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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, DC 20549

FORM 10-K

FOR ANNUAL AND TRANSITION REPORTS
PURSUANT TO SECTIONS 13 OR 15(d) OF
THE SECURITIES EXCHANGE ACT OF 1934

☒ **Annual report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**

for the fiscal year ended February 24, 2006

or

☐ **Transition report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**

For the transition period from ____________ to ____________.

Commission File Number 1-10655

ENVIRONMENTAL TECTONICS CORPORATION

Pennsylvania	**23-1714256**
(State or other jurisdiction of incorporation or organization)	*(I.R.S. Employer Identification No.)*

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

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

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

Title of Each Class	Name of Each Exchange on Which Registered
Common Stock, par value $.05 per share	American Stock Exchange

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

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in rule 405 of the Securities Act.
Yes ☐ No ☒

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or 15(d) of the Act.
Yes ☐ No ☒

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes ☒ No ☐

Indicate by check mark if disclosure of delinquent filers pursuant 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. ☐

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

Large Accelerated Filer ☐ Accelerated Filer ☐ Non-accelerated Filer ☒

As of August 26, 2005, the aggregate market value of the registrant's common stock held by non-affiliates of the registrant was approximately $32,494,000 based upon the closing sale price of the registrant's common stock on the American Stock Exchange of $5.20 on such date. See footnote (1) below.

As of May 11, 2006, there were 9,037,937 shares of the registrant's common stock issued and outstanding.

DOCUMENTS INCORPORATED BY REFERENCE. Portions of Registrant's 2006 Annual Report to Stockholders are incorporated by reference in Part II, Items 5, 6, 7, and 8.

Index to Exhibits appears after page 20 of this Report

(1) The information provided is not an admission that any person whose holdings are excluded from the figure is not an affiliate or that any person whose holdings are included is an affiliate and any such admission is hereby disclaimed. The information provided is solely for recordkeeping purposes of the Securities and Exchange Commission.

ENVIRONMENTAL TECTONICS CORPORATION
ANNUAL REPORT ON FORM 10-K
FOR THE FISCAL YEAR ENDED
FEBRUARY 24, 2006

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FORWARD-LOOKING STATEMENTS

This Annual Report on Form 10-K includes forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. These forward-looking statements are based on the Company's current expectations and projections about future events. These forward-looking statements are subject to known and unknown risks, uncertainties and assumptions about the Company and its subsidiaries that may cause actual results, levels of activity, performance or achievements to be materially different from any future results, levels of activity, performance or achievements expressed or implied by these 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 revenue, costs of raw materials, income or loss, earnings or loss per share, capital expenditures, growth prospects, dividends, capital structure, other financial items and the effects of currency fluctuations, (ii) statements of plans and objectives of the Company or its management or Board of Directors, including the introduction of new products, or estimates or predictions of actions of customers, suppliers, competitors or regulatory authorities, (iii) statements of future economic performance, (iv) statements of assumptions and other statements about the Company or its business, (v) statements made about the possible outcomes of litigation involving the Company, and (vi) statements preceded by, followed by or that include the words "may", "could", "should", "looking forward", "would", "believe", "expect", "anticipate", "estimate", "intend", "plan", or the negative of such terms or similar expressions. These forward-looking statements involve risks and uncertainties which are subject to change based on various important factors. Some of these risks and uncertainties, in whole or in part, are beyond the Company's control. Factors that might cause or contribute to such a material difference include, but are not limited to, those discussed in this Annual Report on Form 10-K, in the section entitled "Risks Particular to Our Business." Shareholders are urged to review these risks carefully prior to making an investment in the Company's common stock.

The Company cautions that the foregoing list of important factors is not exclusive. The Company does not undertake to update any forward-looking statement, whether written or oral, that may be made from time to time by or on behalf of the Company

PART I

Item 1. Business

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

Segments

We operate 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.

> Aircrew Training Devices. Our 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 that we sell in this business segment 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. We provide operational and maintenance services for installed equipment that we manufacture as well as for equipment produced by others.
>
> Entertainment Products. Our entertainment products consist of motion-based simulation rides and other products for the education and amusement industries.
>
> Disaster Management Simulation. Our Disaster Management Simulation line includes real-time interactive training programs that provide instruction on various disaster situations.

The Aircrew Training System segment generated 60%, 60% and 61% of our consolidated revenues for the fiscal years ended February 24, 2006, February 25, 2005 and February 27, 2004, respectively.

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

Sterilizers. We manufacture steam and gas sterilizers for various industrial and pharmaceutical applications. We concentrate on marketing larger custom-designed sterilizers to the pharmaceutical and medical device industries.

