

FORM 10-K  
SECURITIES AND EXCHANGE COMMISSION  
Washington, DC 20549

Annual report pursuant to Section 13 or 15(d) of the Securities Exchange Act Of 1934 For the fiscal year ended February 22, 2002

or

Transition report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934 [no fee required]

For the transition period from \_\_\_\_\_ to \_\_\_\_\_.

Commission File Number 1-10655

ENVIRONMENTAL TECTONICS CORPORATION

-----  
(Exact name of small business issuer in its charter)

Pennsylvania  
-----  
(State or other jurisdiction of  
incorporation or organization)

23-1714256  
-----  
I.R.S. Employer  
Identification No.)

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

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

Securities registered pursuant to Section 12(b) of the Act:

Common Stock, par value \$.05 per share  
-----  
(Title of Class)

Securities registered pursuant to Section 12(g) of the Act: None

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

Yes  No

Check if there is no disclosure of delinquent filers in response to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

As of May 15, 2002, the aggregate market value of the Registrant's common stock held by non-affiliates of the Registrant was approximately \$38,976,000. As of May 15, 2002, there were 7,153,428 shares of Registrant's common stock, \$0.05 par value per share, issued and outstanding.

DOCUMENTS INCORPORATED BY REFERENCE. Portions of Registrant's 2002 Annual Report to Stockholders (the "Annual Report") are incorporated by reference in Part II, Items 5, 6, 7, and 8.

## 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 our current expectations and projections about future events. These forward-looking statements are subject to known and unknown risks, uncertainties and assumptions about us and our subsidiaries, that may cause our 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, the effect of currency fluctuations, capital structure and other financial items, (ii) statements of 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 by customers, suppliers, competitors or regulating 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," "pro forma," "looking forward," "would," "believe," "expect," "anticipate," "estimate," "intend," "plan," or similar expressions. These forward-looking statements involve risks and uncertainties, which are subject to change based on various important factors (some of which, in whole or in part, are beyond the Company's control). The following factors, among others, could cause the Company's financial performance to differ materially from the goals, plans, objectives, intentions and expectations expressed in such forward-looking statements: (1) the strength of the United States and global economies in general and the strength of the regional and local economies in which the Company conducts operations; (2) the effects of, and changes in, U.S. and foreign governmental trade, monetary and fiscal policies and laws; (3) the import of domestic or foreign military or political conflicts and turmoil; (4) the timely development of competitive new products and services by the Company and the acceptance of such products and services by customers; (5) willingness of customers to substitute competitors' products and services and vice versa; (6) the impact on operations of changes in U.S. and governmental laws and public policy, including environmental regulations; (7) the level of export sales impacted by export controls, changes in legal and regulatory requirements; policy changes affecting the markets, changes in tax laws and tariffs, exchange rate fluctuations, political and economic instability, and accounts receivable collection; (8) technological changes; (9) regulatory or judicial proceedings; (10) the impact of any current or future litigation involving the Company; and (11) the success of the Company at managing the risks involved in the foregoing.

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.

## PART I

## Item 1. Business

## (a) Business Development

Environmental Tectonics Corporation ("ETC" or the "Company"), a

Pennsylvania corporation, incorporated in 1969, is principally engaged in the design, manufacture and sale of software driven products used to A) create and monitor the physiological effects of motion on humans and equipment and B) control, modify, simulate and measure environmental conditions. These products include aircrew training systems, entertainment products, sterilizers, environmental and hyperbaric chambers, and other products, which involve similar manufacturing techniques and engineering technologies.

Since February 23, 2001, there has been no material change in the Company's mode of conducting business.

(b) Business of the Company

Segments

The company operates in two primary business segments, Aircrew Training Systems ("ATS") and the Industrial Group.

Aircrew Training Systems. This segment includes three primary product groups: aircrew training devices, entertainment products, and disaster management simulation.

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Aircrew Training Devices. The Company's aircrew training devices are used for medical research, advanced tactical and physiological flight training, and for the indoctrination and testing of military and commercial pilots. The major devices sold in this product area are military and commercial flight simulators, night vision trainers, water survival training equipment, disorientation training equipment, human centrifuges, ejection seat trainers and vehicle and tank simulators. The Company provides operation and maintenance services for installed equipment it manufactures as well as equipment produced by others.

Entertainment Products. The Company's entertainment products consist of motion-based simulation rides and other products.

Disaster Management Simulation. The Company's Disaster Management Systems line includes real-time interactive training programs that allow instruction on various disaster situations.

The aircrew training system class of products as a whole represented 69%, 73% and 76% of consolidated revenues of the Company for the years ended February 22, 2002, February 23, 2001 and February 25, 2000, respectively.

Industrial Group. This segment includes three primary product lines: sterilizers, environmental systems and other products, and hyperbarics.

Sterilizers. The Company manufactures steam and gas sterilizers for various industrial and pharmaceutical applications. The Company concentrates on marketing the larger custom-designed sterilizers to the pharmaceutical and medical device industries.

Environmental Systems and Other Products. The Company's environmental systems business consists of the design and fabrication of sampling and analysis systems, and test equipment and systems. The simulation systems generally consist of an enclosed chamber with instrumentation and equipment which enable the customer to control and modify such environmental factors as temperature, pressure, humidity, wind

velocity and gas content to produce desired conditions. These products include controlled air systems for automotive companies and environmental chambers for HVAC and other applications.

Hyperbarics. The Company's Hyperbarics line includes monoplace (single person) and multiplace (multiple persons) chambers for high altitude training, decompression and wound care applications.

Sales of Industrial Group products were 31%, 27% and 24% of consolidated revenues of the Company for the years ended February 22, 2002, February 23, 2001 and February 25, 2000, respectively.

The Company also provides control upgrades, maintenance and repair services and spare parts for its own and other manufacturers' equipment.

For a more complete description of financial information regarding our business segments, see "Note 10. Business Segment Information" to the Company's consolidated financial statements incorporated herein by reference to the Annual Report.

#### Marketing

The Company currently markets its products and services primarily through its sales offices and employees. At February 22, 2002, approximately 18 employees were committed to sales and marketing functions. The Company uses branch offices in the United Kingdom, the Middle East, and Asia as well as the services of approximately 100 independent sales organizations in seeking foreign orders for its products.

#### Product Development

New products and improvements in existing products are being continually developed in response to inquiries from customers and to management's determination that particular products should be produced or significantly improved. Although the Company does not have a separate research and development group, there are several technical personnel whose main activity is the development and integration of new technologies into our existing products. These personnel include the Vice-President of Engineering and the Vice-President of New Product Development whose additional activity is the introduction of product extensions and new applications of existing technology.

Within the Aircrew Training Systems Segment, product development emphasizes enhancing control systems and software graphics and exploring commercial possibilities. The Company's product development efforts will be focused on two areas:

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- Disaster Management Simulation. The Company is in production of a major contract from the City of Chicago to develop, install and maintain a computer-based Incident Command Simulator. Additionally, the Company is completing orders from respected fire schools throughout the world for simulation products. The company will continue to explore product applications and extensions to this Intelligent Virtual Reality product.
- G-force and Disorientation Trainers.  
-----
  - The Company recently introduced a new second generation General Aviation Trainer (GAT II). Aimed at the commercial aviation market, the GAT II simulates the cockpit controls, displays and

flight characteristics of general aviation private aircraft, business aircraft and helicopters.

- The Company has begun testing on its high-end rapid onset Sustained G Tactical Flight Simulator, the G-FET II TFS.
- The Company recently completed a successful factory acceptance of its new GYROLAB(R) GL-1500 Advanced Flight Simulator Spatial disorientation trainer.
- The Company plans to incorporate additional advanced tactical flight simulation (TFS) applications into additional products in the ATS line.

The Company's wholly owned subsidiary, Entertainment Technology Corporation, develops and manages all of the Company's future entertainment projects. Product development in this class will emphasize entertainment applications of our proven ATS simulation technology.

The Company reported research and development expenses of \$600,000, \$903,000 and \$920,000 for the years ended February 22, 2002, February 23, 2001 and February 25, 2000, respectively. However, most of the cost 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.

#### Supplies

The components being used in the assembly of systems and the parts used to manufacture the Company's products are purchased from equipment manufacturers, electronics supply firms and others. To date, the Company has had no difficulty in obtaining supplies. Further, all raw materials, parts, components, and other supplies used by the Company in the manufacture of its products can be obtained at competitive prices from alternate sources should existing sources of supply become unavailable.

#### Patents and Trademarks

Other than a patent on the GYROLAB Spatial Disorientation Trainer, which expires in December 2004, the Company has no patents or trademarks which it considers significant to its operations.

#### Customers

In the current year and throughout most of its history, the Company has made a substantial portion of sales to a small number of customers that vary within any given year. The Company's business does not depend upon repeat orders from these same customers. Sales of aircrew training systems are made principally to U.S. and foreign governmental agencies. Sales of sterilizers and environmental systems are made to commercial and governmental entities worldwide.

In fiscal 2002, the Company's major customers included the Royal Thai Air Force generating revenues of \$3,285,000 and the Walt Disney companies generating revenues of \$15,859,000 or 48.8% and 10.1%, respectively, of total net sales. These companies do not have any relationship with the Company other than as customers. The Company expects to continue to conduct business with each of these companies in fiscal 2003.

#### Foreign and Domestic Operations and Export Sales

During the years ended February 22, 2002, February 23, 2001 and February 25, 2000, approximately \$1,194,000 (4%), \$2,063,000 (7%) and \$1,587,000 (5%), respectively, of the Company's net revenues were attributable to contracts with agencies of the U.S. Government or with other customers who had prime contracts with agencies of the U.S. government.

During the years ended February 22, 2002, February 23, 2001 and February 25, 2000, \$10,110,000 (31%), \$15,258,000 (47%) and \$23,907,000 (69%), respectively, of the Company's net revenues were attributable to export sales or sales for export. (See Note 10 to the Company's consolidated financial statements incorporated herein by reference to the Annual Report.) On export sales, customers' obligations to the Company are normally secured by irrevocable letters of credit based on the creditworthiness of the customer.

The Company does not believe that the distribution of its sales between foreign and domestic sales for any particular period is necessarily indicative of the distribution expected for any other period.

A large portion of the Company's sales is derived from long-term contracts requiring more than one year to complete. The Company accounts for sales under long-term contracts on the percentage of completion basis. See Note 1 to consolidated financial statements incorporated herein by reference to the Annual Report.

The Company's U.S. Government contracts contain standard terms permitting termination for the convenience of the Government. In the event of termination of such contracts, the Company is entitled to receive reimbursement on the basis of work completed (cost incurred plus a reasonable profit), recording the amounts anticipated to be recovered from termination claims in income as soon as those amounts can be reasonably determined rather than at the time of final settlement. All costs applicable to a termination claim are charged as an offsetting expense concurrently with the recognition of income from the claim.

#### Backlog

The Company's sales backlog at February 22, 2002 and February 23, 2001, for work to be performed and revenue to be recognized under written agreements after such dates, was \$28,148,000 and \$40,439,000, respectively. In addition, the Company's training, maintenance and upgrade contracts backlog at February 22, 2002 and February 23, 2001, for work to be performed and revenue to be recognized after that date under written agreements was \$1,485,000 and \$1,347,000, respectively. Of the February 22, 2002 backlog, approximately \$20,967,000 is under contracts for aircrew training systems and maintenance support including \$13,069,000 for the Walt Disney companies. Approximately 94% of the February 22, 2002, backlog is expected to be completed prior to February 28, 2003.

#### Competition

The Company's business strategy in recent years has been to seek niche markets in which there are not numerous competitors. However, in some areas of its business the Company competes with well-established firms, some of which have substantially greater financial and personnel resources than the Company.

Some competitor firms have technical expertise and production capabilities in one or more of the areas involved in the design and production of physiological flight training equipment, environmental systems, and other specially designed products, and compete with the Company for this business. The competition for any particular project generally is determined by the technological requirements of the project, with consideration also being given to a bidder's reliability, product performance, past performance, and price.

The Company faces particularly intense competition from a number of firms in the sale of hospital sterilizers but faces less competition in the sale of the larger custom-designed industrial sterilizers.

The Company believes that it is a significant participant in the markets in which it competes, especially in aircrew training systems in which the Company believes it is a principal provider of this type of equipment and training in its market area.

## Compliance with Environmental Laws

The Company has not incurred during fiscal 2002, nor does it anticipate incurring during fiscal 2003, any material capital expenditures to maintain compliance with Federal, state and local statutes, rules and regulations concerning the discharge of materials into the environment, nor does the Company anticipate that compliance with these provisions will have a material adverse effect on its earnings or competitive position.

## Employees

On February 22, 2002, the Company had 276 full-time employees, of whom 6 were employed in executive positions, 101 were engineers, engineering designers, or draftspeople, 59 were administrative (sales, accounting, etc.) and clerical personnel, and 110 were engaged principally in production and operations.

## Item 2. Property

The Company owns its executive offices and principal production facilities located on a 5-acre site in the County Line Industrial Park, Southampton, Pennsylvania in an approximately 100,000 square foot steel and masonry building. Approximately 85,000 square feet are devoted to manufacturing and 15,000 square feet to office space. The original building was erected in 1969 and additions were most recently made in 2001. This property serves as collateral for the Company's revolving credit facility. Additionally, the Company rents office space at various sales and support locations throughout the world and at ETC-PZL Aerospace Industries, its Polish subsidiary.

The Company considers its machinery and plant to be in satisfactory operating condition. Increases in the level of operations beyond that expected in the current fiscal year might require the Company to obtain additional facilities and equipment.

## Item 3. Legal Proceedings

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, all such matters are reserved for or are 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 material adverse effect on the financial position of the Company if resolved unfavorably.

## Item 4. Submission of Matters to a Vote of Security Holders

None.

PART II

Item 5. Market for the Registrant's Common Stock and Related Security Holder Matters

See information appearing under the heading "Market for the Registrant's Common Stock and Related Stockholder Matters" in the Annual Report attached hereto as Exhibit 13 and incorporated herein by reference.

Item 6. Selected Financial Data

See information appearing under the heading "Financial Review" in the Annual Report attached hereto as Exhibit 13 and incorporated herein by reference.

Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations

See information appearing under the heading "Management's Discussion and Analysis of Financial Condition and Results of Operations" in the Annual Report attached hereto as Exhibit 13 and incorporated herein by reference.

Item 7A. Quantitative and Qualitative Disclosures About Market Risk

Not applicable.

Item 8. Financial Statements

See the information appearing under the headings "Consolidated Financial Statements" and "Notes to Consolidated Financial Statements" in the Annual Report attached hereto as Exhibit 13 and incorporated herein by reference.

Item 9. Changes in and Disagreements with Accountants on Accounting and Financial Disclosure

Not applicable.

