

| | | |
|--|--------|--------|
| Gross profit | 2,977 | 2,677 |
| Operating expenses: | | |
| Selling and administrative | 1,883 | 1,964 |
| Research and development | 74 | 83 |
| | 1,957 | 2,047 |
| Operating income | 1,020 | 630 |
| Other expenses: | | |
| Interest expense | 515 | 432 |
| Letter of credit fees | 11 | 12 |
| other, net | 64 | 8 |
| | 590 | 452 |
| Income before income taxes | 430 | 178 |
| Provision for income taxes | 138 | 63 |
| Net income | \$ 292 | \$ 115 |
| Earnings per common share (primary and fully diluted) | \$.10 | \$.04 |

See notes to consolidated financial statements.

ENVIRONMENTAL TECTONICS CORPORATION
AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF OPERATIONS

3 Months Ended
(\$000's, except per share data, unaudited)

| | August 30, 1996 | August 25, 1995 |
|--|-----------------|-----------------|
| Net sales | \$4,897 | \$3,559 |
| Cost of goods sold | 3,315 | 2,308 |
| Gross profit | 1,582 | 1,251 |
| Operating expenses: | | |
| Selling and administrative | 979 | 908 |
| Research and development | 22 | 43 |
| | 1,001 | 951 |
| Operating income | 581 | 300 |
| Other expenses: | | |
| Interest expense | 289 | 219 |
| Letter of credit fees | 4 | 4 |
| other, net | 33 | 8 |
| | 326 | 231 |
| Income before income taxes | 255 | 69 |
| Provision for income taxes | 83 | 24 |
| Net income | \$ 172 | \$ 45 |
| Earnings per common share (primary and fully diluted) | \$.06 | \$.02 |

See notes to consolidated financial statements.

ENVIRONMENTAL TECTONICS CORPORATION
AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS
(\$000's, unaudited)

| ASSETS | August 30, 1996 |
|---|-----------------|
| February 23, 1996 | |
| Current assets: | |
| Cash and cash equivalents | \$ - |
| \$ 31 | |
| Cash equivalents restricted for letters of credit | 394 |
| 859 | |
| Accounts receivable, net | 7,742 |
| 7,710 | |
| Costs and estimated earnings in excess of billings on un- completed long-term contracts | 3,965 |
| 4,024 | |
| Inventories | 4,082 |
| 3,611 | |
| Prepaid expenses and other current assets | 493 |
| 574 | |
| Total current assets | 16,676 |
| 16,809 | |
| Property, plant, and equipment, at cost, net | 2,424 |
| 2,498 | |
| Software development costs, net of accumulated amortization of \$2,896 at August 30 and \$2,563 at February 23 | 1,586 |
| 1,617 | |
| Other assets | 2 |
| 2 | |
| Total assets | \$20,688 |
| \$20,926 | |

See notes to consolidated financial statements.

ENVIRONMENTAL TECTONICS CORPORATION
AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS

(\$000's, unaudited)

LIABILITIES
February 23, 1996

August 30, 1996

Current liabilities:

| | |
|---|----------|
| Current portion of long-term debt \$ 2,441 | \$ 7,230 |
| Accounts payable - trade 1,586 | 2,133 |
| Billings in excess of costs and estimated earnings on uncompleted long-term contracts 3,355 | 2,580 |
| Customer deposits 104 | 125 |
| Accrued income taxes 188 | 262 |
| Net arbitration award 445 | 195 |
| Accrued liabilities 812 | 1,048 |
| Total current liabilities 8,931 | 13,573 |
| Long-term debt, less current portion Credit facility payable to banks due March 31, 1997 5,214 | - |
| Other 300 | 292 |
| 5,514 | 292 |
| Deferred income taxes 370 | 370 |
| Total liabilities 14,815 | 14,235 |
| Commitments and contingencies (Note 7) - | - |
| STOCKHOLDERS' EQUITY | |
| Common stock - authorized 10,000,000 shares \$.10 par value; 2,928,944 shares issued and outstanding 293 | 293 |
| Capital contributed in excess of par value of common stock 1,692 | 1,742 |
| Retained earnings 4,126 | 4,418 |
| Total stockholders' equity | 6,453 |

6,111

Total liabilities and
stockholders' equity \$20,688
\$20,926

See notes to consolidated financial statements.