Environmental Systems and Other Products. Our 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 environmental factors such 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. Our hyperbarics product line includes monoplace (single person) and multiplace (multiple persons) chambers for high altitude training, decompression and wound care applications.

Sales of Industrial Group products generated 40%, 40% and 39% of our consolidated revenues for the years ended February 24, 2006, February 25, 2005 and February 27, 2004, respectively.

We also provide control upgrades, maintenance and repair services and spare parts for equipment which we manufacture and for equipment made by other manufacturers.

For a more complete description of financial information regarding our business segments, see “Note 10, “Business Segment Information” to our consolidated financial statements in the Annual Report to Stockholders attached hereto as Exhibit 13 and incorporated herein by reference.

Marketing

We currently market our products and services primarily through our sales offices and employees. At February 24, 2006, approximately 22 employees were committed to sales and marketing functions. We use branch offices in England, Turkey, Egypt, Singapore, the United Arab Emirates, Malaysia and Japan as well as the services of approximately 100 independent sales organizations in seeking foreign orders for our products.

Product Development

We are continually developing new products and improving existing products in response to inquiries from customers and in response to our determination that particular products should be produced or significantly improved. Although we do not have a separate research and development group, we have several technical personnel whose main activity is the development and integration of new technologies into our existing products. These personnel include the Vice President Engineering Manager and the Vice President of Development whose additional responsibility 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. Our product development efforts focus on three areas:

Disaster Management Simulation. During fiscal 2006, our simulation line continued to expand its influence in the disaster management arena by contracting multiple training exercises for Baltimore/Washington International Airport (BWI) covering several different areas of airport disaster response including a security breach, a terrorism-related hazardous materials (HAZMAT) incident and airplane crash landings. They also constructed an Advanced Disaster Management Simulator ADMS-Drive Airport Ground Vehicle Driving Simulator for the Metropolitan Nashville Airport Authority. Locally, the line signed a contract with the Pennsylvania Southeast Region Counter-Terrorism Task Force (CTTF) to provide an ADMS-TEAM training system. In December 2005, the Netherlands National Institute for Fire Services and Disaster Management (NIBRA) passed its 10,000th student through the ADMS training course originally developed and installed by ETC. Earlier this year, our next generation 20-station ADMS System passed initial acceptance by the South Korean National Fire Academy. ADMS has also been successfully utilized to conduct training exercises at the National War College in Washington, DC, and the Port of Jacksonville, Florida.

We will continue to enhance product applications by adding additional software objects and increasing interactivity between the various disaster scenarios.

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G-force and Disorientation Trainers.

During fiscal 2006, our ATFS–400 flight training centrifuge was accepted by the Royal Malaysian Air Force at a ceremony at the new Subang Air Base training facility close to Kuala Lumpur. This device was used by Malaysia to select the first Malaysian cosmonauts, one of which will be chosen to serve as a crewmember on the International Space Station in October 2007. We also began final assembly on our second ATFS-400 which will be used to support research and pilot and space flight training. Proprietary centrifuge and simulation technology, high-fidelity models of the airplane's dynamic performance, the threats experienced by an aircraft in combat and other battle space factors are integrated into the motion controls to create a fully authentic flight environment for any specific combat aircraft.

We were able to expand the functionality of our Gyrolab line as we received significant orders from the Japanese Defense Agency for a GL-4000 and from a Middle Eastern customer for a GL-1500.

We plan to incorporate additional advanced tactical flight simulation (TFS) applications into additional products in the ATS line.

NASTAR

In fiscal 2006, we began construction of the National AeroSpace Training and Research Center (NASTAR Center). This center, set to open in January 2007, will offer a complete range of aviation training and research support for military and civil aviation as well as space travel and tourism. The NASTAR Center will house state of the art equipment including the ATFS-400, GYROLAB GL-2000 Advanced Spatial Disorientation Trainer, Hypobaric Chamber and Night Vision and Night Vision Goggle Training System. These products represent 37 years of pioneering development and training solutions for the most rigorous stresses encountered during high performance aircraft flight including the effects of altitude exposure, High G exposure, spatial disorientation and escape from a disabled aircraft.

We reported research and development expenses of $422,000, $856,000 and $358,000 for the fiscal years ended February 24, 2006, February 25, 2005 and February 27, 2004, respectively. However, most of the cost of our research efforts, which were and continue to be a significant cost of our business, are included in cost of sales for applied research for specific contracts, as well as research for feasibility and technology updates.