PART III



Item 10. Directors and Executive Officers of the Registrant

The following table sets forth certain information as of May 15, 2002, with respect to the directors and executive officers of the Company:

Name -----	Age ---	Served as Director or Officer Since (1) -----	Principal Occupations and Positions and Offices with the Company -----
William F. Mitchell (2)	60	1969	Chairman of the Board, President and Director
Richard E. McAdams (3)	66	1985	Executive Vice President and Director
Pete L. Stephens, M.D. (4)	64	1974	Director
David P. Lazar (5)	45	2000	Director
Duane D. Deaner (6)	54	1996	Chief Financial Officer

- (1) Directors serve one-year terms.
- (2) Mr. Mitchell has been Chairman of the Board, President and Chief Executive Officer of the Company since 1969, except for the period from January 24, 1986 through January 24, 1987, when he was engaged principally in soliciting sales for the Company's products in the overseas markets.
- (3) Mr. McAdams has been with the Company since 1970. He became a Vice President in 1978 with responsibility for contract administration. Mr. McAdams became Executive Vice President of the Company in 1990.
- (4) Recently retired, Dr. Stephens had been a physician engaged in the private practice of medicine for 30 years.
- (5) Since November 2001, Mr. Lazar has served as Senior Executive Vice President of Boenning and Scattergood, Inc., and Managing Director of its investment banking group. Prior to that, Mr. Lazar served as Managing Director of Berwind Financial, L.P. from February 1, 1993, to November 2001. Boenning and Scattergood is a regional investment firm specializing in investment banking services to both privately held and publicly traded companies. Mr. Lazar holds an MBA from the College of William and Mary Graduate School of Business Administration and a B.S. from Duke University. He serves as a trustee of the Academy of Natural Sciences, is a member of the Board of the Recording for the Blind and Dyslexic, and also serves as an advisory director of Lydian Trust Co., a Florida based internet company that provides financial services.
- (6) Mr. Deaner has served as Chief Financial Officer of the Company since January 1996. Mr. Deaner served as Vice President of Finance for Pennfield Precision Incorporated from September 1988 to December 1995.

Committees of the Board of Directors

During the year ended February 22, 2002, the Company had an Audit Committee consisting of the following directors: Messrs. Lazar, Philip L. Wagner and Dr. Pete L. Stephens. Dr. Wagner retired from the Board on December 19, 2001. The independent outside directors also served on the Company's Compensation Committee during the year ended February 22, 2002. The Audit Committee is charged with reviewing and overseeing the Company's financial systems and internal control procedures and conferring with the Company's independent accountants with respect thereto. The Compensation Committee is charged with reviewing the compensation and incentive plans of officers and key personnel.

During the year ended February 22, 2002, the Board of Directors held four meetings and the Audit Committee and Compensation Committee each held one meeting. All members of the Board attended all of the meetings of the Board held while they were members of the Board. All members of the Audit Committee (except Mr. Wagner) and Compensation Committee attended all meetings of the Committee held while they were members thereof.

Directors of the Company who are not officers of the Company are paid \$600 for Board of Directors meetings which they attend. Additional compensation is not paid for committee meetings.

#### Compliance With Section 16(a) of the Exchange Act

Section 16(a) of the Securities Exchange Act of 1934 requires the Company's officers and directors, and persons who own more than ten percent of a registered class of the Company's equity securities to file reports of ownership and changes in ownership with the Securities and Exchange Commission ("SEC") and the American Stock Exchange. Officers, directors and greater than ten percent shareholders are required by SEC regulation to furnish the Company with copies of all Section 16(a) Forms they file. The rules of the SEC regarding the filing of such statement require that "late filings" of such statements be disclosed in the Company's proxy statement.

Based solely on its review of the copies of such forms received by it, or written representations from certain reporting persons that no Forms 5 were required for those persons, the Company believes that, during the fiscal year ended February 22, 2002, its officers, directors and greater than ten percent beneficial owners complied with all applicable filing requirements.

#### Item 11. Executive Compensation

##### SUMMARY COMPENSATION TABLE

The following table sets forth compensation paid by the Company to the Chief Executive Officer for services rendered during fiscal years 2002, 2001, and 2000. There are no other executive officers whose total annual salary and bonus exceeds \$100,000. The footnotes to the table provide additional information concerning the Company's compensation and benefit programs.

Name and Principal Position -----	Fiscal Year ----	Annual Compensation		Other Annual Compen- sation (\$) (2) -----	All Other Compen- sation (\$) (3) -----
		Salary (\$) -----	Bonus (\$) -----		
William F. Mitchell, President and Chief Executive Officer	2002	\$225,000	\$10,051(1)	--	\$4,413
	2001	225,000	\$10,969(1)	--	4,000
	2000	225,000	\$12,023(1)	--	3,876

(1) These amounts represent a portion of a deferred bonus from fiscal 1999 due 75% in 1999 and 5% in each of the five following fiscal years. No bonus awards for fiscal 2000, 2001, or 2002 were paid.

(2) The Company's executive officers receive certain perquisites. For fiscal years 2002, 2001 and 2000, the perquisites received by Mr. Mitchell did not exceed the lesser of \$50,000 or 10% of his salary and bonus.

(3) These amounts represent the Company's contribution to the Retirement Savings Plan.

## Item 12. Security Ownership of Certain Beneficial Owners and Management

The following table sets forth as of May 15, 2002, the number of shares and percentage of the Company's Common Stock owned beneficially by each director, each executive officer named in the Summary Compensation Table, and each person holding, to the Company's knowledge, more than 5% of the outstanding Common Stock. The table also sets forth the holdings of all directors and executive officers as a group.

Name and Address of Beneficial Owner -----	Amount and Nature of Beneficial Ownership(9) -----	Percent of Class -----
William F. Mitchell (1) c/o Environmental Tectonics Corporation County Line Industrial Park Southampton, PA 18966	1,701,998	23.8%
Pete L. Stephens, M.D. (2) 31 Ribaut Drive Hilton Head Island, SC 29926	679,500(3)	9.5%
Richard E. McAdams (2) c/o Environmental Tectonics Corporation County Line Industrial Park Southampton, PA 18966	51,017(4)	*
David P. Lazar (2) c/o Boenning and Scattergood, Inc. 4 Tower Bridge 200 Barr Harbor Dr., Suite 300 West Conshohocken, PA 19428	0	*
ETC Asset Management, LLC 50 Midtown Park East Mobile, AL 36606	832,820(5)	11.1%
T. Todd Martin, III 50 Midtown Park East Mobile, AL 36606	944,520(6)	12.6%
Emerald Advisors, Inc. 1703 Oregon Pike Suite 101 Lancaster, PA 17601	1,350,255(7)	18.9%
All directors and executive officers as a group (5 persons)	2,440,485(8)	33.9%

\* less than 1%

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- (1) Chairman of the Board, President and Director of the Corporation.  
Shares of Common Stock include 177,000 shares held by Mr. Mitchell's wife.
  - (2) Director of the Corporation.
  - (3) Includes 25,500 shares held by or for the benefit of Dr. Stephens' wife and two of his children.
  - (4) Includes options to purchase 30,775 shares of Common Stock held under the Company's Stock Option Plan which are presently exercisable.
  - (5) These shares include 332,820 shares of Common Stock underlying a presently exercisable warrant to purchase shares of Common Stock.
  - (6) These shares include 500,000 shares of Common Stock and 332,820 shares of Common Stock underlying a presently exercisable warrant to purchase shares of Common Stock presently owned by ETC Asset Management, LLC, a limited liability company of which Mr. Martin is manager, 26,900 shares owned by Allied Williams Co, Inc., a corporation of which Mr. Martin is an officer and director, 14,300 shares owned by Mr. Martin jointly with his spouse, and 7000 shares owned by trusts of which Mr. Martin is trustee.

- (7) As reported in a Schedule 13G, dated December 31, 2001, filed by Emerald Advisors, Inc., Emerald has sole voting power with respect to 835,365 shares of Common Stock and sole dispositive power over 1,350,255 shares of Common Stock.
- (8) Includes options to purchase 30,775 and 9,470 shares of Common Stock which may be acquired by Director McAdams and Duane Deaner, Chief Financial Officer, respectively, upon the exercise of options granted under the Company's Stock Option Plan.
- (9) Beneficial ownership has been determined in accordance with Rule 13d-3 under the Securities Exchange Act of 1934. Unless otherwise noted, the Company believes that all persons named in the table have sole voting and investment power with respect to all shares of the Company's Common Stock beneficially owned by them.

Item 13. Certain Relationships and Related Transactions

David P. Lazar, a director of the Company, is a Senior Executive Vice President of Boenning and Scattergood, Inc. and is Managing Director of its investment banking group. Boenning and Scattergood, Inc. has been retained to provide general financial advisory services to the Company.

Item 14. Exhibits and Reports on Form 8-K

(a) Exhibits:

Number -----	Item -----
3.1	Registrant's Articles of Incorporation, as amended, were filed as Exhibit 3.1. to Registrant's Form 10-K for the year ended February 28, 1997 and are incorporated herein by reference.
3.2	Registrant's By-Laws, as amended, were filed as Exhibit 3(ii) to Registrant's Form 10-K for the year ended February 25, 1994 and are incorporated herein by reference.
10.1	Registrant's 1998 Stock Option Plan was filed on October 8, 1998 on Form S-8 and is incorporated herein by reference. *
10.2	Registrant's Employee Stock Purchase Plan was filed on July 6, 1988 as Exhibit A to the Prospectus included in Registrant's Registration Statement (File No. 33-42219) on Form S-8 and is incorporated herein by reference. *
10.3	Registrant's Stock Award Plan adopted April 7, 1993, filed as Exhibit 10(ix) to the Registrant's Form 10-K for the fiscal year ended February 25, 1994 and is incorporated herein by reference. *
10.5	Revolving Credit Agreement, dated as of March 27, 1997, between the Registrant and First Union National Bank was filed as Exhibit 10.6 to Registrant's Form 10-K for the year ended February 28, 1997 and is incorporated herein by reference.
10.6	Amendment to Revolving Credit Agreement dated as of March 29, 2002.
10.7	Stock Purchase Warrant dated as of December 26, 2001, issued by the Registrant to ETC Asset Management, LLC.
13	Portions of Registrant's 2002 Annual Report to Shareholders which are incorporated by reference into this Form 10-K.
21	List of subsidiaries.
23	Consent of Grant Thornton L.L.P.

\* Represents a management contract or a compensatory plan or arrangement.

(b) Reports on Form 8-K:

The Company did not file any Current Reports on Form 8-K during the fiscal quarter ended February 22, 2002.

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SIGNATURES

Pursuant to the requirements of Section 13 or 15 (d) of the Securities Exchange Act of 1934, the registrant caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

ENVIRONMENTAL TECTONICS CORPORATION

By /s/ William F. Mitchell  
-----  
William F. Mitchell,  
President and Chief Executive Officer

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the registrant and in the capacities and on the dates indicated.

Name ----	Position -----	Date ----
/s/ William F. Mitchell ----- William F. Mitchell	Chairman of the Board, Chief Executive Officer, President and Director	June 7, 2002
/s/ Duane D. Deaner ----- Duane D. Deaner	Chief Financial Officer (Principal Accounting Officer)	June 7, 2002
/s/ Richard E. McAdams ----- Richard E. McAdams	Director	June 7, 2002
/s/ David P. Lazar ----- David P. Lazar	Director	June 7, 2002
/s/ Pete L. Stephens ----- Pete L. Stephens, M.D.	Director	June 7, 2002

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ENVIRONMENTAL TECTONICS CORPORATION AND SUBSIDIARIES SCHEDULE II  
VALUATION AND QUALIFYING ACCOUNTS  
(\$ in thousands)

Column A  
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Column B  
-----

Column C  
-----

Column D  
-----

Column E  
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Description	Balance At Beginning of Period	Charges/ (Credits) to Costs/ Expenses	Reductions (1)	Balance at End of Period
Year ended February 22, 2002:				
Valuation and qualifying accounts related to:				
Accounts receivable	\$370	\$ 3	\$ --	\$373
Inventory	\$630	\$108	\$ --	\$738
Property, plant and equipment	\$8,635	\$668	\$ --	\$9,303
Software development costs	\$5,670	\$496	\$ --	\$6,166
Other assets	\$96	\$311	\$294	\$113
Year ended February 23, 2001				
Valuation and qualifying accounts related to:				
Accounts receivable	\$367	\$3	\$ --	\$370
Inventory	\$720	\$100	\$190	\$630
Property, plant and equipment	\$8,004	\$631	\$ --	\$8,635
Software development costs	\$5,215	\$455	\$ --	\$5,670
Other assets	\$61	\$192	\$157	\$96
Year ended February 25, 2000				
Valuation and qualifying accounts related to:				
Accounts receivable	\$385	\$--	\$ 18	\$367
Inventory	\$625	\$95	\$ --	720
Property, plant and equipment	\$7,527	\$535	\$ 58	\$8,004
Software development costs	\$4,619	\$596	\$ --	\$5,215
Other assets	\$25	\$264	\$228	\$61

(1) Amounts written off or retired

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#### EXHIBIT INDEX

Exhibit No.	Item
10.6	Amendment to Revolving Credit Agreement dated as of March 29, 2002.
10.7	Stock Purchase Warrant dated as of December 26, 2001, issued by the Registrant to ETC Asset Management, LLC.
13	Portions of Registrant's 2002 Annual Report to Shareholders which are incorporated by reference into this Form 10-K.
21	List of subsidiaries.
23	Consent of Grant Thornton L.L.P.

\* Represents a management contract or a compensatory plan or arrangement.



SEVENTH AMENDMENT  
TO  
REVOLVING CREDIT AGREEMENT

SEVENTH AMENDMENT TO REVOLVING CREDIT AGREEMENT ("Seventh Amendment"), dated as of March 29, 2002 between ENVIRONMENTAL TECTONICS CORPORATION (the "Borrower") and FIRST UNION NATIONAL BANK, a national banking association (the "Bank").

W I T N E S S E T H

WHEREAS, the Borrower and the Bank are parties to a Revolving Credit Agreement dated as of March 27, 1997 (as amended, the "Agreement") pursuant to which the Bank agreed to make available to the Borrower certain loans upon the terms and conditions specified in the Agreement;

WHEREAS, the parties wish to amend certain terms and conditions of the Agreement, as hereinafter set forth.

NOW, THEREFORE, in consideration of the promises and mutual agreements herein contained, the parties hereto, intending to be legally bound hereby, agree to amend the Agreement as herein stated.

1. Effect of Prior Agreements.

This Seventh Amendment is intended to amend the Agreement, as it has been in effect to the date hereof and as it shall be amended on and after the date hereof. All capitalized terms used herein as defined terms shall have the meanings ascribed to them in the Agreement unless herein provided to the contrary.

2. Amendments.

- (a) The defined term "Termination Date" set forth in Article I of the Agreement is hereby amended and restated as "November 30, 2002".
- (b) Effective as of May 1, 2002, the defined term "Applicable Margin" set forth in Article I of the Agreement shall be deemed to be: (i) with respect to Adjusted Base Rate Loans, one percent (1%); and (ii) with respect to Adjusted LIBOR Rate Loans, three and one-half percent (3.5%). References to the Applicable Margin in Sections 2.1(b)(2) and 2.1A(4) of the Agreement shall be deemed references to the Applicable Margin for Adjusted Base Rate Loans.
- (c) Section C of Schedule 6.16 is amended and restated in its entirety to read as follows:
  - C. Funds Flow Coverage Ratio - The Borrower shall have a Funds Flow Coverage Ratio of not less than 0.75 as of the fiscal quarter ending on November 23, 2001 and each subsequent fiscal quarter end.

3. Conditions Precedent. To induce the Bank to enter into this Seventh Amendment and to extend the Loans contemplated herein, the Borrower shall perform the following conditions to the Bank's satisfaction prior to the Bank's acting in reliance hereon:

- a. The Borrower shall deliver, and shall cause each Guarantor to deliver an executed copy of this Seventh Amendment, together with all other documents to be executed in connection herewith;



b. The Borrower shall deliver, an executed Fourth Allonge to Line of Credit Note;

c. The Borrower shall pay to the Bank an amendment fee of \$40,000;

d. The Borrower shall pay all fees and expenses incurred by the Bank, including but not limited to legal fees and expenses, in connection with the preparation and negotiation of this Amendment.

e. The Borrower shall deliver all other documents and certificates reasonably requested by the Bank.