ENVIRONMENTAL TECTONICS CORPORATION
AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS

6 Months Ended
(\$000's, unaudited)

August 30, 1996

February 23, 1996

Increase (decrease) in cash

Reconciliation of net income
to net cash provided
by (used in) operating
activities:

| | | |
|---|----|-------|
| Net income | \$ | 292 |
| \$ 115 | | |
| Adjustments to reconcile net income to net cash used in operating activities: | | |
| Depreciation and amortization | | 571 |
| 457 | | |
| (Increase) decrease in assets | | |
| Accounts receivable | | (32) |
| 2,432 | | |
| Costs and estimated earnings in excess of billings | | 59 |
| (779) | | |
| Inventories | | (471) |
| (23) | | |
| Prepaid expenses and other current assets | | 81 |
| (269) | | |
| (Decrease) increase in liabilities | | 555 |
| (248) | | |
| Accounts payable | | |
| Billings in excess of costs and estimated earnings | | (775) |
| (357) | | |
| Customer deposits | | 21 |
| (118) | | |
| Payments under settlement agreements | | (350) |
| -- | | |
| Accrued liabilities and income taxes | | 310 |
| (57) | | |
| Net cash provided by operating activities | | 261 |
| 1,153 | | |

| | |
|--|-------|
| Cash flows from investing activities: | |
| Acquisition of equipment | (115) |
| (124) | |
| Increase in software development costs | (309) |
| (291) | |
| Decrease in other assets | -- |
| 42 | |
| Net cash used in investing activities | (424) |
| (373) | |

| | |
|---|-------|
| Cash flows from financing activities: | |
| Borrowings under credit facility | |
| 375 | |
| Increase in cash equivalents restricted | |
| for letters of credit | 465 |
| (227) | |
| Payments under credit facility | (325) |
| (1,000) | |
| Principal payments of capital leases | |
| and other long-term debt | (8) |
| (65) | |
| Proceeds from issuance of common stock | -- |
| 71 | |
| Net cash provided by (used in) | |
| financing activities | 132 |
| (846) | |
| Net decrease in cash | (31) |
| (66) | |
| Cash at beginning of period | 31 |
| 66 | |
| Cash at end of period | \$ -- |
| \$ -- | |

| | |
|---|--------|
| Supplemental schedule of cash flow information: | |
| Interest paid | \$ 515 |
| \$ 342 | |
| Income taxes paid | 60 |
| -- | |

See notes to consolidated financial statements.

ENVIRONMENTAL TECTONICS CORPORATION
AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(\$000's)

1. The information in this report reflects all adjustments which are, in the opinion of management, necessary to a fair statement of the results for the interim periods presented.

There has been no significant change in the Company's effective tax rate since February 23, 1996.

2. Under the Company's 1988 Incentive Stock Option Plan, 500,000 shares of the Company's common stock are currently reserved for issuance in connection with the exercise of options, and options to acquire 124,550 shares are currently outstanding.

3. Earnings per common share are based on net income divided by

the number of common and common stock equivalent shares (shares issuable upon the exercise of stock options and warrants) outstanding. Weighted average number of common shares and equivalents outstanding were approximately 2,960,000 (primary and fully diluted) in 1996 and 2,874,000 (primary) in 1995.

4. Inventories consist of the following:

| | August 30, 1996 | February 23, 1996 |
|-----------------|-----------------|-------------------|
| Raw materials | \$ 733 | \$ 696 |
| Work in Process | 3,349 | 2,915 |
| Finished Goods | -- | -- |
| | \$4,082 | \$3,611 |

5. The components of accounts receivable are as follows:

| | August 30, 1996 | February 23, 1996* |
|--|-----------------|--------------------|
| U.S. Government receivables billed and unbilled contract costs subject to negotiation | \$ 4,530 | \$ 3,848 |
| U.S. receivables billed | 286 | 746 |
| International receivables billed | 3,050 7,866 | 3,240 7,834 |
| Less allowance for doubtful accounts | (124) | (124) |
| | \$ 7,742 | \$ 7,710 |

*Restated to conform to current classifications.

