FORM 10-QSB
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

(Mark One)

[x] QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended May 29, 1998

OR

[ ] TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the transition period from _______ to _______

Commission File No. 1-10655

ENVIRONMENTAL TECTONICS CORPORATION
(Exact name of registrant as specified in its charter)

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

COUNTY LINE INDUSTRIAL PARK
SOUTHAMPTON, PENNSYLVANIA 18966
(Address of principal executive offices
(Zip Code)

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

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

Yes x No

The number of shares outstanding of the registrant's common stock as of July 10, 1998 is: 3,069,156

Environmental Tectonics Corporation
Consolidated Income Statements
(unaudited)

(thousands, except share and per share information)

| | Three months ended: May 29, 1998 | May 30, 1997 |
|---|---|---|
| Net Sales | $7,460 | $6,644 |
| Cost of goods sold | 4,711 | 4,684 |
| Gross profit | 2,749 | 1,960 |
| Operating expenses: | | |
| Selling and administrative | 1,662 | 1,130 |
| Research and development | 88 | 40 |
| | 1,750 | 1,170 |

| | | |
|---|---|---|
| Operating income | 999 | 790 |
| Other expenses: | | |
| Interest expense | 265 | 217 |
| Other, net | 22 | 27 |
| | 287 | 244 |
| Income before income taxes | 712 | 546 |
| Provision for income taxes | 248 | 186 |
| Net income | $464 | $360 |
| Per share information: | | |
| Income available to common shareholders | $384 | $304 |
| Income per share: basic | $0.13 | $0.10 |
| Income per share: diluted | $0.12 | $0.10 |
| Number of shares: basic | 3,035,851 | 2,967,542 |
| Number of shares: diluted | 3,256,608 | 3,142,003 |

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



Environmental Tectonics Corporation
Consolidated Balance Sheets
(unaudited)

| Assets | May 29, 1998 | February 27, 1998 |
|---|---|---|
| | (amounts in thousands) | |
| Current assets: | | |
| Cash and cash equivalents | $529 | $225 |
| Cash equivalents restricted for letters of credit | 25 | 15 |
| Accounts receivable, net | 8,797 | 8,448 |
| Costs and estimated earnings in excess of billings on uncompleted long-term contracts | 8,828 | 5,651 |
| Inventories | 2,679 | 3,058 |
| Deferred tax asset | 770 | 770 |
| Prepaid expenses and other current assets | 390 | 283 |
| Total current assets | 22,018 | 18,450 |
| Property, plant and equipment, at cost, net of accumulated depreciation of $6,861 at May 29, 1998 and $6,729 at February 27, 1998 | 3,043 | 2,837 |
| Software development costs, net of accumulated amortization of $4,093 at May 29, 1998 and $3,914 at February 27, 1998 | 1,074 | 1,155 |
| Goodwill | 662 | - |
| Other assets | 468 | 513 |
| Total assets | $27,265 | $22,955 |

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

Consolidated Balance Sheets (unaudited)

| | May 29 1998 | February 27 1998 |
|---|---|---|
| | (amounts in thousands) | |
| Liabilities and Stockholders' Equity | | |
| Liabilities | | |
| Current liabilities: | | |
| Current portion of long-term debt | $148 | $148 |
| Convertible notes payable - related parties | 300 | 800 |
| Accounts payable - trade | 1,253 | 1,424 |
| Billings in excess of costs and estimated earnings on uncompleted long-term contracts | 1,040 | 1,145 |
| Customer deposits | 910 | 1,373 |
| Accrued income taxes | 285 | 984 |
| Accrued liabilities | 1,663 | 1,114 |
| Total current liabilities | 5,599 | 6,988 |
| Long-term debt, less current portion: | | |
| Credit facility payable to banks | 4,631 | 467 |
| Subordinated debt | 3,741 | 3,730 |
| Other | 476 | 159 |
| | 8,848 | 4,356 |
| Deferred income taxes | 702 | 702 |
| Total liabilities | 15,149 | 12,046 |
| Redeemable cumulative preferred stock, $100 par and redemption value; 25,000 shares authorized, issued and outstanding | 2,340 | 2,330 |
| Minority interest | 300 | - |
| Stockholders' equity | | |
| Common stock; $.10 par value; 10,000,000 shares authorized; 3,065,106 and 3,006,596 issued and outstanding at May 29, 1998 and February 27,1998, respectively | 306 | 300 |
| Capital contributed in excess of par value of common stock | 3,177 | 2,671 |
| Retained earnings | 5,993 | 5,608 |
| Total stockholders' equity | 9,476 | 8,579 |
| Total liabilities and stockholders' equity | $27,265 | $22,955 |