4. Additional Covenants. Borrower and each Guarantor covenant and agree to continue to deliver to the Bank, as and when requested by the Bank: (i) schedules of all patents, trademarks and/or copyrights (including applications for the same) owned by the Borrower and the Guarantors; and (ii) schedules of any and all accounts receivable of Borrower or any Guarantor which arise out of contracts with the United States or any department, agency or instrumentality thereof. Additionally, Borrower and each Guarantor covenant and agree that they shall execute and deliver to the Bank, upon the Bank's request: (i) all patent, trademark and/or copyright security agreements and such other documents as Bank shall at any time require to perfect or continue the perfected status of the Bank's security interest in such patents, trademarks and copyrights; and (ii) an assignment of claims for such accounts receivable and cooperate with the Bank in taking any other steps required, in the Bank's judgment, to perfect or continue the perfected status of the Bank's security interest in such accounts receivable and proceeds. Failure of the Borrower or any Guarantor to comply with the foregoing conditions subsequent shall constitute an immediate Event of Default under the Agreement.

5. Reaffirmation. The Borrower hereby affirms and reaffirms to the Bank all of the terms and conditions of the Agreement and the other Loan Documents, including, without limitation, the confession of judgment provision contained therein, and agrees to abide thereby until all of the Borrower's obligations to the Bank are satisfied and/or discharged in their entirety.

6. Guarantors' Acknowledgments. Each Guarantor:

a. Hereby acknowledges and consents to the provisions of this Seventh Amendment and confirms and agrees that its obligations under its respective Guaranty Agreement shall be unimpaired hereby and that all terms and conditions of its respective Guaranty Agreement shall remain in full force and effect and unmodified hereby and are hereby ratified and confirmed.

b. Hereby acknowledges the continued existence, validity and enforceability of its respective Guaranty Agreement, agrees that the terms, conditions, representations and covenants of its respective Guaranty Agreement, including, without limitation, such Guarantor's consent to the Bank entering a judgment against it by confession, are binding upon it and certifies that there exists no defenses, offsets or counterclaims thereto as of the date hereof subject to limitation set forth therein.

7. Unlimited General Release by Borrower and Guarantors

The Borrower and each of the Guarantors, on behalf of itself and any person or entity claiming by, through or under it (collectively referred to as the "Releasors"), hereby unconditionally remises, releases and forever discharges the Bank and its past and present officers, directors, shareholders, agents, accountants, auditors, parent corporation, subsidiaries, affiliates, trustees, administrators, attorneys, predecessors, successors and assigns and, where applicable, the heirs, executors, administrators, successors and assigns of any such person or entity, as releasees (collectively referred to as the "Releasees"), of and from any and all manner of actions, causes of action, suits, debts, dues, accounts, bonds, covenants, contracts, agreements, promises, warranties, guaranties, representations, liens, mechanics' liens, judgments, claims, counterclaims, crossclaims, defenses and/or demands whatsoever,

including, but not limited to, claims for contribution and/or indemnity, whether now known or unknown, past or present, asserted or unasserted, contingent or liquidated, at law or in equity, or resulting from any assignment, if any (collectively referred to as "Claims"), which any of Releasors ever had or now have against any of the Releasees, for or by reason of any cause, matter or thing whatsoever, arising from the beginning of time to the date of execution of this Seventh Amendment, including but not limited to, any and all Claims relating to or arising from the lending relationship between the Bank and the Borrowers. The Borrower and each Guarantor warrants and represents that it has not assigned, pledged, hypothecated and/or otherwise divested itself and/or encumbered all or any part of the Claims being released hereby and that it agrees to indemnify and hold harmless any and all of Releasees against whom any Claim so assigned, pledged, hypothecated, divested and/or encumbered is asserted.

8. Miscellaneous.

a. All terms, conditions, provisions and covenants in the Agreement, the Note, the Security Agreement and the Guaranty Agreements and all other Loan Documents delivered to the Bank in connection therewith shall remain unaltered and in full force and effect except as modified or amended hereby and are hereby ratified and confirmed.

b. This Seventh Amendment shall be governed and construed according to the laws of the Commonwealth of Pennsylvania.

c. This Seventh Amendment shall inure to the benefit of, and be binding upon, the parties hereto and their respective successors and permitted assigns.

d. This Seventh Amendment may be executed in one or more counterparts, and by different parties on different counterparts, each of which shall be deemed an original, all of which together shall constitute one and the same instrument, and in making proof of this Seventh Amendment it shall be necessary only to produce one counterpart.

e. This Seventh Amendment shall have effect as of its date.

IN WITNESS WHEREOF, the parties hereto have executed this Seventh Amendment as of the day and year first above written.

BORROWER:

ENVIRONMENTAL TECTONICS CORPORATION

By: \_\_\_\_\_  
Title: \_\_\_\_\_

BANK:

FIRST UNION NATIONAL BANK

By: \_\_\_\_\_  
Title: \_\_\_\_\_

GUARANTORS:

ENVIRONMENTAL TECTONICS CORPORATION  
EUROPE) LIMITED

By: \_\_\_\_\_

Title: \_\_\_\_\_

ETC INTERNATIONAL CORPORATION

By: \_\_\_\_\_

Title: \_\_\_\_\_

ENTERTAINMENT TECHNOLOGY  
CORPORATION

By: \_\_\_\_\_

Title: \_\_\_\_\_

STOCK PURCHASE WARRANT

This Warrant is issued as of this 26th day of December, 2001, by ENVIRONMENTAL TECTONICS CORPORATION, a Pennsylvania corporation (the "Company"), to ETC ASSET MANAGEMENT, LLC, an Alabama limited liability company (ETC ASSET MANAGEMENT, LLC and any subsequent assignee or transferee hereof are hereinafter referred to collectively as "Holder" or "Holders").

AGREEMENT:

1. Issuance of Warrant; Term. The Company hereby grants to Holder the right to purchase 332,820 shares of the Company's common stock, par value \$.05 per share (the "Common Stock"). The shares of Common Stock issuable upon exercise of this Warrant are hereinafter referred to as the "Shares." This Warrant shall be exercisable at any time and from time to time from the date hereof until March 27, 2004.

2. Exercise Price. The exercise price (the "Exercise Price") per share for which all or any of the Shares may be purchased pursuant to the terms of this Warrant shall be Fifty Cents (\$.50).

3. Exercise. This Warrant may be exercised by the Holder hereof (but only on the conditions hereinafter set forth) as to all or any increment or increments of one hundred (100) Shares (or the balance of the Shares if less than such number), upon delivery of written notice of intent to exercise to the Company at the following address: 125 James Way, Southampton, PA 18966-3877 or such other address as the Company shall designate in a written notice to the Holder hereof, together with this Warrant and payment to the Company of the aggregate Exercise Price of the Shares so purchased. The Exercise Price shall be payable, at the option of the Holder, (i) by certified or bank check, (ii) by the surrender of a portion of this Warrant where the Shares subject to the portion of this Warrant that is surrendered have a Fair Market Value (as defined in Section 4(c) below) equal to the aggregate Exercise Price. Upon exercise of this Warrant as aforesaid, the Company shall as promptly as practicable, and in any event within fifteen (15) days thereafter, execute and deliver to the Holder of this Warrant a certificate or certificates for the total number of whole Shares for which this Warrant is being exercised in such names and denominations as are requested by such Holder. If this Warrant shall be exercised with respect to less than all of the Shares, the Holder shall be entitled to receive a new Warrant covering the number of Shares in respect of which this Warrant shall not have been exercised, which new Warrant shall in all other respects be identical to this Warrant. The Company covenants and agrees that it will pay when due any and all state and federal issue taxes which may be payable in respect of the issuance of this Warrant or the issuance of any Shares upon exercise of this Warrant.

4. Covenants and Conditions. The above provisions are subject to the following:

(a) Neither this Warrant nor the Shares have been registered under the Securities Act of 1933, as amended ("Securities Act") or any state securities laws ("Blue Sky Laws"). The shares issued upon exercise of this warrant shall be "restricted securities" within the meaning of Rule 144 as

promulgated under the Securities Act by the Securities and Exchange Commission and the certificates representing such Shares shall bear substantially the following legend:

THE SHARES OF COMMON STOCK REPRESENTED BY THIS CERTIFICATE HAVE NOT BEEN REGISTERED UNDER THE SECURITIES ACT OF 1933, AS AMENDED (THE "ACT"), OR ANY APPLICABLE STATE SECURITIES LAW AND MAY NOT BE TRANSFERRED UNTIL (I) A REGISTRATION STATEMENT UNDER THE ACT AND SUCH APPLICABLE STATE SECURITIES LAWS SHALL HAVE BECOME EFFECTIVE WITH REGARD THERETO, OR (II) IN THE OPINION OF COUNSEL ACCEPTABLE TO THE COMPANY, REGISTRATION UNDER SUCH ACT AND SUCH APPLICABLE STATE SECURITIES LAWS IS NOT REQUIRED IN CONNECTION WITH SUCH PROPOSED TRANSFER.

The Holder hereof and the Company agree to execute such other documents and instruments as counsel for the Company reasonably deems necessary to effect the compliance of the issuance of this Warrant and any shares of Common Stock issued upon exercise hereof with applicable federal and state securities laws.

(b) The Company covenants and agrees that all Shares which may be issued upon exercise of this Warrant will, upon issuance and payment therefor, be legally and validly issued and outstanding, fully paid and nonassessable, free from all taxes, liens, charges and preemptive rights, if any, with respect thereto or to the issuance thereof. The Company shall at all times reserve and keep available for issuance upon the exercise of this Warrant such number of authorized but unissued shares of Common Stock as will be sufficient to permit the exercise in full of this Warrant.

(c) The Company covenants and agrees that it shall not sell any shares of the Company's capital stock at a price per share below the Fair Market Value of such shares, without the prior written consent of the Holder hereof except pursuant to exercise of (i) options outstanding as of March 27, 1997, or (ii) options granted subsequent to March 27, 1997, provided, however, the exercise price of such options is no less than the Fair Market Value of the Common Stock at the date of the grant. In the event that the Company sells shares of the Company's capital stock in violation of this Section 4(c), the number of shares issuable upon exercise of this Warrant shall be equal to the product obtained by multiplying the number of shares issuable pursuant to this Warrant prior to such sale by the quotient obtained by dividing (i) the Fair Market Value of the shares issued in violation of this Section 4(c) by (ii) the price at which such shares were sold.

(d) "Fair Market Value" per share of Common Stock shall mean (i) in the case of a security listed or admitted to trading on any securities exchange, the last reported sale price, regular way (as determined in accordance with the practices of such exchange), on such day, or if no sale takes place on such day, the average of the closing bid and asked prices on such day (and in the case of a security traded on more than one national securities exchange, at such price or such average, upon the exchange on which the volume of trading during the

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last calendar year was the greatest), (ii) in the case of a security not then listed or admitted to trading on any securities exchange, the last reported sale price on such day, or if no sale takes place on such day, the average of the closing bid and asked prices on such day, as reported by a reputable quotation service designated by the Company, (iii) in the case of a security not then listed or admitted to trading on any securities exchange and as to which no such reported sale price or bid and asked prices are available, the average of the reported high bid and low asked prices on such day, as reported by a reputable quotation service, or the Wall Street Journal, or if there are no bids and asked prices on such day, the average of the high bid and low asked prices, as so reported, on the most recent day (not more than 30 days prior to the date in question) for which prices have been so reported, and (iv) in the case of a security determined by the Company's Board of Directors as not having an active quoted market or in the case of other property, such fair market value as shall be determined by the Board of Directors.

5. Transfer of Warrant. Subject to the provisions of Section 4 hereof,

this Warrant may be transferred, in whole or in part, to any person or business entity, by presentation of the Warrant to the Company with written instructions for such transfer; provided, however, that this Warrant shall not be transferred without the prior written consent of the Company to either of Wyle Labs or Latecoere or to any entity that controls, is controlled by, or is under common control with either of Wyle Labs or Latecoere. Upon such presentation for transfer, the Company shall promptly execute and deliver a new Warrant or Warrants in the form hereof in the name of the assignee or assignees and in the denominations specified in such instructions. The Company shall pay all expenses incurred by it in connection with the preparation, issuance and delivery of Warrants under this Section.

6. Warrant Holder Not Shareholder; Rights Offering; Preemptive Rights. Except as otherwise provided herein, this Warrant does not confer upon the Holder, as such, any right whatsoever as a shareholder of the Company. Notwithstanding the foregoing, if the Company should offer to all of the Company's shareholders the right to purchase any securities of the Company, then all shares of Common Stock that are subject to this Warrant shall be deemed to be outstanding and owned by the Holder and the Holder shall be entitled to participate in such rights offering. The Company shall not grant any preemptive rights with respect to any of its capital stock without the prior written consent of the Holder.

7. Adjustment Upon Changes in Stock.

(a) If all or any portion of this Warrant shall be exercised subsequent to any stock split, stock dividend, recapitalization, combination of shares of the Company, or other similar event, occurring after the date hereof, then the Holder exercising this Warrant shall receive, for the aggregate price paid upon such exercise, the aggregate number and class of shares which such Holder would have received if this Warrant had been exercised immediately prior to the record date for such stock split, stock dividend, recapitalization, combination of shares, or other similar event. If any adjustment under this Section 7(a), would create a fractional share of Common Stock or a right to acquire a fractional share of Common Stock, such fractional share shall be disregarded and the number of shares subject to this Warrant shall be the next higher number of shares, rounding all fractions upward. Whenever there shall be an adjustment pursuant to this Section 7(a), the Company shall forthwith notify the Holder or Holders of this Warrant of such adjustment, setting forth in reasonable detail the event requiring the adjustment and the method by which such adjustment was calculated.

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(b) If all or any portion of this Warrant shall be exercised subsequent to any merger, consolidation, exchange of shares, separation, reorganization or liquidation of the Company, or other similar event, occurring after the date hereof, as a result of which shares of Common Stock shall be changed into the same or a different number of shares of the same or another class or classes of securities of the Company or another entity, or the holders of Common Stock are entitled to receive cash or other property, then the Holder exercising this Warrant shall receive, for the aggregate price paid upon such exercise, the aggregate number and class of shares, cash or other property which such Holder would have received if this Warrant had been exercised immediately prior to such merger, consolidation, exchange of shares, separation, reorganization or liquidation, or other similar event. If any adjustment under this Section 7(b) would create a fractional share of Common Stock or a right to acquire a fractional share of Common Stock, such fractional share shall be disregarded and the number of shares subject to this Warrant shall be the next higher number of shares, rounding all fractions upward. Whenever there shall be an adjustment pursuant to this Section 7(b), the Company shall forthwith notify the Holder or Holders of this Warrant of such adjustment, setting forth in reasonable detail the event requiring the adjustment and the method by which such adjustment was calculated.