Subsidiaries

We presently have four operating subsidiaries. Entertainment Technology Corporation, our wholly-owned subsidiary, is a Pennsylvania corporation that focuses on the development, manufacturing and distribution of our entertainment products. ETC-PZL Aerospace Industries, our 95%-owned subsidiary, is a Polish corporation that manufactures simulators. ETC-Europe, our 99%-owned subsidiary, is a United Kingdom corporation that focuses on generating international sales. NASTAR Center LLC is our wholly-owned subsidiary which houses our NASTAR Center and all its activities. ETC-Delaware, our wholly-owned subsidiary, is a Delaware corporation that serves as a holding company.

Suppliers

The components being used in the assembly of systems and the parts used to manufacture our products are purchased from equipment manufacturers, electronics supply firms and others. Historically, we have had no difficulty in obtaining supplies. Further, all raw materials, parts, components and other supplies which we use to manufacture our products can be obtained at competitive prices from alternate sources should existing sources of supply become unavailable.

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Patents and Trademarks

We presently hold the following patents which we deem significant to our operations:

Patent Number	Title	Expiration Date
5,051,094	"G-Force Trainer"	9/24/08
6,818,178 B2	"Method for High Vacuum Sterilization of Closures"	1/15/23

3. We also hold a trademark on our logo, ETC®, as well as on the following products:

BARA-MED®	Medical Hyperbaric Chamber
DATAPRINT®	Digital Printer for Sterilizers
ETC®	Logo for Environmental Tectonics Corporation (*Stylized Mark* – See attached sample)
GAT-II®	General Aviation Trainer
G-LAB®	Human Centrifuge/USAF Type
GYROLAB®	Spatial Disorientation Device
MRC Monster Roll Cage®	Interactive Simulator in the Nature of an Amusement Ride Machine that incorporates Virtual Reality Effects (*Stylized Mark* – See attached sample)
THE RIDE WORKS®	(Facility for) Manufacture of Amusement and Entertainment Rides to the order and specification of others.

4. ETC's UNREGISTERED (™) TRADEMARKS are:

ADMS™	Advanced Disaster Management Simulator
ATFS™	Advanced Tactical Flight Simulator
Advanced Tactical Flight Simulator™	Advanced Tactical Flight Simulator, ATFS-100, -200, -300, -400
BARA-LAB™	Hyperbaric Chamber (other than medical)
BIG MAC™	Entertainment ride based on a multi-armed Centrifuge Device
CAS™	Conditioned Air Supply
DMI™	Disaster Management Institute
EAGLE-VISION™	Visual Performance/Procedures Trainer
EPC™	Engine Pressure Controller/Environmental System
ETC™	ETC Biomedical Systems (***Stylized "ETC" with caduceus***. See sample below).
ETC™	Entertainment Technology Corporation (*Stylized "ETC" and name in color*. See sample below).
G-FET™	Human Centrifuge (U.S. Navy type)
G-FET-II™	Human Centrifuge (Malaysian Air Force type)
G-MAS™	Missile Avoidance System

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	(Centrifuge feature)
GRAPH MASTER PROGRAMMER ™	Industrial Sterilizer Control
GUARDIAN MONITORING PACKAGE ™	GMP features for Sterilizers
GYRO-1 ™	Multi-purpose basic Instrument Flight Trainer
GYRO-SAT™	Situational Awareness Trainer (feature of a Gyrolab)
GYROSIM ™	Gyrolab as a Simulator
LANE MASTER ™	Automobile Emissions Analyzer
MAC ™	Entertainment Ride based on a Multi-Armed Centrifuge Device
NASTARSM CENTER	The National Aerospace Training & Research Center (Stylized Mark – see attached sample)
OASIS ™	Software-driven tool to build Test and Training Systems and scoring them; curriculum development, capability assessment, etc .
ProFlyer ™	Commercial Flight and Navigational Procedures Trainer meeting European regulations for civilian pilot training and certification
PRO-GENESIS ™	Control Unit/column for Sterilizers
ProTrainer ™	Commercial Instrument Procedures Trainer meeting FAA's PCATD requirements
SENTRY 84 ™	Automobile Emissions Analyzer
SMOOTH RIDE ™	Computer Control Profile for Hyperbaric Chambers
TNET™ and/orTRAINING NET ™	Computer Software for training emergency personnel in firefighting, disaster management, etc.
TESS ™	Total Emissions Suppression System, EtO Sterilizer
Thrills Without Ills ™	Describing ETC's entertainment rides, particularly those utilizing ETC's Human Centrifuge Technology, which precludes motion sickness commonly associated with motion-based entertainment rides .
VPT-1000™	Visual Procedures Trainer

Customers

In the current fiscal year and throughout most of our history, we have made a substantial portion of our sales to a small number of customers that vary within any given fiscal year. We do not depend upon repeat orders from these same customers. We sell our aircrew training systems principally to U.S. and foreign governmental agencies. We sell sterilizers and environmental systems to commercial and governmental entities worldwide.