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

Unbilled contract costs subject to negotiation represent claims made or to be made against the U.S. Government. In fiscal 1995, the Company recorded approximately \$1.4 million of claims revenue related to two certain aircrew training systems contracts. No claims revenue was recorded in fiscal 1996 or 1997. The Company has recorded claims to the extent of contract costs incurred. These costs have been incurred in connection with U.S. Government-caused delays, errors in specifications and designs, and other unanticipated causes and may not be received in full during fiscal 1997. In accordance with generally accepted accounting principles, revenue recorded by the Company from a claim does not exceed the incurred contract costs related to the claim. The Company estimates that the total net claims filed and to be filed approximate \$7.3 million, a portion of which has been included in U.S. Government receivables billed and unbilled contract costs subject to negotiation. Such claims are subject to negotiation and audit by the U.S. Government.

See also footnote number 6.

6. Subsequent Event

On October 1, 1996, the Company was notified of the results of an arbitration award concerning a large contract with the Royal Thai Air Force (the "RTAF"). In October 1993, the Company had been notified by the RTAF that the RTAF was

terminating a certain \$4.6 million simulator contract with the Company, alleging a failure to completely perform. In connection with this termination, the RTAF made a call on a \$229,000 performance bond, as well as a drew on approximately \$1.1 million of advance payment letters of credit. The RTAF also asserted liquidated damages against the Company. In October 1993, the surety made payment on the \$229,000 performance bond, and in the first quarter of fiscal 1995, it made payment on the approximately \$1.1 million advance payment letters of credit.

On October 1, 1996, the Thai Trade Arbitration Council rendered its decision, under which the contract was reinstated in full, and the Company was instructed to complete the remainder of the contract work. Upon completion of the contract, the RTAF will pay the Company the 10% balance due, and will also release the performance bond and advance payment guarantee that were called. Additionally, no penalties will be assessed against the Company. An amount of \$1,374,000 related to this settlement is included in International receivables billed at August 30 and February 23, 1996.

7. Contingencies

Certain 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, 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.

Item 2. Management's Discussion and Analysis:

ENVIRONMENTAL TECTONICS CORPORATION AND SUBSIDIARIES

MANAGEMENT'S DISCUSSION AND ANALYSIS OF RESULTS OF OPERATIONS AND FINANCIAL CONDITION August 30, 1996

Material Changes in Financial Condition

Cash provided from operations decreased from \$1,153,000 in the prior year period to \$261,000 in the current six months ended August 30, 1996. The decrease primarily resulted from reduced cash from accounts receivable partially offset by increased accounts payable and accrued liabilities and reduced prepaid expenses. Although the accounts receivable balance was basically constant from February 23 to August 30, 1996, the prior period reflected a large decrease due to collection of receivables billed on two certain international aircrew training systems contracts and two certain domestic sterilizer contracts. Increases in the current period in accounts payable and accrued liabilities reflected the overall increased purchase activity, while the decrease in prepaid expenses resulted from amortization of prepaid commissions.

The Company has a revolving credit agreement with two banks, which provides financing of up to \$7.7 million. The facility expires by its terms on March 31, 1997. The credit facility permits both direct borrowing for working capital and other corporate purposes and the issuance of letters of credit for the Company. At August 30, 1996, there were outstanding letters of credit of approximately \$190,000 and borrowings of approximately

\$7.2 million under the credit facility.

The Company's sales backlog at August 30, 1996 and February 23, 1996 for work to be performed, training and maintenance contracts, and prospective revenue to be recognized after that date under written agreements was approximately \$31,500,000 and \$23,000,000 respectively.