8. Certain Notices. In case at any time the Company shall propose to:

(a) declare any cash dividend upon its Common Stock;

(b) declare any dividend upon its Common Stock payable in stock or make any special dividend or other distribution to the holders of its Common Stock;

(c) offer for subscription to the holders of any of its Common Stock any additional shares of stock in any class or other rights;

(d) reorganize, or reclassify the capital stock of the Company, or consolidate, merge or otherwise combine with, or sell of all or substantially all of its assets to, another corporation;

(e) voluntarily or involuntarily dissolve, liquidate or wind up of the affairs of the Company; or

(f) redeem or purchase any shares of its capital stock or securities convertible into its capital stock;

then, in any one or more of said cases, the Company shall give to the Holder of the Warrant, by certified or registered mail, (i) at least twenty (20) days' prior written notice of the date on which the books of the Company shall close or a record shall be taken for such dividend, distribution or subscription rights or for determining rights to vote in respect of any such reorganization, reclassification, consolidation, merger, sale, dissolution, liquidation or winding up, and (ii) in the case of such reorganization, reclassification, consolidation, merger, sale, dissolution, liquidation or winding up, at least twenty (20) days' prior written notice of the date when the same shall take place. Any notice required by clause (i) shall also specify, in the case of any such dividend, distribution or subscription rights, the date on which the holders of Common Stock shall be entitled thereto, and any notice required by clause (ii) shall specify the date on which the holders of Common Stock shall be entitled to exchange their Common Stock for securities or other property deliverable upon such reorganization, reclassification, consolidation, merger, sale, dissolution, liquidation or winding up, as the case may be.

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9. Article and Section Headings. Numbered and titled article and section headings are for convenience only and shall not be construed as amplifying or limiting any of the provisions of this Warrant.

10. Notice. Any and all notices, elections or demands permitted or required to be made under this Warrant shall be in writing, signed by the party giving such notice, election or demand and shall be delivered personally, telecopied, telexed, or sent by certified mail or overnight via nationally recognized courier service (such as Federal Express), to the other party at the address set forth below, or at such other address as may be supplied in writing and of which receipt has been acknowledged in writing. The date of personal delivery or telecopy or two (2) business days after the date of mailing (or the next business day after delivery to such courier service), as the case may be, shall be the date of such notice, election or demand. For the purposes of this Warrant:

The Address of Holder is: ETC Asset Management, LLC  
c/o Armbrecht Jackson LLP  
Post Office Box 290  
Mobile, Alabama 36601  
Attention: Tom Oldweiler  
Fax. No.

The Address of Company is: Environmental Tectonics Corporation  
125 James Way  
Southampton, Pennsylvania 18966-3877  
Attention: William F. Mitchell  
Fax No. (215) 357-4000

with a copy to:

Stevens & Lee, A Professional Corporation  
One Glenhardie Corporate Center  
1275 Drummers Lane  
P.O. Box 236  
Wayne, Pennsylvania 19087-0236  
Attention: Jeffrey P. Waldron, Esq.  
Fax No. (610) 687-1384

11. Severability. If any provision(s) of this Warrant or the application thereof to any person or circumstances shall be invalid or unenforceable to any extent, the remainder of this Warrant and the application of such provisions to other persons or circumstances shall not be affected thereby and shall be enforced to the greatest extent permitted by law.

12. Entire Agreement. This Warrant between the Company and Holder represents the entire agreement between the parties concerning the subject matter hereof, and all oral discussions and prior agreement are merged herein.

13. Governing Law and Amendments. This Warrant shall be construed and enforced under the laws of the State of Tennessee applicable to contracts to be wholly performed in such State. No amendment or modification hereof shall be effective except in a writing executed by each of the parties hereto.

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14. Counterparts. This Warrant may be executed in any number of counterparts and be different parties to this Warrant in separate counterparts, each of which when so executed shall be deemed to be an original and all of which taken together shall constitute one and the same Warrant.

15. Jurisdiction and Venue. The Company hereby consents to the jurisdiction of the courts of the State of Tennessee and the United States District Court for the Middle District of Tennessee, as well as to the jurisdiction of all courts from which an appeal may be taken from such courts, for the purpose of any suit, action or other proceeding arising out of any of its obligations arising under this Agreement or with respect to the transactions contemplated hereby, and expressly waives any and all objections it may have as to venue in any of such courts.

IN WITNESS WHEREOF, the parties hereto have set their hands as of the date first above written.

COMPANY:

ENVIRONMENTAL TECTONICS  
CORPORATION:

By: /s/ Duane Deaner

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Duane Deaner  
Chief Financial Officer

HOLDER:

ETC ASSET MANAGEMENT, LLC

By: /s/ T. Todd Morton

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Name: T. Todd Morton  
Title: Manager

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PORTIONS OF  
ENVIRONMENTAL TECTONICS CORPORATION  
2002  
ANNUAL SHAREHOLDERS' REPORT

## FINANCIAL REVIEW

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

Fiscal Year End	2002 ----	2001 ----	2000 ----	1999 ----	1998 ----
Net sales	\$32,527	\$32,452	\$34,920	\$29,225	\$29,284
Gross profit	11,465	13,075	12,798	11,672	9,298
Operating income	2,873	4,122	5,327	4,759	4,208
Net income	1,741	2,021	2,837	2,170	1,794
Earnings per common share:					
Basic	.24	.29	.40	.32	.25
Diluted	.23	.27	.36	.29	.23
Working capital	30,683	25,070	16,306	13,755	11,462
Long-term obligations	16,688	12,778	4,455	4,219	4,356
Total assets	48,482	40,705	31,897	35,448	22,955
Total stockholders' equity	20,782	18,796	16,245	11,030	8,579
Weighted average common shares:					
Basic	7,143,000	7,087,000	6,604,000	5,861,000	5,981,000
Diluted	7,499,000	7,499,000	7,319,000	6,312,000	6,496,000

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 currently prohibited from declaring any cash dividends on common stock under the terms of its credit facility.

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

FORWARD-LOOKING STATEMENTS

This Annual Report 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 our current expectations and projections about future events. These forward-looking statements are subject to known and unknown risks, uncertainties and assumptions about us and our subsidiaries, that may cause our 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 includes 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, the effect of currency fluctuations, capital structure and other financial items, (ii) statements of 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 by customers, suppliers, competitors or regulating 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," "pro forma," "looking forward," "would," "believe," "expect," "anticipate," "estimate," "intend," "plan," or similar expressions. These forward-looking statements involve risks and uncertainties, which are subject to change based on various important factors (some of which, in whole or in part, are beyond the Company's control). The following factors, among others, could cause the Company's financial performance to differ materially from the goals, plans, objectives, intentions and expectations expressed in such forward-looking statements: (1) the strength of the United States and global economies in general and the strength of the regional and local economies in which the Company conducts operations; (2) the effects of, and changes in U.S. and foreign governmental trade, monetary and fiscal policies and laws; (3) the impact of domestic or foreign military or political conflicts and turmoil; (4) the timely development of competitive new products and services by the Company and the acceptance of such products and services by customers; (5) willingness of customers to substitute competitors' products and services and vice versa; (6) the impact on operations of changes in U.S. and governmental laws and public policy, including environmental regulations; (7) the level of export sales impacted by export controls, changes in legal and regulatory requirements, policy changes affecting the markets, changes in tax laws and tariffs, exchange rate fluctuations, political and economic instability, and accounts receivable collection; (8) technological changes; (9) regulatory or judicial proceedings; (10) the impact of any current or future litigation involving the Company; and (11) the success of the Company at managing the risks involved in the foregoing.

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.

Results of Operation

Fiscal 2002 versus Fiscal 2001

The company had a net income of \$1,741,000 or \$.23 per share (diluted) in 2002, versus a net income of \$2,021,000 or \$.27 per share (diluted) in 2001.

Operating income was \$2,873,000, a decrease of \$1,249,000 or 30.3% over 2001. This decrease was primarily the result of a reduced gross margin partially offset by lower general and administrative expenses and research and development expenses. On a pro-forma basis, excluding claims revenue booked in both periods, gross profit for 2002 actually increased \$452,000 or 4.2% in 2002 as compared to 2001 as most operating groups experienced both higher gross profit and an improved gross profit rate as a percentage of revenues.

The Company recognizes revenue utilizing three methods. On long-term contracts, the percentage of completion method is applied based on costs incurred as a percentage of estimated total costs. 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 facts requiring the revisions become known. 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, and revenue on parts and services, is recognized as shipped. 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 after 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, revenue on contract claims and disputes, for 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 amount can be reliably estimated.

Revenue recorded on a contract claim cannot exceed the incurred contract costs related to that claim. Significant claims outstanding at February 22, 2002 included the U.S. Navy (\$5.5 million recorded) and an international customer (\$5.7 million recorded). On May 9, 2002, the Company reached a final settlement agreement totaling approximately \$6.9 million with the U.S. Navy for all outstanding amounts. The gain, if any, resulting from the settlement would be recognized in fiscal 2003. The outstanding claims with the international customer are either under review by the customer or in litigation. Although recorded as a current asset in the financial statements, all claim revenues may not be received in full during fiscal 2003.

Total sales increased \$75,000 or 0.2% in 2002 over 2001 representing increases in entertainment (up \$7,459,000, 88.8%), environmental (up \$428,000, 17.7%) and hyperbaric systems (up \$967,000, 31.1%). Partial offsets were Aircrew training Systems (ATS) sales (down \$6,793,000, 50.3%) including sales from the Company's Polish subsidiary, sales of sterilizers and simulation sales of the Company's Florida branch. Entertainment sales benefited from increased production on the Company's main ride contract. Environmental sales were up internationally representing a test room for Russia and two large chamber contracts in China. Hyperbaric sales increased as two large chambers for a Southeast Asian customer were shipped. ATS sales were negatively impacted by the general economic downturn and global disruption that affected the world last

year. With the tightening of worldwide governmental spending and the political fall out from the September 11, 2001 tragedy, as an international supplier of aircrew training devices, the Company saw a significant impairment in its ability to close many large international contracts, most of which have been under proposal for some time. This was coupled with a major economic disruption and currency devaluation in Turkey, where the Company's ETC-Information Systems performs contract software for local customers, and the inability of the Polish Government to approve a national budget, which delayed contract awards for our Polish Subsidiary. Sterilizer shipments were hindered by customer schedule slippages, while decreases in the Simulation line reflected reduced activity on a percentage of completion revenue basis for a large contract for a simulator at Chicago's O'Hare and Midway Airports, although this group was awarded four contracts in the second half of the year. Geographically, domestic sales were up \$6,092,000 or 40.3%, and represented 65.2% of total sales, up from 46.6% in 2001, primarily reflecting the aforementioned entertainment activity. U.S. Government sales were down \$869,000 or 42.1%, and represented 3.7% of total sales, down from 6.4% in 2001, on lower claims revenue. International sales, including those from the Company's foreign subsidiaries, were down \$5,148,000 or 33.7% and represented 31.1% of total sales, down from 47.0% from 2001, reflecting the aforementioned global conditions during much of fiscal 2002. Additionally, international sales were down due to reduced sales in the United Kingdom and Nigeria, as large contracts were completed or stopped in these regions. U.S. Government sales reflected reduced ATS claim revenue. Throughout the Company's history, most of the sales for Aircrew Training products have been made to international customers. The Company has subsidiaries in the United Kingdom, Poland and Turkey, 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. Customers in 2002 representing 10% or more of sales were the Walt Disney companies, \$15,859,000, or 48.8%, and the Royal Thai Air Force \$3,285,000 or 10.1%. In 2002, international sales totaling at least \$500,000 per country were made to customers in Great Britain, Japan, Turkey, Thailand, Russia, and Nigeria. 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 Walt Disney companies constituted 44.1% of the Company's backlog at February 22, 2002.

Risks associated with international operations that might be different from those domestically include the strength of global economies in general and the strength of the regional and local economies in which the Company conducts operations, the effect of foreign military or political conflicts and turmoil, changes in foreign governmental trade, monetary and fiscal policies and laws, export controls, exchange rate fluctuations and political and economic instability. Unusual risks that might be associated with sales to less developed nations include U.S. Dollar and monetary system controls and a heightened risk of political, economic and civil turmoil.

The Company considers its business activities to be divided into two segments: Aircrew Training Systems (ATS) and Industrial Group. On a segment basis, sales of the Company's Aircrew Training Systems (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 \$22,629,000 in 2002, a decrease of \$692,000, or 3.0% over 2001. Sales of these products accounted for 69.6% of the Company's sales compared to 72.6% in 2001. 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 \$766,000 to \$9,898,000, an increase of 8.4%, and constituted 30.4% of the Company's total sales compared to 27.4% in 2001.

claims revenue. On a pro-forma basis, excluding claims revenue booked in each period, gross profit for 2002 increased \$452,000 or 4.2% over 2001, as most of the business groups except ATS evidenced both increased gross profit dollars and an improved gross margin rate as a percent of sales.

Operating profit decreased \$1,249,000 or 30.3% in 2002 compared to 2001. On a segment basis, ATS had an operating profit of \$2,631,000, a decrease of \$3,163,000 from 2001, while the Industrial Group had an operating profit of \$1,347,000 compared to an operating loss of \$906,000 in 2001. These segment operating profits were offset, in part, by unallocated corporate expenses of \$1,105,000, an increase of 339,000 over 2001.

Selling and administrative expenses decreased \$58,000 or 0.7% in 2002 as compared to 2001 primarily reflecting reduced legal expenses to support international claims. As a percentage of sales, selling and administrative expenses were 24.6% compared to 24.8% in 2001.

Research and development expenses decreased significantly, down \$303,000 or 33.6% in 2002 as compared to 2001, as these activities were curbed during the year, especially 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 2002 were \$989,000 compared to \$550,000 in 2001. Amortization of software costs, which was charged to cost of sales, was \$496,000 and \$455,000 for 2002 and 2001, respectively.

Interest expense (net of interest income) increased \$269,000 or 32.6% in 2002 over 2001 reflecting higher borrowings albeit at a lower average rate. Additionally, during the third fiscal quarter of 2002, \$195,000 of 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 \$45,000 or 41.3% in 2002 over 2001 principally due to increased letter of credit fees.

The Company's provision for taxes, rate-wise, reflected a rate of 30% before the impact of approximately \$619,000 of research and experimentation tax credit refunds. The Company will continue to use research and experimentation tax credits, if applicable, to reduce its federal income tax.

During fiscal 2002, the Company received inquiries and estimated tax assessments for the years 1995 through 1999 from Inland Revenue in Great Britain related to the Company's Great Britain operation. The Company believes that the assessments are arbitrary and have no legal basis. The Company has responded to Inland Revenue and has agreed to review all in-country activity and taxes paid related to the Company's subsidiary, ETC Europe, for the years in question. At this point, the Company believes that additional taxes, if any, will be immaterial, and the Company has some options to offset some or all of any additional payments including applying any additional tax liability against the company's current income tax reserve.

Subsequent to fiscal year end, the Company was notified that the Internal Revenue Service was going to conduct an audit of the Company's U.S. Fiscal 2000 tax filing. As of the date of this Annual Report, this audit was still in process and the Company is not able to assess whether any additional taxes will result from the review.

#### Fiscal 2001 versus Fiscal 2000

The Company had a net income of \$2,021,000 or \$.27 per share (diluted) in 2001, versus a net income of \$2,837,000 or \$.36 per share (diluted) in 2000. Operating income was \$4,122,000 in 2001, a decrease of \$1,205,000 or 22.6% over 2000. This decrease was primarily the result of higher general and administrative expenses partially offset by an increased gross margin as the rate as a percentage of sales was up by 3.7 percentage points. The improvement in the gross margin rate as a percentage of sales reflected both an improvement in Entertainment line performance and an overall increase in Aircrew Training Systems gross margin on higher domestic and international claims revenue and

corresponding gross margin. Claims bookings for the year increased operating income by \$1,325,000, net of associated manufacturing costs and legal expenses. Included in the above was a claim against an international customer which was settled in the three months ended February 23, 2001. On a pro-forma basis, excluding claims revenue booked in both periods, gross profit for 2001 decreased by \$1,988,000 or 15.5%, from Fiscal 2000 primarily reflecting lower sales and corresponding gross margin in international Hyperbaric systems and PTS and domestic simulation sales.

