477
Identifiable assets	33,160	5,408	38,568
Expenditures for segment assets	557	92	649
	2004	2003	2002
Reconciliation to consolidated amounts:			
Corporate assets	<u>10,721</u>	<u>14,869</u>	<u>9,914</u>
Total assets	\$48,696	\$47,698	\$48,482
Segment operating income	\$983	\$5,031	\$3,978
Less interest expense	(1,606)	(518)	(1,094)
Income taxes (benefit)/provision	<u>(256)</u>	<u>1,128</u>	<u>282</u>
Total (loss)/income for segments	(367)	3,385	2,602



Notes to Consolidated Financial Statements (\$ in thousands, except share data)

9. Business Segment Information (Continued):

Corporate home office expense	(852)	(915)	(1,105)
Interest and other expenses	(130)	(338)	(144)
Income tax benefit	554	323	375
Minority interest	2	38	13
Net (loss)/income	<u>\$(793)</u>	<u>\$2,493</u>	<u>\$1,741</u>

Segment operating income consists of net sales less applicable costs and expenses relating to these revenues. Unallocated expenses including general corporate expenses, letter of credit fees, interest expense, and income taxes have been excluded from the determination of the total profit for segments. General corporate expenses are primarily central administrative office expenses. Property, plant, and equipment are not identified with specific business segments because most of these assets are used in each of the segments.

Approximately 22% of sales totaling \$5,714 in 2004 were made to two international customers in the ATS segment. Approximately 57% of sales totaling \$24,471 in fiscal 2003 were made to one international and one domestic customer in the ATS segment. Approximately 59% of sales totaling \$19,143 in fiscal 2002 were made to one international and one domestic customer in the ATS segment.

Included in the segment information for the year ended February 27, 2004, are export sales of \$15,421. Of this amount, there are sales to or relating to governments or commercial accounts in Malaysia of \$2,874 and the United Kingdom of \$2,840. Sales to the U.S. government and its agencies aggregated \$1,717 for the year ended February 27, 2004.

Included in the segment information for the year ended February 28, 2003 are export sales of \$14,805. Of this amount, there are sales to or relating to governments or commercial accounts in Malaysia of \$7,203. Sales to the U.S. government and its agencies aggregated \$4,626 for the year ended February 28, 2003.

Included in the segment information for the year ended February 22, 2002 are export sales of \$10,110. Of this amount, there are sales to or relating to governments or commercial accounts in Thailand of \$3,284. Sales to the U.S. government and its agencies aggregated \$1,194 for the year ended February 22, 2002.

10. Stock Options:

A summary of the status of the Incentive Stock Option Plan as of and for the fiscal years ended:

	<u>February 27, 2004</u>		<u>February 28, 2003</u>		<u>February 22, 2002</u>	
	Shares	Weighted average exercise price	Shares	Weighted average exercise price	Shares	Weighted average exercise price
Outstanding at beginning of year	421,614	\$7.20	448,514	\$7.04	464,350	\$6.95
Granted	--	--	-	-	27,564	7.38
Exercised	(17,800)	5.12	(4,150)	4.73	(32,400)	5.89
Forfeited	<u>(27,812)</u>	7.74	<u>(22,750)</u>	4.52	<u>(11,000)</u>	7.43
Outstanding at end of year	376,002	7.21	421,614	7.20	448,514	7.04
Options exercisable at year end	370,564	-	408,981	-	240,325	-
Weighted average fair value of options granted during the year	-	-	-	-	-	\$7.01



Notes to Consolidated Financial Statements (\$ in thousands, except share data)

10. Stock Options (Continued):

The following information applies to options outstanding at February 27, 2004:

Range of exercise prices	Options outstanding		Options exercisable		
	Number Outstanding at February 27, 2004	Weighted average remaining contractual life (years)	Weighted average exercise price	Number exercisable at February 27, 2004	Weighted average exercise price
\$2.25 to \$3.38	9,200	2.45 years	\$2.25	9,200	\$2.25
\$5.00 to \$7.50	82,302	5.01 years	\$5.67	76,864	\$5.55
\$7.81	<u>284,500</u>	4.65 years	\$7.81	<u>284,500</u>	\$7.81
Total	376,002			370,564	

11. Claims and Litigation:

In April 2003, Boenning & Scattergood, Inc. ("B&S") filed suit against the Company in the Court of Common Pleas in Philadelphia, Pennsylvania, seeking payment of \$902 for financing fees allegedly due to B&S pursuant to the terms of an agreement for investment banking services which was entered into with a predecessor of B&S (the "B&S Agreement"). B&S alleged that it contacted the investors in the Company's February 2003 financing transaction and that it earned the claimed financing fees pursuant to the terms of the B&S agreement. The Company responded to the complaint and also filed a counterclaim for breach of contract and professional malpractice. The Company believes that it has valid defenses to each of the claims of B&S and intends to vigorously defend itself against these claims. At this time, however, the Company is unable to predict the outcome of this matter.

In June 2003, Associated Mezzanine investors, LLC ("AMI") filed suit against the Company in the United States District Court for the Eastern District of Pennsylvania seeking payment of \$196 for costs, fees and expenses allegedly due to AMI pursuant to the terms of an agreement which the Company entered into with AMI (the "AMI Agreement"). AMI claimed that it located suitable investors for the Company's February 2003 financing transaction and that it earned the claimed fees and is entitled to reimbursement of the claimed costs and expenses pursuant to the terms of the AMI Agreement. In March 2004, this suit was settled without any material impact on the Company's results of operations.