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



Consolidated Statements of Cash Flows (unaudited)

| | Three months ended: May 29 1998 | May 30 1997 |
|---|---|---|
| | (amounts in thousands) | |

| | | |
|---|---|---|
| Cash flows used by operating activities: | | |
| Net income | $464 | $360 |
| Adjustments to reconcile net income to net cash (used) provided by operating activities: | | |
| Depreciation and amortization | 373 | 301 |
| Provision for losses on accounts receivable and inventories | (14) | 25 |
| Changes in operating assets and liabilities: | | |
| Accounts receivable | (321) | 1,023 |
| Costs and estimated earnings in excess of billings on uncompleted long-term contracts | (2,909) | (1,565) |
| Inventories | 429 | 143 |
| Prepaid expenses and other current assets | (99) | (516) |
| Other assets | | (184) |
| Accounts payable | (235) | (825) |
| Billings in excess of costs and estimated earnings on uncompleted long-term contracts | (105) | 468 |
| Customer deposits | (463) | (544) |
| Accrued income taxes | (699) | (27) |
| Other accrued liabilities | 527 | 127 |
| Payments under settlement agreements | (60) | (75) |
| Net cash used by operating activities | (3,112) | (1,289) |
| Cash flows used by investing activities: | | |
| Acquisition of equipment | (158) | (87) |
| Capitalized software development costs | (99) | (90) |
| Net cash acquired from purchase of subsidiary | 60 | - |
| Net cash used in investing activities | (197) | (177) |
| Cash flows from financing activities: | | |
| Net payments under credit facility | 4,164 | (4,480) |
| Proceeds from subordinated debt, net | - | 3,190 |
| Proceeds from preferred stock, net | - | 2,292 |
| Payment of dividends on preferred stock | (68) | - |
| Decrease in cash equivalents restricted for letters of credit | (10) | 406 |
| Decrease in notes payable - related party | (500) | (500) |
| Net increase of other long-term debt | 27 | (27) |
| Proceeds from issuance of common stock/ warrants | - | 525 |
| Net cash provided by financing activities | 3,613 | 1,406 |



| | | |
|---|---|---|
| Net increase (decrease) in cash and cash equivalents | 304 | (60) |
| Cash and cash equivalents at beginning of period | 225 | 189 |
| Cash and cash equivalents at end of period | $529 | $129 |
| Supplemental schedule of cash flow information: | | |
| Interest paid | 188 | 265 |
| Income taxes paid | 756 | 213 |

Supplemental information on noncash operating and investing activities:

The Company transferred $36 of other assets to property, plant and equipment.

In connection with an acquisition, the Company issued 55,000 shares of its

common stock and a three-year interest-
only note for $375.

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



Notes to Consolidated Financial Statements

1. Basis of Presentation

The accompanying consolidated financial statements include the accounts of Environmental Tectonics Corporation ("ETC" or the "Company"), its wholly-owned subsidiary ETC International Corporation and its majority-owned subsidiary ETC-PZL Aerospace Industries, Ltd. ("ETC-PZL").

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

Certain information in footnote disclosures normally included in financial statements prepared in accordance with generally accepted accounting principles has been condensed or omitted pursuant to such rules and regulations, although the Company believes the disclosures are adequate to make the information presented not misleading. These financial statements should be read in conjunction with the financial statements and the notes thereto included in the Company's Annual Report on Form 10-KSB for the year ended February 27, 1998.

2. Earnings per Share

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 demonstrates the components of basic and diluted earning per share for the three month periods ended May 29, 1998 and May 30, 1997.