The Company recognizes revenue utilizing three methods. On long-term contracts, the percentage of completion method is applied based on costs incurred as a percentage of estimated total costs. 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 facts requiring the revisions become known. 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, or to be completed in less than one year, and where there are no post-shipment services included in the contract, and revenue on parts and services, are recognized as shipped. Revenue on contracts under \$100, or to be completed in less than one year, and where post-shipment services (such as installation and customer acceptance) are required, is recognized after customer acceptance. Revenue for service contracts is recognized ratably over the life of the contract with related material costs expensed as incurred.

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In accordance with accounting principles generally accepted in the United States of America, revenue on contract claims and disputes, for 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 amount can be reliably estimated.

Revenue recorded on a contract claim cannot exceed the incurred contract costs related to that claim. Significant claims outstanding at February 23, 2001, included the U.S. Navy (\$5.5 million recorded) and an international customer (\$5.8 million recorded). Although recorded as current in the financial statements, claim revenues may not be received in full during fiscal 2002. Claims against the U.S. Navy, totaling approximately \$12.0 million, were filed in previous years. One of the claims against an international customer was settled in the fourth quarter of fiscal 2001, and another claim was formally filed with the customer subsequent to fiscal year end. A third claim is still being developed.

Total sales decreased \$2,468,000 or 7.1% in 2001 from 2000 as sales performance was mixed, with the most significant decreases being evidenced in the Company's Polish Subsidiary and Simulation and Hyperbaric product areas. Sales of the Polish Subsidiary were negatively impacted by economic and political issues in Poland, most notably the inability of the Polish Government to finalize the national budget. Decreases in the Simulation line reflected reduced activity on a percentage of completion revenue basis for a large contract for a simulator at Chicago's O'Hare and Midway Airports. Due to a change in administration, the City of Chicago has experienced delays in completing the building to house the simulator. Hyperbaric sales were down from the prior year primarily due to reduced percentage of completion sales to a

customer in Nigeria. A partial offset was seen in the Environmental, Sterilizer and Entertainment lines (Entertainment was up \$4,719,000 or 128.2%) and sales from the Company's UK Subsidiary, which was purchased in March 2000. Environmental sales benefited from higher domestic sales of standard products including environmental test rooms, air supply units, and conditioned air supply units. Sterilizer sales were helped by the Company's new line of sterilizer control upgrades, retrofits, and an increase in autoclave sales to domestic customers. Entertainment sales benefited from increased revenue on a percentage of completion basis for a large entertainment ride contract currently in process. Geographically, international sales, including those from the Company's foreign subsidiaries, were down \$7,363,000 or 31.0% in 2001 and represented 50.6% of total sales, down from 68.5% in 2000. International sales were down primarily due to reduced sales in Nigeria. U.S. Government sales reflected reduced ATS products and revenues. Throughout the Company's history, most of the sales for Aircrew Training Products have been made to international customers. The Company has subsidiaries in the United Kingdom, Poland and Turkey, 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. U.S. Government sales were down \$671,000 or 42.3% in 2001, and represented 2.8% of total sales, down from 4.5% in 2000. Providing a partial offset was an increase in domestic sales, which were up \$5,566,000 or 58.2% in 2001, primarily from the aforementioned increase in the Entertainment line. Domestic sales represented 46.6% of the Company's total sales, up from 27.0% in the prior period. Customers in 2001 representing 10% or more of sales were the United Kingdom Ministry of Defense, \$5,524,000 or 17.0%, and the Walt Disney companies, \$8,400,000 or 25.9%. In 2001, international sales totaling at least \$500,000 per country were made to customers in Great Britain, Poland, Japan, Turkey, Thailand, Egypt and Spain. 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. Additionally, open orders for the Walt Disney companies constituted 56.5% of the Company's backlog at February 23, 2001.

Risks associated with international operations that might be different from those domestically include the strength of global economies in general and the strength of the regional and local economies in which the Company conducts operations, the effect of foreign military or political conflicts and turmoil, changes in foreign governmental trade, monetary and fiscal policies and laws, export controls, exchange rate fluctuations and political and economic instability. Unusual risks that might be associated with sales to less developed nations include U.S. Dollar and monetary system controls and a heightened risk of political, economic and civil turmoil.

The Company considers its business activities to be divided into two segments: Aircrew Training Systems (ATS) and Industrial Simulation. On a segment basis, sales of the Company's Aircrew Training Systems (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 \$23,567,000 in 2001, a decrease of \$2,794,000 or 10.6% over 2000. Sales of these products accounted for 72.6% of the Company's sales in 2001 compared to 75.5% in 2000. 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 \$326,000 to \$8,885,000, an increase of 3.8%, and constituted 27.4% of the Company's total sales compared to 24.5% in 2000.

Gross profit increased \$277,000 or 2.2% in 2001 over 2000. As a percentage of sales, gross profit was 40.3% in 2001, up from 36.6% in 2000. This increase was attributable to an improvement in the rate as a percentage of sales and higher domestic and international claims revenue and resulting gross margin.

Operating profit decreased \$1,205,000 or 22.6% in 2001 compared to 2000. On a segment basis, ATS had an operating profit of \$5,794,000 in 2001, an increase of \$755,000 from 2000, while the Industrial Group had an operating loss of \$906,000 compared to an operating profit of \$1,355,000 in 2000. These segment operating profits were offset, in part, by unallocated corporate expenses of \$766,000 in 2001, a decrease of \$170,000 over 2000. Unallocated corporate expenses include corporate officers' salaries and benefits, stockholder expenses, accounting and legal expenses and contributions.

Selling and administrative expenses increased \$1,499,000 or 22.9% in 2001, due principally to higher legal expenses to support the Company's domestic and international claims, higher staffing and related expenses in support of the Company's aggressive new initiatives, a corporate-wide ramp-up of worldwide marketing efforts, and additional selling and administrative expenses for the Company's UK subsidiary, which was purchased in March 2000. As a percentage of sales, selling and administrative expenses were 24.8% in 2001 compared to 18.8% in 2000.

Research and development expenses decreased by \$17,000 or 1.8% in 2001 from 2000, primarily due to ATS and entertainment product applications. 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 2001 were \$550,000 compared to \$555,000 in 2000. Amortization of software costs, which was charged to cost of sales, was \$455,000 and \$596,000 for 2001 and 2000, respectively.

Interest expense (net of interest income) increased \$87,000 or 11.8% in 2001 from 2000 reflecting higher borrowings at a higher average rate. Letter of credit and other expenses decreased by \$10,000 or 9.2% in 2001 principally due to decreased bank charges.

The Company's provision for taxes, rate-wise, remained unchanged in 2001 from 2000 and approximated the statutory rate.

#### Liquidity and Capital Resources

At February 22, 2002, the Company had a Credit Agreement with a bank that provided a credit facility of \$15 million. This agreement was amended on March 29, 2002. This amendment extended the expiration date of the Credit Agreement to November 30, 2002 and increased the interest rate from (i) the bank's prime rate less a factor ranging from 0% to 0.5% based on the Company's leverage ratio or adjusted LIBOR, to (ii) the bank's prime rate plus 1% for adjusted base rate loans or adjusted LIBOR plus 3.5% for adjusted LIBOR rate loans. The amendment also adjusted the Funds Flow Ratio through the expiration date of the Credit Agreement. On June 5, 2002, the Company's bank agreed to extend the expiration date of the Credit Agreement to February 28, 2003. Substantially all of the company's short-term financing is provided by this bank. As of June 5, 2002, the Company had \$1,485,000 available under the credit agreement.

During fiscal 2002, the Company used \$720,000 of cash for operating activities. This was primarily the result of an increase in accounts receivable and inventories coupled with a reduction in billings in excess of costs and estimated earnings on uncompleted long-term contracts. Partial offsets were provided by net income, non-cash charges, and an increase in accounts payable and customer deposits. In general, the net use of cash for operations reflected a build up of current assets, primarily accounts receivable (which includes claims receivables) partially offset by a smaller increase in current liabilities.

Investing activities used \$1,638,000 and consisted of purchases for capital equipment and capitalized software.

Financing activities generated \$3,714,000 of cash. This included the net effect of bank borrowing and cash from the issuance of stock partially offset by an increase in restricted cash and payments on other long term obligations. During the first quarter of fiscal 2002 the Company made a payment



of \$350,000 representing the final balance due for the purchase of ETC-PZL Aerospace Industries, the Company's Polish subsidiary. (Reference Notes to the Consolidated Financial Statements Number 7, Long-Term Obligations and Credit Arrangements.)

The Company believes it will be able to meet the revised covenant and also that cash generated from operating activities, available borrowing under the Credit Agreement, coupled with cash to be received from the approximate \$6.9 million final settlement agreement reached with the U.S. government on May 9, 2002, will be sufficient to meet its future obligations.

In reference to the Company's outstanding claims with 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 good experience in that recoveries have exceeded claims (see Note 3 of Notes to Consolidated Financial Statements).

The Company's sales backlog at February 22, 2002 and February 23, 2001, for work to be performed and revenue to be recognized under written agreements after such dates, was \$28,148,000 and \$40,439,000, respectively. In addition, the Company's training, maintenance and upgrade contracts backlog at February 22, 2002 and February 23, 2001, for work to be performed and revenue to be recognized after that date under written agreements, was approximately \$1,485,000 and \$1,347,000, respectively. Of the February 22, 2002 backlog, approximately \$20,967,000 was under contracts for ATS and maintenance support including \$13,069,000 for the Walt Disney companies. Approximately 94% of the February 22, 2002 backlog is expected to be completed prior to February 28, 2003. The decline in the Company's backlog primarily reflected continued production on a large entertainment project for the Walt Disney Companies which was not offset by additional contracts in the other product areas. It should be noted that the Company's order flow does not follow any seasonal pattern and that large contracts can and have been booked at various times during the fiscal year.

#### Recent Accounting Pronouncements

##### Reporting Comprehensive Income:

In June 1997, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards (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. Other comprehensive income consists of foreign currency translation adjustments. The adoption of SFAS No. 130 did not have a material impact on the Company's consolidated financial position or results of operations.

##### 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 information about operating segments in complete sets of financial statements of the enterprise and in condensed 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. The adoption of SFAS No. 131 had no impact on the Company's

consolidated financial position or results of operations.

Derivative Financial Instruments:

In January 2001, the FASB issued SFAS No. 133, "Accounting for Derivative Instruments and Hedging Activities". SFAS No. 133 requires the recognition of all derivative financial instruments as either assets or liabilities in the Consolidated Balance Sheet, and the periodic adjustment of those instruments to fair value. The classification of gains and losses resulting from changes in the fair value of derivatives is dependent on the intended use of the derivative and its resulting designation. Adjustments to reflect changes in fair values of derivatives that are not considered highly effective hedges are reflected in earnings. Adjustments to reflect changes in fair values of derivatives that are considered highly effective hedges are either reflected in earnings and largely offset by corresponding adjustments related to the fair values of the hedged items, or reflected in other comprehensive income until the hedged transaction matures and the entire transaction is recognized in earnings. The change in fair value of the ineffective portion of a hedge is immediately recognized in earnings. SFAS No. 133 is effective for all periods beginning after June 15, 1999. This effective date was later deferred to all periods beginning after June 15, 2000 by SFAS No. 137, "Accounting for Derivative Instruments and Hedging activities-Deferral of the Effective Date of FASB Statement Number 133." The adoption of SFAS No. 133 had no impact on the Company's consolidated financial position or results of operations.

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Business Combinations and Goodwill and Intangible Assets:

On July 20, 2001, the FASB issued SFAS No. 141, Business Combinations, and SFAS No. 142, Goodwill and Intangible Assets. SFAS 141 is effective for all business combinations completed after June 30, 2001. SFAS 142 is effective for fiscal years beginning after December 15, 2001; however, certain provisions of this Statement apply to goodwill and other intangible assets acquired between July 1, 2001, and the effective date of SFAS 142. Major provisions of these Statements and their effective dates are as follows:

- \* all business combinations initiated after June 30, 2001 must use the purchase method of accounting. The pooling of interest
- o method of accounting is prohibited except for transactions initiated before July 1, 2001.
- o intangible assets acquired in a business combination must be recorded separately from goodwill if they arise from contractual or other legal rights or are separable from the acquired entity and can be sold, transferred, licensed, rented or exchanged, either individually or as part of a related contract, asset or liability.
- o goodwill, as well as intangible assets with indefinite lives, acquired after June 30, 2001, will not be amortized. Effective February 23, 2002, all previously recognized goodwill and intangible assets with indefinite lives will no longer be subject to amortization.
- o effective February 23, 2002, goodwill and intangible assets with indefinite lives will be tested for impairment annually and whenever there is an impairment indicator.
- o all acquired goodwill must be assigned to reporting units for purposes of impairment testing and segment reporting.

Although it is still reviewing the provisions of these Statements, management's preliminary assessment is that these Statements will not have a material impact on the Company's financial position or results of operations.

Asset Retirement Obligations:

In August 2001, The FASB issued SFAS No. 143, Accounting for Asset Retirement Obligations. SFAS No. 143 applies to all entities, including rate-regulated entities, that have legal obligations associated with the retirement of a tangible long-lived asset that result from acquisition, construction or development and (or) normal operations of the long-lived asset. The application of this statement is not limited to certain specialized industries, such as the extractive or nuclear industries. This Statement also applies, for example, to a company that operates a manufacturing facility and has a legal obligation to dismantle the manufacturing plant and restore the underlying land when it ceases operation of that plant. A liability for an asset retirement obligation should be recognized if the obligation meets the definition of a liability and can be reasonably estimated. The initial recording should be at fair value. SFAS No. 143 is effective for financial statements issued for fiscal years beginning after June 15, 2002, with earlier application encouraged. The provisions of this statement are not expected to have a material impact on the financial condition or results of operations of the Company.

Impairment or Disposal of Long-Lived Assets:

In August 2001, the FASB issued SFAS No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets. SFAS No. 144 retains the existing requirements to recognize and measure the impairment of long-lived assets to be held and used or to be disposed of by sale. However, SFAS No. 144 makes changes to the scope and certain measurement requirements of existing accounting guidance. SFAS No. 144 also changes the requirements related to reporting the effects of a disposal or discontinuation of a segment of a business. SFAS No. 144 is effective for financial statements issued for fiscal years beginning after December 15, 2001 and interim periods within those fiscal years. The adoption of this statement is not expected to have a significant impact on the financial condition or results of operations of the Company.

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

The Company's Common Stock (the Common Stock) is traded on the American Stock Exchange under the symbol ETC. As of May 15, 2002, the Company had 294 shareholders of record.

The following table sets forth the quarterly ranges of high and low sale prices, and the closing sale price, for shares of the Common Stock for the periods indicated. Such prices represent quotations between dealers and do not include mark-ups, markdowns or commissions, and may not necessarily represent actual transactions.

	Sale Prices		Closing Sale Price
	High ----	Low ---	
2002			
First Quarter	\$10.05	\$8.30	\$ 9.10
Second Quarter	9.05	6.80	7.20
Third Quarter	8.50	6.60	7.00

Fourth Quarter	7.50	5.70	6.45
2001			
First Quarter	\$15-5/8	\$7-7/8	\$9-1/2
Second Quarter	10-1/2	8-1/8	9-1/16
Third Quarter	9-3/4	7	7-5/16
Fourth Quarter	8-3/5	6-3/8	8-2/5

The Company has never paid any cash dividends on the Common Stock in the past and does not anticipate that any cash dividends will be declared or paid in the foreseeable future. The Company's current line of credit facility prohibits the payment of any dividends by the Company without the lender's prior written consent.