Material Changes in Results of Operations

Net sales of approximately \$9.4 million for the six months and approximately \$4.9 million for the three months ended August 30, 1996 increased by 29% and 38% in comparison to the respective equivalent prior year's periods. Increases were evidenced across all product lines except environmental which was negatively impacted by reduced bookings at the end of last year. The most significant increases for the current six month period was evidenced in sterilizers (up 78%) and aircrew training systems (up 46%).

Gross profit increased by \$300,000 for the six months and \$331,000 for the three months ended August 30, 1996 as compared to the prior year's respective periods. The increases reflected the aforementioned sales increases partially offset by a sales mix shift to lower-margin sterilizer sales in the current periods.

Operating expenses were up \$50,000 for the three months ended August 30, 1996, but fiscal year to date are down by \$90,000 versus the prior year. As a percent of net sales, operating expenses for the six months ended August 30, 1996, decreased to 20.8% versus 28.2% in the prior year's period.

Interest expense increased in both respective current periods reflecting an increase in the interest rate charged by the Company's primary lender coupled with additional interest expense paid on a federal tax settlement.

The increase in other expenses for both current periods resulted from amortization of a deferred finance charge associated with warrants issued in conjunction with the Company's credit facility which expires in March, 1997.

PART II - Other Information

Item 1. Legal proceedings:

See Note 7 in Part I.

Item 4. Submission of Matters to Vote of Security Holders

The 1996 Annual Meeting of Shareholders (the "Meeting") of the Company was held on August 9, 1996. Notice of the Meeting was mailed to shareholders on or about July 15, 1996.

The Meeting was held:

1. To elect five directors to serve until their successors have been elected and qualified.
2. To consider and act upon a proposal to amend the Company's Articles of Incorporation to authorize 1,000,000 shares of preferred stock ("Matter No. 2").

There was no solicitation in opposition to the nominees of the board of Directors for election to the Board of

Directors. All nominees of the Board of Directors were elected. The number of votes cast for, as well as the number of votes withheld, for each of the nominees for election to the Board of Directors were as follows:

| Nominee | For | Withheld |
|---------------------|-----------|----------|
| Richard E. McAdams | 2,552,612 | 53,976 |
| William F. Mitchell | 2,552,612 | 53,976 |
| Michael A. Mulshine | 2,552,612 | 53,976 |
| Pete L. Stephens | 2,552,612 | 53,976 |
| Philip L. Wagner | 2,483,412 | 54,176 |

Matter No. 2 was approved by shareholders at the Meeting. The votes cast for this matter were as follows:

| For | Against | Abstentions and Broker Non-Votes |
|-----------|---------|-------------------------------------|
| 1,847,654 | 2,991 | 3,641 |

Item 6. Exhibits and Reports on Form 8-K:

a. Exhibits

Exhibit 27 - Financial Data Schedule.

b. Reports on Form 8-K

No reports on Form 8-K were filed during the three months ended August 30, 1996.

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

ENVIRONMENTAL TECTONICS CORPORATION
(Registrant)

By /s/ Duane D. Deaner
Duane D. Deaner, Chief
Financial Officer and
Principal Accounting Officer

Date: October 14, 1996

EXHIBIT INDEX

| Exhibit No. | Description |
|-------------|--------------------------|
| 27 | Financial Data Schedule. |

<ARTICLE> 5

| | | |
|------------------------------|-------|-------------|
| <PERIOD-TYPE> | 6-MOS | |
| <FISCAL-YEAR-END> | | FEB-28-1997 |
| <PERIOD-END> | | AUG-30-1996 |
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| <ALLOWANCES> | | 124,000 |
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| <CURRENT-ASSETS> | | 16,676,000 |
| <PP&E> | | 8,347,000 |
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| <BONDS> | | 7,522,000 |
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| <PREFERRED> | | 0 |
| <COMMON> | | 293,000 |
| <OTHER-SE> | | 6,160,000 |
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| <EXTRAORDINARY> | | 0 |
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