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

| | Three months ended: May 29, 1998 | May 30, 1997 |
|---|---|---|
| Net income | $464 | $360 |
| Less preferred stock dividends | (69) | (49) |
| Less accretion of preferred stock | (11) | (7) |
| Income available to common stockholders | $384 | $304 |



| | | |
|---|---|---|
| Basic earnings per share: | | |
| Weighted average shares | 3,035,851 | 2,967,542 |

| | | |
|---|---|---|
| Per share amount | $0.13 | $0.10 |
| Diluted earnings per share: | | |
| Weighted average shares | 3,035,851 | 2,967,542 |
| Effect of dilutive securities: | | |
| Stock options | 24,918 | 42,594 |
| Stock warrants | 195,839 | 131,867 |
| | 3,256,608 | 3,142,003 |
| Per share amount | $0.12 | $0.10 |

There were conversion provisions of convertible subordinated debt and preferred stock totaling 358,333 shares of common stock, which were not included in the computation of diluted earnings per share because the effect of the assumed conversion was anti-dilutive.

3. Accounts Receivable

The components of accounts receivable are as follows:

| | May 29, 1998 | February 27, 1998 |
|---|---|---|
| | (amounts in thousands) | |
| U.S. Government receivables billed and unbilled contract costs subject to negotiation | $4,948 | $4,563 |
| U.S. commercial receivables billed | 945 | 1,071 |
| International receivables billed | 3,255 | 3,193 |
| | 9,148 | 8,827 |
| Less allowance for doubtful accounts | (387) | (379) |
| | $8,761 | $8,448 |

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 under a contract for a centrifuge. Theses costs were recorded during fiscal years 1994, 1995 and 1998. The Company has recorded claims, amounting to $2.75 million and accounts receivable of $1.7 million. 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 1999. In accordance with generally accepted accounting principles, revenues recorded by the Company from a claim does not exceed the incurred contract costs related  to the claim. The Company currently has approximately $10.3 million in claims filed with the U.S. Government, which are subject to negotiation and audit by the U.S. Government. The U.S. Government has responded to the claims with either denials or deemed denials that the Company has appealed. Additional amounts are under review for the period November 1995 through October 1996 to determine what, if any, additional amounts can be filed as supplemental claims.

International receivables billed:

International receivables billed includes $1.8 million related to a certain contract with the Royal Thai Air Force.

In October 1993, the Company was notified by the Royal Thai Air Force ("RTAF") that the RTAF was terminating a certain $4.6 million simulator contract with the Company. Although the Company had performed in excess of 90% of the contract, the RTAF alleged a failure to completely perform. In connection with this termination, the RTAF made a call on a $229,000 performance bond, as well as a draw on an approximately $1.1 million of 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. The Company subsequently requested an extension on the completion time due to various extenuating circumstances, including allowable "force majeure" events. On December 22, 1997, the Company successfully performed acceptance testing and the unit passed with no discrepancy reports. Upon completion of the contract, the RTAF will pay the Company the open receivable balance ($1.8 million), consisting of the performance bond and the advance payment, plus 10% due on the balance of the contract. Payment of the open balance is currently in progress. However, the Company is not able to determine what, if any, impact the extended completion period and the current economic condition in Thailand will have upon final payment. Except as noted in the award, the rights and obligations of the parties remain as per the original contract.

4. Inventories

Inventories are valued at the lower of cost or market using the first-in, first out (FIFO) method and consist of the following:

| | May 29, 1998 | February 27, 1998 |
|---|---|---|
| | (amounts in thousands) | |
| Raw materials | $ 473 | $ 404 |
| Work in Process | 1,938 | 2,654 |
| | $2,411 | $3,058 |



5. Subordinated Debt and Preferred Stock

The components of the subordinated debt and preferred stock at May 29, 1998 and February 27,1998, were as follows:

| | May 29, 1998 | | February 27, 1998 | |
|---|---|---|---|---|
| | Subordinated Debt | Preferred Stock | Subordinated Debt | Preferred Stock |
| | (amounts in thousands) | | | |
| Face value | $4,000 | $2,500 | $4,000 | $2,500 |
| Deferred financing costs | (311) | (208) | (311) | (208) |
| Amortization of finance costs | 52 | - | 41 | - |
| Accretion of preferred stock | - | 48 | - | 38 |
| Total | $3,741 | $2,340 | $3,730 | $2,330 |