Report of Independent Certified Public Accountants

Board of Directors  
Environmental Tectonics Corporation

We have audited the accompanying consolidated balance sheets of Environmental Tectonics Corporation and Subsidiaries as of February 22, 2002 and February 23, 2001, 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 22, 2002. 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 auditing standards generally accepted in the United States of America. Those standards require that we plan and perform our 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 22, 2002 and February 23, 2001, and the consolidated results of their operations and cash flows for each of the three fiscal years in the period ended February 22, 2002, in conformity with accounting principles generally accepted in the United States of America.

As discussed in Note 1 to the consolidated financial statements, the Company has recorded receivables in the amount of \$11.9 million related to claims made to or against the United States government and an international customer for contract costs incurred through February 22, 2002. The total net claims amount made is approximately \$26 million based on costs incurred through February 22, 2002, and is subject to negotiation, arbitration and audit by the U.S. government and the international customer. On May 9, 2002, the Company reached a final settlement agreement with the United States government on one of its claims totaling approximately \$6.9 million.

/s/ Grant Thornton LLP  
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Philadelphia, Pennsylvania

April 24, 2002 (except for notes 1 and 3,  
as to which the date is May 9, 2002 and  
Note 7, as to which the date is June 5, 2002)

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

	February 22, 2002 ----	February 23, 2001 ----
<b>ASSETS</b>		
Cash and cash equivalents	\$2,261	\$851
Cash equivalents restricted for letters of credit	569	544
Accounts receivable, net	19,856	16,776
Costs and estimated earnings in excess of billings on uncompleted long-term contracts	9,391	9,595
Inventories	7,161	4,624
Deferred tax asset	715	615
Prepaid expenses and other current assets	921	423
	-----	-----
Total current assets	40,874	33,428
Property, plant and equipment, net	5,318	5,337
Software development costs, net of accumulated amortization of \$6,166 and \$5,670 in 2002 and 2001, respectively	1,684	1,191
Other assets	606	749
	-----	-----
Total assets	\$48,482	\$40,705
	=====	=====
<b>LIABILITIES</b>		
Current portion of long-term obligations	\$ 281	\$ 643
Accounts payable - trade	3,438	1,929
Billings in excess of costs and estimated earnings on uncompleted long-term contracts	499	1,712
Customer deposits	3,684	1,443
Accrued income taxes	731	754
Accrued commissions	738	668
Other accrued liabilities	820	1,209
	-----	-----
Total current liabilities	10,191	8,358
	-----	-----
Long-term obligations, less current portion:		
Credit facility payable to banks	11,755	7,564
Long term bonds	4,920	5,195
Other	13	19
	-----	-----
	16,688	12,778
	-----	-----
Deferred tax liability	735	674
	-----	-----
Total liabilities	27,614	21,810
	-----	-----
Minority Interest	86	99
<b>STOCKHOLDERS' EQUITY</b>		
Common stock - authorized 20,000,000 shares, \$.05 par value; 7,142,946 and 7,110,546 shares issued and outstanding in 2002 and 2001, respectively	357	355
Capital contributed in excess of par value of common stock	6,703	6,514
Accumulated other comprehensive loss	(172)	(226)
Retained earnings	13,894	12,153
	-----	-----
Total stockholders' equity	20,782	18,796
	-----	-----
Total liabilities and stockholders' equity	\$48,482	\$40,705
	=====	=====

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 22, 2002 ----	52 Weeks Ended February 23, 2001 ----	52 Weeks Ended February 25, 2000 ----
Net sales	\$32,527	\$32,452	\$34,920
Cost of goods sold	21,062	19,377	22,122
Gross profit	11,465	13,075	12,798
Operating expenses:			
Selling and administrative	7,992	8,050	6,551
Research and development	600	903	920
Operating income	8,592	8,953	7,471
Other expenses:			
Interest expense (net)	1,094	825	738
Letter of credit fees	102	65	53
Other, net	42	34	56
	924	847	1,238
Income before provision for/(benefit from) income taxes and minority interest	1,635	3,198	4,480
Provision for/(benefit from) income taxes	(93)	1,126	1,573
Income before minority interest	\$1,728	\$2,072	\$2,907
Income (loss) attributable to minority interest	(13)	51	70
Net income	\$1,741	\$2,021	\$2,837
Per share information Earnings per common share:			
Basic	\$.24	\$.29	\$.40
Diluted	\$.23	\$.27	\$.36
Income available to common stockholders	\$1,741	\$2,021	\$2,671
Weighted average common shares:			
Basic	7,143,000	7,087,000	6,604,000
Diluted	7,499,000	7,499,000	7,319,000

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

Consolidated Statements of Changes in Stockholders' Equity  
(\$ in thousands, except share data)

For the years ended February 22, 2002, February 23, 2001, and February 25, 2000

Common stock		Capital contributed in excess of par value of common stock	Accumulated other comprehensive income (loss)	Retained earnings	Total stockholders' equity
Shares	Amount				
-----	-----	-----	-----	-----	-----

Balance, February 26, 1999	3,083,206	\$308	\$3,240	\$21	\$7,461	\$11,030
Net income for the year	-	-	-	-	2,837	2,837
Foreign currency translation adjustment	-	-	-	(83)	-	(83)
Total comprehensive income	-	-	-	(83)	2,837	2,754
Stock Split effective May 28, 1999	3,083,206	-	-	-	-	-
Accretion of preferred stock	-	-	-	-	(128)	(128)
Dividends on preferred stock	-	-	-	-	(38)	(38)
Shares issued in connection with conversion of preferred stock	666,666	33	2,467	-	-	2,500
Shares issued in connection with employee stock purchase and stock option plans	31,202	2	125	-	-	127
Balance, February 25, 2000	6,864,280	343	5,832	(62)	10,132	16,245
Net income for the year	-	-	-	-	2,021	2,021
Foreign currency translation adjustment	-	-	-	(164)	-	(164)
Total comprehensive income	-	-	-	(164)	2,021	1,857
Shares issued in connection with conversion of warrants	212,866	10	508	-	-	518
Shares issued in connection with employee stock purchase and stock option plans	33,400	2	174	-	-	176
Balance, February 23, 2001	7,110,546	355	6,514	(226)	12,153	18,796
Net income for the year	-	-	-	-	1,741	1,741
Foreign currency translation adjustment	-	-	-	54	-	54
Total comprehensive income	-	-	-	(172)	1,741	1,795
Shares issued in connection with employee stock purchase and stock option plans	32,400	2	189	-	-	191
Balance, February 22, 2002	7,142,946	\$357	\$6,703	\$(172)	\$13,894	\$20,782

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

### Consolidated Statements of Cash Flows (\$ in thousands)

	Year Ended February 22, 2002	Year Ended February 23, 2001	Year Ended February 25, 2000
	----	----	----
Cash flows from operating activities:			
Net income	\$1,741	\$2,021	\$2,837
Adjustments to reconcile net income to net cash used in operating activities			
Depreciation and amortization	1,475	1,278	1,395
Increase (decrease) in allowance for accounts receivable and inventory	111	(87)	77
Minority interest in net (loss) income	(13)	(170)	(6)
Deferred income taxes (benefit)	(39)	96	397
Changes in operating assets and liabilities:			
(Increase) decrease in assets			
Accounts receivable	(3,083)	(6,007)	(1,097)
Costs and estimated earnings in excess of billings on uncompleted long-term contracts	204	(717)	1,538
Inventories	(2,645)	(630)	(888)
Prepaid expenses and other current assets	(530)	5	145
Other assets	(136)	34	(125)
Increase (decrease) in liabilities:			
Accounts payable	1,509	99	276
Billings in excess of costs and estimated earnings on uncompleted long-term contracts	(1,213)	(1,570)	(3,493)
Customer deposits	2,241	(1,492)	(2,761)
Accrued income taxes	(23)	291	(465)
Other accrued liabilities	(319)	264	(93)
Payments under settlement agreements	-	(85)	(120)
Net cash used in operating activities	(720)	(6,670)	(2,383)
Cash flows from investing activities:			
Acquisition of equipment	(649)	(2,628)	(1,014)
Software development costs	(989)	(550)	(555)
Purchase of subsidiary, net of cash acquired	-	195	-
Net cash used in investing activities	(1,638)	(2,983)	(1,569)
Cash flows from financing activities:			
Borrowings under credit facility	10,899	8,071	4,093
Payments under credit facility	(6,708)	(4,600)	-
Proceeds from (payments on) long-term bonds	(275)	5,470	-
Net payments on subordinated debt	-	-	(3,774)
Payment of dividends on preferred stock	-	-	(38)
Deferred financing costs	-	(175)	-
Decrease (increase) in restricted cash	(25)	(512)	15
Net decrease in other long-term obligations	(368)	(5)	(40)

Proceeds from issuance of common stock/warrants	191	694	160
Net cash provided by financing activities	3,714	8,943	416
	-----	-----	-----
Effect of exchange rates on cash	54	(164)	(83)
	-----	-----	-----
Net (decrease) increase in cash and cash equivalents	1,410	(874)	(3,619)
Cash and cash equivalents at beginning of year	851	1,725	5,344
	-----	-----	-----
Cash and cash equivalents at end of year	\$2,261	\$ 851	\$1,725
	=====	=====	=====
Supplemental schedule of cash flow information:			
Interest paid	\$766	\$806	\$421
Income taxes paid	\$582	\$649	\$1,533
Supplemental information on non-cash operating and investing activities:			

During the year ended February 23, 2001, the Company purchased for \$100 a 99% ownership in ETC Europe, resulting in goodwill of \$26.

During the year ended February 25, 2000, the Company reclassified \$216 from inventory to property, plant and equipment.

During the year ended February 25, 2000, 25,000 shares of the Company's Series A Preferred Stock were converted into 666,666 shares of common stock, which was subsequently issued to Sirrom Capital Corporation. (Reference Footnote 7, Long-term Obligation and Credit Arrangement).

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

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

1. Summary of Significant Accounting Policies:

Nature of Business:

Environmental Tectonics Corporation ("ETC" or the "Company") is primarily engaged in the development, marketing and manufacturing of Aircrew Training Systems (ATS) and industrial simulation equipment. The Company utilizes its internally developed software systems in virtually all of its products. ETC focuses on software enhancements, product extensions, new product development and new marketplace applications. Sales of ATS products are made principally to U.S. and foreign government agencies and to the entertainment market. Sales of industrial simulation equipment, which includes sterilizers, environmental systems, and hypo/hyperbaric equipment, are made to both commercial customers and governmental agencies worldwide.

Stock Split: On February 25, 1999, the Company's Board of Directors declared a 2-for-1 stock split for stockholders of record on May 17, 1999. All earnings per share and share amounts in the financial statements for all years presented have been restated to reflect the 2-for-1 split.

Principles of Consolidation:

The consolidated financial statements include the accounts of Environmental Tectonics Corporation, its wholly owned subsidiary, ETC International Corporation, its 95% owned subsidiary, ETC-PZL Aerospace Industries SP. Z 0.0, and its 99% owned subsidiary, ETC Europe. All material inter-company accounts and transactions have been eliminated. The Company's fiscal year is the 52- or 53-week annual accounting period ending the last Friday in February.

Use of Estimates:

In preparing financial statements in conformity with accounting principles generally accepted in the United States, management is required to make estimates and assumptions that affect the reported amounts of assets and



liabilities, the disclosure of contingent assets and liabilities at the date of the financial statements, and revenues and expenses during the reporting period. Actual results could differ from those estimates. Significant estimates are made for revenue recognition under the percentage of completion method (see Note 1, Revenue Recognition), claims receivable, inventory, and computer software costs.

At February 22, 2002, the Company had recorded receivables in the amount of \$11.9 million for claims made or to be made against the United States government and an international customer for contract costs incurred through February 22, 2002. The total net claims amount filed with the U.S. government and an international customer at February 22, 2002, approximated \$26.0 million based on costs incurred through February 22, 2002, and additional claims are in preparation for filing in fiscal 2003 against an international customer. On May 9, 2002, the Company reached a final settlement agreement totaling approximately \$6.9 million with the U.S. government for all outstanding amounts of approximately \$11.8 million. The international claims are subject to negotiation, arbitration and audit by the international customer.

#### Revenue Recognition:

Revenue is recognized on long-term contracts utilizing the percentage of completion method based on costs incurred as a percentage of estimated total costs. 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 facts requiring the revisions become known. 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 for contracts under \$100, or to be completed in less than one year, and where there are no post-shipment services included in the contract, and revenue on parts and services, are recognized as shipped. Under these contracts, title passes at shipment. Revenue on those types of contracts where post-shipment services (such as installation and acceptance) are required is recognized after 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 any applicable provisions of SAB 101 for the fiscal year ending February 23, 2001, with no impact on the Company's results of operations.

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

#### 1. Summary of Significant Accounting Policies (Continued):

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 should 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 includes

amounts for shipping and handling, therefore, it 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. Accordingly, 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 the year the Company had cash and cash equivalents in excess of insured amounts. However, most 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:

The Company amortizes costs in excess of fair values of net assets of the businesses acquired using the straight - line method over a period not to exceed 20 years. The Company periodically reviews the value of its goodwill to determine if an impairment has occurred. Effective February 22, 2002, the Company will no longer amortize goodwill pursuant to SFAS No. 142 Business Combinations and Goodwill and Intangible Assets (see below).

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 \$17, \$35, and \$36 in fiscal years 2002, 2001 and 2000, respectively, and accumulated amortization was \$113 and \$96 as of February 22, 2002 and February 23, 2001, respectively.

#### Amortization of 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 over a period ranging from 36 to 60 months (dependent upon the life of the product) on a straight-line basis 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 \$989 and \$550, respectively, for the years ended February 22, 2002 and February 23, 2001. Related software amortization totaled \$496, \$455 and \$596, respectively, for fiscal 2002, 2001, and 2000.

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

1. Summary of Significant Accounting Policies (Continued):

Research and Development:

Research and development expenses are charged to operations as incurred. During fiscal 2002, 2001 and 2000 the Company incurred research and development costs of approximately \$600, \$903, and \$920, respectively.

Amortization of Deferred Financing Costs:

During fiscal 2002 all remaining capitalized costs relating to the March 1997 financing of the Company were charged to income. Capitalized costs relating to the Company's bond issuance on March 15, 2000 are being amortized over the relevant term. Amortization expense relating to deferred financing costs was \$293, \$146 and \$331 in 2002, 2001, and 2000, respectively (see note 7).

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 tax laws.

Long-Lived Assets:

The Company follows 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 provides 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. Basically, this involves reviewing goodwill and other intangibles to assess recoverability from future operations using undiscounted future cash flows. Any impairments are recognized in operating results to the extent that carrying value exceeds fair value, which is determined based on the net present value of estimated future cash flows. The adoption of SFAS No. 121 had no material effect on the Company's consolidated financial position or results of operations. Effective February 22, 2002, the Company adopted SFAS No. 144 Impairment or Disposal of Long-Lived Assets (see below) which proscribes additional impairment testing for long-lived assets.

Stock Options:

The Company accounts for stock options in accordance with SFAS No. 123, "Accounting for Stock-Based Compensation," 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, the standard permits entities to continue accounting for employee stock options and similar instruments under Accounting Principles Board (APB) Opinion No. 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 (see note 12). The Company's Incentive Stock Option Plan is accounted for under APB Opinion No. 25. Under the provisions of that accounting pronouncement, noncompensatory stock options (that is, options where the price to be paid for the shares is equal to the market price of the stock on the date of grant) require no such accounting entries upon issuance.