In June 2003 Entertainment Technology Corporation, a wholly-owned subsidiary of the Company, filed suit against Walt Disney World Co. and other entities ("Disney") in the United States District Court for the Eastern District of Pennsylvania, alleging breach of contract for, among other things, failure to pay all amounts due under a contract for the design and production of the amusement park ride "Mission:Space" located in Disney's Epcot Center. In response, in August 2003, Disney filed counterclaims against both Entertainment Technology Corporation and the Company (under a guarantee) for, among other things, alleged failures in performance and design in the contract. Disney is seeking damages in excess of \$150. Entertainment Technology Corporation and the Company believe that they have valid defenses to each of Disney's counterclaims and intend to vigorously defend against these counterclaims. At this time, the parties are engaged in the discovery process. The parties have exchanged self-executing disclosures and responses to interrogatories, and will be producing documents shortly, after which depositions will occur. Accordingly, Entertainment Technology Corporation and the Company are unable to predict the outcome of this matter.

Certain other claims, suits, and complaints arising in the ordinary course of business have been filed or are pending against the Company. In the opinion of management, after consultation with legal counsel handling these specific matters, all such matters are reserved for or adequately covered by insurance or, if not so covered, are without merit or are of such kind, or involve such amounts, as would not have a significant effect on the financial position or results of operations of the Company if disposed of unfavorably.

**Notes to Consolidated Financial Statements (\$ in thousands, except share data)****12. Employee Benefit Plan:**

The Company maintains a retirement savings 401(k) plan for eligible employees. The Company's contributions to the plan are based on a percentage of the employees' qualifying contributions. The Company's contributions totaled \$107, \$112 and \$114 in fiscal 2004, fiscal 2003, and fiscal 2002, respectively.

The Company has an Employee Stock Purchase Plan which was adopted by the Board of Directors on November 3, 1987. All employees meeting service requirements, except officers, directors and 10% shareholders, are eligible to voluntarily purchase common stock through payroll deductions up to 10% of salary. The Company makes a matching contribution of 20% of the employee's contribution. The Company has reserved 270,000 shares for issuance under the plan.



Notes to Consolidated Financial Statements (\$ in thousands, except share data)

13. Quarterly Consolidated Financial Information (Unaudited):

Financial data for the interim periods of fiscal 2004, 2003 and 2002 were as follows:

Fiscal Year 2004	<u>Quarter Ended</u>			
	May 30	August 29	November 28	February 27
Net sales	\$6,130	\$4,752	\$7,115	\$7,998
Gross profit	2,287	1,786	1,774	4,096
Operating income/(loss)	520	(395)	(700)	706
Income/(loss) before income taxes	133	(862)	(987)	111
Minority interest	(4)	(2)	(3)	6
Net income/(loss)	70	(622)	(704)	463
Earnings/(loss) per common share:				
Basic	.01	(.09)	(.10)	.06
Diluted	.01	(.09)	(.10)	.06

Fiscal Year 2003	<u>Quarter Ended</u>			
	May 24	August 23	November 22	February 23
Net sales	\$11,207	\$11,041	\$12,162	\$8,713
Gross profit	3,583	3,263	3,579	3,773
Operating income	1,075	1,108	874	1,059
Income before income taxes	831	936	584	909
Minority interest	(27)	(5)	(6)	-
Net income	585	736	436	736
Earnings per common share:				
Basic	.08	.10	.06	.10
Diluted	.08	.10	.06	.10

Fiscal Year 2002	<u>Quarter Ended</u>			
	May 25	August 24	November 23	February 22
Net sales	\$8,340	\$7,414	\$8,230	\$8,543
Gross profit	2,693	2,393	3,667	2,712
Operating income	449	546	1,351	527
Income before income taxes	58	275	805	398
Minority interest	(5)	(4)	2	(6)
Net income	224	297	662	558
Earnings per common share:				
Basic	.03	.04	.09	.08
Diluted	.03	.04	.09	.07



CERTIFICATION PURSUANT TO 18 U.S.C. SECTION 1350 AS ADOPTED PURSUANT TO SECTION 302 OF THE SARBANES-OXLEY ACT OF 2002.

I, William F. Mitchell, certify that:

1. I have reviewed this Annual Report on Form 10-K of Environmental Tectonics Corporation;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) for the registrant and have:
 - a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
 - b) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
 - c) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officers and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent functions):
 - a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
 - b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: May 27, 2004

A handwritten signature in cursive script that reads "Wm F Mitchell".

By William F. Mitchell
William F. Mitchell
President and Chief Executive Officer



CERTIFICATION PURSUANT TO 18 U.S.C. SECTION 1350 AS ADOPTED PURSUANT TO SECTION 302 OF THE SARBANES-OXLEY ACT OF 2002.

I, Duane D. Deaner, certify that:

1. I have reviewed this Annual Report on Form 10-K of Environmental Tectonics Corporation;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) for the registrant and have:
 - a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
 - b) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
 - c) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officers and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent functions):
 - a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
 - b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: May 27, 2004

By Duane D. Deaner
Duane D. Deaner
Chief Financial Officer