6. Stockholders' Equity

The components of stockholders' equity at May 29, 1998 and February 27, 1998 were as follows:

| | Common stock Shares | Common stock Amount | Additional Capital | Retained Earnings |
|---|---|---|---|---|
| | (amounts in thousands, except share information) | | | |
| Balance, February 27, 1998 | 3,006,596 | $300 | $2,671 | $5,608 |
| Net income for three month period ended May 29, 1998 | | | | 464 |
| Stock issued in connection with acquisition | 55,000 | 5 | 490 | |
| Divided on preferred stock | | | | (68) |
| Accretion of preferred stock | | | | (11) |
| Shares issued in connection with employee stock purchase and stock option plans | 3,510 | 1 | 16 | |
| Balance at May 29, 1998 | 3,065,106 | $306 | $3,177 | $5,993 |



7. Acquisition of ETC-PZL Aerospace Industries, Ltd.

On April 21, 1998, ETC acquired 65% ownership of MP-PZL Aerospace Industries, Ltd. ("MP-PZL"), a simulation and advanced training device manufacturing company located in Warsaw, Poland for $375,000 in cash, a 10% interest-only three-year note payable for $350,000 and 55,000 shares of ETC's common stock. MP-PZL was subsequently renamed ETC-PZL Aerospace Industries, Ltd. ("ETC-PZL"). ETC's cost for this acquisition was $1,220,000 and has been recorded in the accompanying balance sheet under the purchase method of accounting for business combinations. In connection with the acquisition, the Company has recorded goodwill of approximately $662,000 and a minority interest of approximately $300,000.

ETC-PZL's fiscal period ends December 31, 1998. The results of ETC-PZL for the period April 21, 1998 (the date of acquisition) through June 30, 1998 will be included in ETC's results of operation for the three month period ended August 28, 1998. No operating results of ETC-PZL have been included in the accompanying income statements.

8. Computer Software Costs

The American Institute of Certified Public Accountants ("AICPA") issued Statement of Position ("SOP") 98-1 "Accounting for the Costs of Computer Software Developed or Obtained for Internal Use." The SOP was issued to provide authoritative guidance on the subject of accounting for the costs associated with the purchase or development of computer software for internal use. The statement is effective for fiscal years beginning after December 15, 1998. This statement is not expected to have a material impact on the Company's financial position or results of operation.

9. Reporting Comprehensive Income

In June 1997, the FASB issued SFAS No. 130, "Reporting Comprehensive Income." SFAS No. 130 establishes standards to provide prominent disclosure of comprehensive income items. Comprehensive income is the change in equity of a business enterprise during a period from transactions and other events and circumstances from non-owner sources. SFAS No. 130 is effective for all periods beginning after December 15, 1997. Effective February 28, 1998, the Company adopted SFAS No. 130 which had no material impact on the Company's consolidated financial position or results of operation.

10. Business Segment Presentation

In June 1997, the FASB issued SFAS No. 131, "Disclosures about Segments of an Enterprise and Related Information." SFAS No. 131 requires that public business enterprises report certain financial information about operating segments in the complete sets of financial statements of the enterprise and in condensed <PAGE 10> financial statements of interim periods issued to shareholders. It also requires that public business enterprises report certain information about their products and services, the geographic areas in which they operate and their major customers. SFAS No. 131 is effective for all periods beginning after December 15, 1997. Effective February 28, 1998, the Company adopted SFAS No. 131 which had no impact on the Company's consolidated financial position or results of operation.

11. Year 2000 Issue

Many existing computer programs use only two digits to identify a year in the date field. These programs were designed and developed without considering the impact of the upcoming change in the century. If not corrected, many computer applications could fail or create erroneous results by or at the year 2000. The year 2000 issue affects virtually all companies and organizations. The Company is currently utilizing internal resources to identify, convert or replace its systems for year 2000 compliance. The Company estimates that costs associated with the year 2000 issue, which are currently being expensed as incurred, will not have a material impact on its financial position or results of operations.



Environmental Tectonics Corporation
Management's Discussion and Analysis of Results of
Operations and Financial Condition

Results of Operations
Three months ended May 29, 1998 compared to May 30, 1997.

The Company had net income of $464,000 or $.12 per share (diluted), an increase of $104,000 or 29% over the first quarter of fiscal 1998. Operating income increased $209,000 or 27%.