When exercised, cash and additional equity are recognized. All of the Company's stock options plans are noncompensatory.

Advertising Costs:

The Company expenses advertising costs (which include trade shows) as incurred. Advertising expense was \$438, \$345 and \$270 in 2002, 2001, and 2000, 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," which is effective for financial statements issued after December 15, 1997. The new standard eliminates primary and fully diluted earnings per share and requires presentation of basic and diluted earnings per share together with disclosure of how the per share amounts were computed. 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 reconciliation of the numerators and denominators of the basic and diluted earnings per share computations. All earnings per share and share amounts have been restated to reflect a 2 for 1 stock split effective May 28, 1999.

	Year ended February 22, 2002		
	Income (\$000)	Weighted average shares	Per share amount
	----- (numerator)	----- (denominator)	-----
Net income	\$1,741		
Basic earnings per share			
Income available to common stockholders	\$1,741 =====	7,142,946 =====	\$.24 =====
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	\$1,741 =====	7,498,586 =====	\$.23 =====

	Year ended February 23, 2001		
	Income (\$000)	Weighted average shares	Per share amount
	----- (numerator)	----- (denominator)	-----
Net income	\$2,021		
Basic earnings per share			
Income available to common stockholders	\$2,021 =====	7,087,163	\$.29 =====

Effective of dilutive securities			
Stock options		97,653	
Stock warrants		313,901	
		-----	
Diluted earnings per share			
Income available to common stockholders plus			
effect of dilutive securities	\$2,021	7,498,717	\$ .27
	=====	=====	=====

	Year ended February 25, 2000		
	Income (\$000)	Weighted average shares	Per share amount
	-----	-----	-----
	(numerator)	(denominator)	
Net income	\$2,837		
Less preferred stock dividends	(38)		
Less accretion of preferred stock	(128)		
	-----		
Basic earnings per share			
Income available to common stockholders	\$2,671	6,604,184	\$ .40
	-----	-----	-----
Effective of dilutive securities			
Stock options		224,151	
Stock warrants		490,358	
		-----	
Diluted earnings per share			
Income available to common stockholders plus			
effect of dilutive securities	\$2,671	7,318,693	\$ .36
	-----	-----	-----

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

1. Summary of Significant Accounting Policies (Continued):

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

Recent Accounting Pronouncements:

Reporting Comprehensive Income:

In June 1997, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards (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. Other comprehensive income consists of foreign currency translation adjustments. The adoption of SFAS No. 130 did not have a material impact on the Company's consolidated financial position or results of operations.

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 information about operating segments in complete sets of financial statements of the enterprise and in condensed 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. The adoption of SFAS No. 131 had no impact on the Company's consolidated financial position or results of operations.

Derivative Financial Instruments:

In January 2001, the FASB issued SFAS No. 133, "Accounting for Derivative Instruments and Hedging Activities". SFAS No. 133 requires the recognition of all derivative financial instruments as either assets or liabilities in the Consolidated Balance Sheet, and the periodic adjustment of those instruments to fair value. The classification of gains and losses resulting from changes in the fair value of derivatives is dependent on the intended use of the derivative and its resulting designation. Adjustments to reflect changes in fair values of derivatives that are not considered highly effective hedges are reflected in earnings. Adjustments to reflect changes in fair values of derivatives that are considered highly effective hedges are either reflected in earnings and largely offset by corresponding adjustments related to the fair values of the hedged items, or reflected in other comprehensive income until the hedged transaction matures and the entire transaction is recognized in earnings. The change in fair value of the ineffective portion of a hedge is immediately recognized in earnings. SFAS No. 133 is effective for all periods beginning after June 15, 1999. This effective date was later deferred to all periods beginning after June 15, 2000 by SFAS No. 137, "Accounting for Derivative Instruments and Hedging activities-Deferral of the Effective Date of FASB Statement Number 133." The adoption of SFAS No. 133 had no impact on the Company's consolidated financial position or results of operations.

Business Combinations and Goodwill and Intangible Assets:

On July 20, 2001, the FASB issued SFAS No. 141, Business Combinations, and SFAS No. 142, Goodwill and Intangible Assets. SFAS 141 is effective for all business combinations completed after June 30, 2001. SFAS 142 is effective for fiscal years beginning after December 15, 2001; however, certain provisions of this Statement apply to goodwill and other intangible assets acquired between July 1, 2001, and the effective date of SFAS 142. Major provisions of these Statements and their effective dates are as follows:

- \* all business combinations initiated after June 30, 2001 must use the purchase method of accounting. The pooling of interest.
- o method of accounting is prohibited except for transactions initiated before July 1, 2001.
- o intangible assets acquired in a business combination must be recorded separately from goodwill if they arise from contractual or other legal rights or are separable from the acquired entity and can be sold, transferred, licensed, rented or exchanged, either individually or as part of a related contract, asset or liability.

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

1. Summary of Significant Accounting Policies (Continued):

- o goodwill, as well as intangible assets with indefinite lives, acquired after June 30, 2001, will not be amortized. Effective February 23, 2002, all previously recognized goodwill and intangible assets with indefinite lives will no longer be subject to amortization.
- o effective February 23, 2002, goodwill and intangible assets with

indefinite lives will be tested for impairment annually and whenever there is an impairment indicator.

- o all acquired goodwill must be assigned to reporting units for purposes of impairment testing and segment reporting.

Although it is still reviewing the provisions of these Statements, management's preliminary assessment is that these Statements will not have a material impact on the Company's financial position or results of operations.

#### Asset Retirement Obligations:

In August 2001, The FASB issued SFAS No. 143, Accounting for Asset Retirement Obligations. SFAS No. 143 applies to all entities, including rate-regulated entities, that have legal obligations associated with the retirement of a tangible long-lived asset that result from acquisition, construction or development and (or) normal operations of the long-lived asset. The application of this statement is not limited to certain specialized industries, such as the extractive or nuclear industries. This Statement also applies, for example, to a company that operates a manufacturing facility and has a legal obligation to dismantle the manufacturing plant and restore the underlying land when it ceases operation of that plant. A liability for an asset retirement obligation should be recognized if the obligation meets the definition of a liability and can be reasonably estimated. The initial recording should be at fair value. SFAS No. 143 is effective for financial statements issued for fiscal years beginning after June 15, 2002, with earlier application encouraged. The provisions of this statement are not expected to have a material impact on the financial condition or results of operations of the Company.

#### Impairment or Disposal of Long-Lived Assets:

In August 2001, the FASB issued SFAS No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets. SFAS No. 144 retains the existing requirements to recognize and measure the impairment of long-lived assets to be held and used or to be disposed of by sale. However, SFAS No. 144 makes changes to the scope and certain measurement requirements of existing accounting guidance. SFAS No. 144 also changes the requirements related to reporting the effects of a disposal or discontinuation of a segment of a business. SFAS No. 144 is effective for financial statements issued for fiscal years beginning after December 15, 2001 and interim periods within those fiscal years. The adoption of this statement is not expected to have a significant impact on the financial condition or results of operations of the Company.

## 2. Acquisitions

ETC-PZL Aerospace Industries SP. Z O.O.  
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On April 21, 1998, the Company acquired a 65% ownership in MP-PZL Aerospace Industries, Ltd. ("MP-PZL"), a simulation and advanced training device manufacturing company located in Warsaw, Poland, for \$375 in cash, an 8% interest-only three-year note payable for \$350 and 55,000 shares of the Company's common stock valued at \$495. MP-PZL was subsequently renamed ETC-PZL Aerospace Industries SP. Z O.O. ("ETC-PZL"). The Company's cost for this acquisition was \$1,220 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 recorded goodwill of \$662.

On September 9, 2000, the Company purchased an additional 30% ownership interest in ETC-PZL for \$300 cash, bringing the Company's total ownership to 95%. This transaction resulted in a reduction in goodwill of \$101.

Pro-Pilot Assets  
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During the fiscal quarter ended November 24, 2000, the Company purchased the assets of the "Pro-Pilot" flight simulation game for \$400. This purchase was classified as an asset purchase (and not a business combination)

and thus no goodwill resulted from the transaction.

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

3. Accounts Receivable:

The components of accounts receivable at February 22, 2002 and February 23, 2001, are as follows:

	2002	2001
	----	----
U.S. government receivables billed and unbilled contract costs subject to negotiation	\$6,281	\$5,707
U.S. commercial receivables billed	2,918	2,484
International receivables billed and unbilled contract costs subject to negotiation	11,030	8,955
	-----	-----
	20,229	17,146
Less allowance for doubtful accounts	(373)	(370)
	-----	-----
	\$19,856	\$16,776
	=====	=====

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

Unbilled contract costs subject to negotiation represent claims made against the U.S. government under a contract for a centrifuge. These costs, totaling \$3,898, were recorded beginning in fiscal year 1994, including \$1,148 recorded during the three months ended May 26, 2000. Additionally, there is an open receivable of \$1,649 representing the balance due under the contract. On May 9, 2002, the Company reached a final settlement agreement totaling approximately \$6.9 million with the U.S. Navy for all outstanding amounts. The gain, if any, resulting from the settlement would be recognized in fiscal 2003.

International receivables billed:

International receivables billed included \$700 and \$930 respectively at February 22, 2002 and February 23, 2001 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 the termination, the RTAF made a call on a \$230 performance bond, as well as a draw on an approximately \$1.1 million 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 with no discrepancy reports. Although the contract was not completed in the time allotted, the Company has requested an extension on the completion time due to various extenuating circumstances, including allowable "force majeure" events, one of which was a delay in obtaining an export license to ship parts required to complete the trainers. On August 30, 2001, the Company received a payment of \$230,000 representing the amount due on the performance bond. The balance due on the contract is still under review by the customer, but it is probable that the Company will initiate legal proceedings to collect the balance. At this point, 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 due.

Unbilled contract costs subject to negotiation represent claims made or to be made against an international customer for two contracts covering 1996 to the present. Claims receivables and resulting revenue aggregating \$5,735 have been recorded. 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 2003. In conformity with accounting principles generally accepted in the United States of America, revenue recorded by the Company from a claim does not exceed the incurred contract costs related to the claim. The Company has submitted a claim to the customer for one of the contracts and has also submitted to the customer requests for equitable contract price adjustments on the other contract. The company is currently updating and finalizing additional claims. As a related item, during the third quarter of fiscal 2000, the aforementioned international customer, citing failure to deliver product within contract terms, assessed liquidated damages totaling approximately \$1.6 million on two contracts currently in progress. The Company disputes the basis for these liquidated damages and plans to contest them vigorously. However, following generally accepted accounting principles, the Company has reduced contract values and corresponding revenues by approximately \$1.6 million.

On July 20, 2001, the Company was notified by the international customer that they were terminating the centrifuge contract, which was approximately 90% complete. The termination included a request for the refund of advance milestone payments made to date. At this point, the Company is not able to assess the ultimate impact of the termination on current operations and financial results.

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

3. Accounts Receivable (Continued):

The Company is currently in arbitration on this matter. As of February 22, 2002, the company had recorded on its books the following amounts for the contract inception to date: revenue (including claims revenue) of \$19,730, cost of goods sold of \$13,202, costs and estimated earnings in excess of billings on uncompleted long term contracts of \$16,604, claims receivables of \$3,125, and billings in excess of costs and estimated earnings on uncompleted long term contracts of \$10,099.

Claim bookings in fiscal 2002 decreased operating income by \$661. Claims bookings in fiscal 2001 increased operating income by \$1,325. Both amounts are net of associated manufacturing costs and legal expenses.

Unbilled costs

Amounts not billed nor yet billable totaled \$28.5 million at February 22, 2002. 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, upon shipment, etc. Service contracts are billed monthly or quarterly. Parts and service are billed as shipped or completed.

4. Costs and Estimated Earnings on Uncompleted Contracts:

The following is a summary of long-term contracts in progress at February 22, 2002 and February 23, 2001:

	2002 -----	2001 -----
Costs incurred on uncompleted long-term contracts	\$29,004	\$30,251
Estimated earnings	12,677	10,209
	-----	-----
	41,681	40,460
Less billings to date	(32,789)	(32,577)
	-----	-----
	\$8,892	\$7,883
	=====	=====

	2002 -----	2001 -----
Included in accompanying balance sheets under the following captions:		
Costs and estimated earnings in excess of billings on uncompleted long-term contracts	\$9,391	\$9,595
Billings in excess of costs and estimated earnings on uncompleted long-term contracts	(499)	(1,712)
	-----	-----
	\$8,892	\$7,883
	=====	=====

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 2002 and 2001 and \$306 in 2000, respectively.

5. Inventories:

Inventories consist of the following:

	Raw Material -----	Work in Process -----	Finished Goods -----	Total -----
February 22, 2002	\$110	44,470	2,581	\$7,161
February 23, 2002	359	2,105	2,160	\$4,624

Inventory is presented net of an allowance for obsolescence of \$ 738 and \$ 630 in 2002 and 2001, respectively.

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

6. Property, Plant and Equipment:

The following is a summary of property, plant and equipment, at cost, and estimated useful lives at February 22, 2002 and February 23, 2001:

	2002 -----	2001 -----	Estimated useful lives -----
Land	\$100	\$100	
Building and building additions	3,763	3,260	40 years
Machinery and equipment	8,173	8,039	3-5 years
Office furniture and equipment	1,192	1,180	10 years
Building improvements	1,393	1,393	5-10 years
	-----	-----	-----
	14,621	13,972	
Less accumulated depreciation	(9,303)	(8,635)	
	-----	-----	
Property, plant and equipment, net	\$5,318	\$5,337	
	=====	=====	

Depreciation expense for the years ended February 22, 2002, February 23, 2001, and February 25, 2000, was \$ 668, \$ 602 and \$ 535, respectively.

7. Long-Term Obligation and Credit Arrangements:

Long-term obligations at February 22, 2002 and February 23, 2001 consist of the following:

	2002 -----	2001 -----
Credit facility payable to banks	\$ 11,755	\$7,564
Long Term Bonds	5,195	5,470
Subordinated debt, net	-	350
Term loans payable, accruing interest at between 9% and 9.9% collateralized by priority liens on certain equipment	19	37
	16,969	13,421
Less current portion	(281)	(643)
	-----	-----
	\$ 16,688	\$12,778
	=====	=====

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

2003	\$281
2004	12,036
2005	281
2006	281
2007 and thereafter	4,090
	-----
Total future obligations	\$16,969

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 days outstanding method as of February 22, 2002 and February 23, 2001 are as follows:

	2002 -----	2001 -----
Approximate average loan balance	10,631	3,764
Maximum aggregate	11,926	7,564
Weighted average interest rate	6.35%	8.74%

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

7. Long-Term Obligation and Credit Arrangements (Continued):

Interest is charged on direct borrowings at the bank's prime rate less a factor ranging from 0% to 0.5% based on the Company's Leverage Ratio, as defined, or adjusted LIBOR in 2002 and 2001. The interest rates ranged from 4.50% to 8.25% during fiscal 2002 and from 7.85% to 8.83% during fiscal 2001.

The Company's letter of credit limit is \$5.0 million, provided that the cumulative of all outstanding trade letters of credit does not exceed \$2.5 million. The balance outstanding under these provisions at February 22, 2002, was \$3,034. Fees on letters of credit outstanding were 1.25% at February 22, 2002 and 0.75% at February 23, 2001.

On February 25, 2000, the Company signed an amendment to its revolving Credit Agreement originally entered into on March 27, 1997, which increased its credit facility to \$15 million and extended its expiration date to August 31,

2002. These funds are available to support working capital needs and letters of credit. Terms and conditions of the amendment remained essentially the same as the original agreement. The Credit Agreement is collateralized by substantially all of the Company's assets. The Company is prohibited from declaring any cash dividends under the terms of the Credit Agreement. This facility bears interest at the bank's prime lending rate less a factor ranging from 0% to 0.5% based on the Company's Leverage Ratio, as defined, or adjusted LIBOR. A commitment fee of 0.2% is charged for unused available funds. The credit facility includes certain covenants related to, among other things, prohibitions on incurring additional debt, change in ownership of certain officers, payment of dividends and maintenance, on a quarterly basis, of certain financial ratios. Substantially all of the Company's short-term financing is provided by this bank.

At February 23, 2001, the Company was in violation of one of its Credit Agreement loan covenants, specifically the requirement to maintain a specified Funds Flow Ratio. This violation resulted from the unusually high capital spending for the Company's modernization program in relation to net income in the fiscal period. Accordingly, the Company received a waiver for this violation at February 23, 2001, from its Bank and also the bank agreed to adjust this covenant for the period through November 23, 2001.

On March 29, 2002, the Company signed an amendment to its revolving credit agreement which extended the expiration date of the Credit Agreement to November 30, 2002 and increased the interest rate from (i) the bank's prime rate less a factor ranging from 0% to 0.5% based on the Company's leverage ratio or adjusted LIBOR, to (ii) the bank's prime rate plus 1% for adjusted base rate loans or adjusted LIBOR plus 3.5% for adjusted LIBOR rate loans. The amendment also adjusted the Funds Flow Ratio through the expiration date of the Credit Agreement. On June 5, 2002, the Company's bank agreed to extend the expiration date of the Credit Agreement to February 28, 2003. Substantially all of the company's short-term financing is provided by this bank. As of June 5, 2002, the Company had \$1,485,000 available under the credit agreement.

On March 27, 1997, the Company issued \$4 million of subordinated debentures, bearing interest at 12% per annum, due March 27, 2004, to a financial institution. On January 11, 2000, the Company utilized \$4.1 million of its revolving credit facility to repay these subordinated debentures. See also commentary concerning long term bonds. In connection with the subordinated debentures, warrants were issued to acquire 332,820 shares of the Company's common stock at an exercise price of \$.50 per share; \$499 of the proceeds from the sale of the debentures was allocated to the warrants and credited to capital contributed in excess of par value of common stock. This amount had been fully amortized to interest expense as of February 22, 2002.

On March 27, 1997, the Company also issued 25,000 shares of 11% redeemable convertible preferred stock for \$2.5 million. Each share of preferred stock was convertible, at the option of the shareholder, into 26.66 shares of the Company's common stock at a price of \$3.75 per share. On February 26, 1999, the Company issued a redemption notice to redeem the outstanding 25,000 shares of Series A Preferred Stock in their entirety. On March 25, 1999, the Company received notice that Sirrom Capital Corporation had exercised its conversion privilege under the terms of the agreement to convert its 25,000 shares of Series A Preferred Stock into the Company's common shares. Consequently, on April 19, 1999, the Series A Preferred was retired and 666,666 shares of common stock were issued to Sirrom Capital Corporation. Concurrent with this transaction the Company charged retained earnings for \$128 representing the difference between book and face value of the Preferred Stock and then reclassified \$2,500 of Preferred Stock value to common stock at par and additional paid in capital.

Total financing fees associated with the March 27, 1997 financing were approximately \$876, all of which had been charged to interest expense or accreted to retained earnings by February 22, 2002. The proceeds from these transactions were used to repay, in full, amounts outstanding with a prior lender.

Subordinated debt at February 25, 2001, consisted of debt issued for the acquisition of ETC-PZL (see note 2).

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

7. Long-Term Obligation and Credit Arrangements (Continued):

As a condition to the extension of the prior credit facility through March 31, 1997, warrants were issued to an affiliate of a Bank to purchase 200,000 shares of the Company's common stock at a price equal to \$2.59. On March 6, 2000, these warrants were exercised and the Company received \$518 representing the full purchase price. Subsequently, on March 20, 2000, the Company issued 212,866 shares (representing the original warrant value as adjusted) of its common shares.

On March 15, 2000, the Company issued approximately \$5.5 million of unregistered Taxable Variable Rate Demand/Fixed Rate Revenue Bonds (Series of 2000). Net proceeds from these bonds were used to repay a \$4.1 million 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 \$5.6 million 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 1.94% on May 16, 2002) 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 the aforementioned financial instruments approximates their fair values at February 22, 2002

8. 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 22, 2002 are \$194 in 2003; \$141 in 2004; \$127 in 2005; \$84 in 2006; and \$44 in 2007 and thereafter.

Total rental expense for all operating leases for the years ended February 22, 2002, February 23, 2001, and February 25, 2000, was \$197, \$117, and \$39, respectively.

9. Income Taxes:

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

	52 Weeks Ended February 22, 2002 ----	52 Weeks Ended February 23, 2001 ----	52 Weeks Ended February 25, 2000 ----
Currently payable:			
Federal	\$42	\$906	\$889
State	134	109	179
Foreign taxes	(230)	15	108
	(54)	1,030	1,176
	----	-----	-----
Deferred:			
Federal	(36)	88	360
State	(3)	8	37
	(39)	96	397
	-----	-----	-----
	\$ (93)	\$1,126	\$1,573
	=====	=====	=====

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

	52 Weeks Ended February 22, 2002 -----	52 Weeks Ended February 23, 2001 ----	52 Weeks Ended February 25, 2000 ----
Statutory income tax	34.0%	34.0%	34.0%
State income tax, net of federal tax benefit	5.4	2.2	2.9
Benefit of foreign sales corporation And extraterritorial income	(3.4)	(5.5)	(5.2)
Research and experimentation tax credit refunds attributable to open tax years	(37.8)	-	-
Research and experimentation and Other tax credits	(9.2)	-	-
Benefit of foreign and foreign-source			

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

9. Income Taxes (Continued):

Income or loss	(1.0)	-	-
Other, net	6.4	4.6	3.4
	(5.6)%	35.3%	35.1%
	=====	=====	=====

The domestic Company has filed for federal income tax refunds approximating \$619 as a result of amended income tax returns to utilize the research and experimentation tax credit for all open years. The Company will continue to use research and experimentation tax credits, if applicable, to reduce its federal income tax.

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

	2002 ----	2001 ----	2000 ----
Deferred tax assets:			
Net products liability settlement	75	74	115
Vacation reserve	58	58	59
Inventory reserve	275	233	270
Receivable reserve	139	138	138
Warranty reserve	46	46	46
Other, net	122	66	61
	---	--	--
Total current deferred tax asset	\$715	\$615	\$689
	----	----	----
Deferred tax liabilities:			
Amortization of capitalized software	\$488	\$429	\$395
Depreciation	247	245	257
	---	---	---
Total noncurrent deferred tax liability	\$735	\$674	\$652
	=====	=====	=====

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

10. 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 Industrial Simulation. 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 -----
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
Identifiable assets	32,683	5,408	38,091
Expenditures for segment assets	557	92	649
2001 ----			
Net sales	\$23,567	\$8,885	\$32,452
Interest expense	558	94	652
Depreciation and amortization	796	482	1,278
Operating income	5,794	(906)	4,888
Income tax provision	1,833	(350)	1,483
Identifiable assets	27,534	4,652	32,186
Expenditures for segment assets	2,306	322	2,628
2000 ----			
Net sales	\$26,361	\$8,559	\$34,920
Interest expense	465	125	590
Depreciation and amortization	1,024	371	1,395
Operating income (loss)	5,039	1,355	6,394
Income tax provision (benefit)	1,601	431	2,032
Identifiable assets	20,344	5,538	25,882
Expenditures for segment assets	650	167	817
	2002 ----	2001 ----	2000 ----
Reconciliation to consolidated amounts:			
Corporate assets	10,391	13,171	11,553
Total assets	\$48,482	\$40,705	\$31,897
Segment operating income	\$3,978	\$4,888	\$6,394
Less interest expense	(1,094)	(652)	(590)
Less income taxes	(282)	(1,483)	(2,032)
Total profit for segments	2,602	2,641	3,772
Corporate home office expense	(1,105)	(766)	(936)
Interest and other expenses	(144)	(272)	(388)
Income tax benefit	375	357	459
Minority interest	13	(51)	(70)
Net income	\$1,741	\$2,021	\$2,837
	=====	=====	=====

Segment operating income (loss) consists of net sales less applicable costs and expenses relating to these revenues. Unallocated 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.

10. Business Segment Information (Continued):

Approximately 58.9% of sales totaling \$19,143 in 2002 were made to one international and one domestic customer in the ATS segment. Approximately 43% of sales totaling \$13,924 in 2001 were made to one international and one domestic customer in the ATS segment. Approximately 63% of sales totaling \$16,609 in 2000 were made to two international and one domestic customer in the ATS segment.

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 aggregate \$1,194 for the year ended February 22, 2002.

Included in the segment information for the year ended February 23, 2001 are export sales of \$16,404. Of these amounts, there are sales to or relating to governments or commercial accounts in Great Britain of \$5,660. Sales to the U.S. government and its agencies aggregate \$2,064 for the year ended February 23, 2001.

Included in the segment information for the year ended February 25, 2000 are export sales of \$23,907. Of these amounts, there are sales to or relating to governments or commercial accounts in Great Britain (\$4,821), Poland (\$4,201), and Nigeria (\$8,107) for ATS sales. Sales to the U.S. government and its agencies aggregated \$1,587 for the year ended February 25, 2000.

11. Stock Options:

In August 1999 the Company adopted an Incentive Stock Option Plan to replace the 1988 Incentive Stock Option Plan which expired in August 1999. The plan authorizes a committee of the Board of Directors to grant options for the purchase of up to 1,000,000 shares of common stock to qualifying officers and other key employees. The Plan provides that the option price shall not be less than 100% (or in the case of a ten-percent owner, 110%) of the current market price of the stock on the date of the grant. Options may be exercised on a cumulative basis at the rate of 25% per year commencing one year after the date of grant and have a maximum term of 10 years. The Plan will terminate on August 1, 2008. At February 22, 2002, there were 622,436 shares available to be granted under the Plan.

Since the exercise price of each option is not less than 100% of the current market price of the Company's stock on the date of grant, no compensation cost has been recognized for the Plan. Had compensation cost for the Plan been determined based on the fair value of the options at the grant dates consistent with the method of SFAS No. 123, the Company's net income and earnings per share would have been reduced to the pro forma amounts indicated below. Reported amounts reflect the 2 for 1 stock split declared by the Company on February 25, 1999 (see note 1).

	2002 ----	2001 ----	2000 ----
Net income:			
As reported	\$1,741	\$2,021	\$2,837
Pro forma	\$1,282	\$1,549	\$2,350
Basic earnings per share:			
As reported	\$.24	\$.29	\$.40
Pro forma	\$.18	\$.22	\$.33
Diluted earnings per share:			
As reported	\$.23	\$.27	\$.36
Pro forma	\$.17	\$.21	\$.30

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 2002: dividend yield of 0%; expected volatility of 60.3%; risk-free interest rate of 5.15%; and expected life of five years.



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

11. Stock Options (Continued):

A summary of the status of the current Incentive Stock Option Plan and the 1988 Incentive Stock Option Plan as of February 22, 2002, February 23, 2001, and February 25, 2000, and changes during the years ending on those dates is presented below.

	2002 ----		2001 ----	
	Shares -----	Weighted average exercise price -----	Shares -----	Weighted average exercise price -----
Outstanding at beginning of year	464,350	\$6.95	497,750	\$6.80
Granted	27,564	7.38	-	-
Exercised	(32,400)	5.89	(33,400)	4.79
Forfeited	(11,000)	7.43	-	-
Outstanding at end of year	448,514	7.04	464,350	6.95
Options exercisable at year end	240,325		147,936	
Weighted average fair value of options granted during the year		\$7.01		\$-

  

	2000 ----	
	Shares -----	Weighted Average exercise price -----
Outstanding at beginning of year	543,700	\$6.57
Granted	-	-
Exercised	(28,950)	3.59
Forfeited	(17,000)	4.86
Outstanding at end of year	497,750	6.80
Options exercisable at year end	41,657	
Weighted average fair value of options granted during the year		\$-

The following information applies to options outstanding at February 22, 2002:

Weighted average exercise price	Options outstanding -----		Weighted average exercise price	Options exercisable -----	
	Number Outstanding at February 22, 2002	Weighted average remaining contractual life (years)		Number exercisable at February 22, 2002	price
Range of exercise prices -----					
\$2.25 to \$3.38	12,200	4.5 years	\$2.25	12,200	\$2.25
\$5.00 to \$7.50	122,564	7.5 years	\$5.53	71,250	\$5.00
\$7.81 to \$9.76	313,750	6 years	\$7.81	156,875	\$7.81

12. Claims and Litigation

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.

13. 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 \$114, \$124, and \$121 in 2002, 2001, and 2000, respectively.

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

13. Employee Benefit Plan (Continued):

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.

14. Quarterly Consolidated Financial Information (Unaudited):

Financial data for the interim periods of 2002, 2001 and 2000 were as follows:

Fiscal Year 2002	Quarter Ended			
	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	158	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

Fiscal Year 2001	Quarter Ended			
	May 26	August 25	November 24	February 23
	--	--	--	--
Net sales	\$7,157	\$6,994	\$8,622	\$9,679
Gross profit	3,355	2,678	2,809	4,233
Operating income	1,522	482	617	1,501
Income before income taxes	1,351	246	335	1,266
Minority interest	2	22	0	27
Net income	882	118	227	794
Earnings per common share:				
Basic	.13	.02	.03	.11
Diluted	.12	.02	.03	.10

Fiscal Year 2000	Quarter Ended			
	May 28	August 27	November 26	February 25
	--	--	--	--
Net sales	\$8,295	\$8,279	\$9,107	\$9,239
Gross profit	3,418	2,679	3,381	3,320
Operating income	1,426	716	1,401	1,784
Income before income taxes	1,231	522	1,187	1,540
Minority Interest	(35)	(32)	8	129
Net income	835	372	763	867
Earnings per common share:				
Basic	.11	.05	.11	.13
Diluted	.10	.05	.10	.11

Note: All earnings per share amounts have been restated to reflect a 2 for 1 stock split effective May 28, 1999.

EXHIBIT 21

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List of Subsidiaries

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Name	Jurisdiction	% Ownership
----	-----	-----
Entertainment Technology Corporation	PA	100%
ETC International Corporation	Barbados	100%
ETC-PZL Aerospace Industries	Poland	95%
ETC-Europe	Great Britain	99%

Consent of Independent Certified Public Accountants  
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We have issued our report dated April 24, 2002 (except for notes 1 and 3, as to which the date is May 9, 2002 and note 7, as to which the date is June 5, 2002), accompanying the consolidated financial statements incorporated by reference in the Annual Report of Environmental Tectonics Corporation and Subsidiaries on Form 10-K for the year ended February 22, 2002 and Part II of this form. We have also audited Schedule II for each of the three years in the period ended February 22, 2002. In our opinion, this schedule represents fairly, in all material respects, the information required to be set forth therein. We hereby consent to the incorporation by reference of said reports in the Registration Statement of Environmental Tectonics Corporation and Subsidiaries of Form S-8 (File No. 333-65469, effective October 8, 1998), Form S-8 (File No 2-92407, effective August 14, 1984) and on Form S-3 (File No. 33-42219, effective September 4, 1991).

/s/ Grant Thornton LLP  
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Philadelphia, Pennsylvania  
June 7, 2002