Sales were $7,460,000, an increase of $816,000 or 12%. This increase primarily reflected higher sales of Aircrew Training Systems ("ATS") products in international markets.

Overall, international sales increased $816,000 or 20% over the first quarter of fiscal 1998 and accounted for $5,224,000 or 70% of the Company's total sales, up from 66% a year ago.

Gross profit increased $789,000 or 40%, reflecting higher sales at higher gross margins. As a percentage of sales, gross profit was 37% compared to 30% for the same period a year ago. This increase was the result of production efficiencies related to improved factory utilization as well as a product mix shift to higher margin ATS products, which accounted for $5,809,000 or 78% of sales.

Selling and administrative expenses increased $532,000 or 47% due principally to variable costs related to the higher sales volume, principally commissions and travel expenses. As a percentage of sales, these expenses were 22%, compared to 17% for the same period a year ago. However, when adjusted for the increased variable costs, the percentage of sales was approximately equal to the prior period.

Interest expense increased $48,000 or 22%, reflecting both higher borrowings at a lower rate and increased amortization of various deferred financing fees associated with the credit facility of March 1997. The Company's tax rate approximates the statutory rate.

Liquidity and Capital Resources

During the three month period ended May 29, 1998, the Company used $3,112,000 for operating activities. This was primarily the result of an increase in costs and estimated earnings in excess of billings and a reduction in customer deposits and income tax accruals. These uses of cash were offset in part by net income and non-cash charges of depreciation, amortization and increases in accruals. The Company expects to increase its billings for long-term contracts during the second and third quarters of fiscal 1999.



Investment activities included capital expenditures ($158,000) and capitalized software costs ($99,000). The Company acquired 65% ownership of MP-PZL Aerospace Industries, Ltd. ("MP-PZL"), a simulation and advanced training device manufacturer located in Warsaw, Poland, for $375,000 in cash, a 10% interest-only three-year note payable for $350,000 and 55,000 shares of ETC's common stock. MP-PZL was subsequently renamed ETC-PZL Aerospace Industries, Ltd.

On May 26, 1998, the Company received a commitment from its bank to maintain its credit facility at $10 million and to extend the maturity date of the total facility from May 31, 1999 to May 31, 2000. Funds were provided for operating and investing activities from the Company's credit facility. The Company believes that cash generated from operating activities as well as available borrowings under its credit facility will be sufficient to meet its obligations. At July 8, 1998, the Company had $1.2 million available under its credit facility.

The Company's sales backlog at June 30, 1998 and February 27,1998 for work to be performed and revenue to be recognized under written agreements after such dates was approximately $27.0 million and $30.4 million, respectively.

This report contains certain 'forward-looking statements' including, without limitation, statements containing the words "believes," "anticipates," "intends," "expects" and words of similar import relating to the Company's operations. There are important factors that could cause actual results to differ materially from those indicated by such forward-looking statements including contract cancellations, political unrest in customer countries, general economic conditions and the risk factors detailed from time to time in ETC's periodic reports and registration statements filed with the Securities and Exchange Commission, including, without limitation, ETC's Annual Report on Form 10-KSB for the fiscal year ended February 27, 1998.



Environmental Tectonics Corporation
Form 10-QSB
Part II

Item 1. Legal Proceedings

There were no material developments in the litigation previously described in the Company's Annual Report on Form 10-KSB for the fiscal year ended February 27, 1998.

Item 2. Changes in Securities

The constituent instruments defining the rights of the holders of any class of securities were not modified nor were the rights evidenced by any class of registered securities materially limited or qualified during the period covered by this report.

Item 3. Defaults Upon Senior Securities

No defaults occurred during the period covered in this report.

Item 4. Submission of Matters to Vote of Security Holders

None

Item 5. Other Information

None

Item 6. Exhibits and Reports on Form 8-K

(a) Exhibits:

Exhibit 27 - Financial Data Schedule

(b) Reports on Form 8-K

None



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 Deaner
Duane Deaner,
Chief Financial Officer (authorized officer, principal financial officer and principal accounting officer)

Date: July 13, 1998



EXHIBIT INDEX

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

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| | | |
|---|---|---|
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