In fiscal 2006 two customers represented 10% or more of sales, L-3 Communications and the Pakistan Air Force, which together generated $7,509,000 or 30% of total sales. We do not have any relationship with these customers other than as customers. We expect to continue to conduct business with both of these customers in fiscal 2007, albeit at a much reduced level.

Foreign and Domestic Operations and Export Sales

During the fiscal years ended February 24, 2006, February 25, 2005 and February 27, 2004, approximately $2,586,000 (10%), $2,904,000 (10%) and $1,717,000 (7%), respectively, of our 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 fiscal years ended February 24, 2006, February 25, 2005 and February 27, 2004, $13,343,000 (53%), $12,912,000 (47%) and $15,421,000 (59%), respectively, of our net revenues were attributable to export sales, including those in our foreign subsidiaries. Our customers' obligations to us with regards to export sales are normally secured by irrevocable letters of credit based on the creditworthiness of the customer and the geographic area of the world in which they are located.

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During the fiscal years ended February 24, 2006, February 25, 2005 and February 27, 2004, $9,140,000 (37%), $11,998,000 (43%) and $8,857,000 (34%), respectively, of our net revenues were attributable to domestic sales to customers other than the U.S. government. (See “Note 10. Business Segment Information” to our consolidated financial statements in the Annual Report to Stockholders attached hereto as Exhibit 13 and incorporated herein by reference).

We do not believe that the distribution of our sales between foreign and domestic sales for any particular period is necessarily indicative of the distribution expected for any other period.

We derive a large portion of our sales from long-term contracts requiring more than one year to complete. We account for sales under long-term contracts on the percentage of completion basis. See the section Critical Accounting Policies in the Management’s Discussion and Analysis of Financial Condition and Results of Operations and “Note 2. Summary of Significant Accounting Policies” to our consolidated financial statements in the Annual Report to Stockholders attached hereto as Exhibit 13 and incorporated herein by reference.

Our U.S. Government contracts contain standard terms permitting termination for the convenience of the U.S. Government. In the event of termination of a government contract, we are entitled to receive reimbursement on the basis of work completed (cost incurred plus a reasonable profit). We customarily record the amounts that we anticipate 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.

Manufacturing Facilities

Our manufacturing facility is located on a five-acre site in Southampton, PA, northwest of Philadelphia. We have approximately 85,000 square feet devoted to manufacturing, assembly and testing. We have two centrifuge bays with specially designed foundations for testing human centrifuges and other centrifuge-technology-based simulators and amusement rides. ETC is ISO 9001-2000 certified.

Backlog

Our sales backlog at February 24, 2006 and February 25, 2005, for work to be performed and revenue to be recognized under written agreements after such dates, was $8,132,000 and $19,084,000 respectively. In addition, our training, maintenance and upgrade contracts backlog at February 24, 2006 and February 25, 2005, for work to be performed and revenue to be recognized after such dates under written agreements, was $1,774,000 and $2,232,000, respectively. Of the February 24, 2006 backlog, we have contracts for approximately $5,371,000 for aircrew training systems and maintenance support, including $2,243,000 for the Japanese Defense Agency, $975,000 for the Pakistan Air Force, and $798,000 for Singapore. We expect to complete approximately 94% of the February 24, 2006 backlog prior to February 23, 2007, the end of our 2007 fiscal year. Of the February 25, 2005 backlog, we completed approximately 82% by February 24, 2006.

The decrease in bookings and resulting backlog reflects the difficult world conditions for the Company’s products, especially in the ATS line.

Competition

Our business strategy in recent years has been to seek niche markets in which there is limited competition. However, in some areas of our business we compete with well-established firms, some of which have substantially greater financial and personnel resources than we have.

Some competing 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 us 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.

We face competition in the sale of the larger custom-designed industrial sterilizers both from other manufacturers and from our customers’ in-house production capabilities.

We believe that we are a significant participant in the markets in which we compete, especially in the market for aircrew training systems where we believe that we are a principal provider of this type of equipment and training in our market area.

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Compliance with Environmental Laws

We have not incurred during fiscal 2006, nor do we anticipate incurring during fiscal 2007, 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 do we anticipate that compliance with these provisions will have a material adverse effect on our earnings or competitive position.

Compliance with Export Controls

Depending on the product, customer, location and the application or use, many of our aeromedical products require an export license from the U.S. Commerce or State Department. Although most of these licenses are readily obtainable in a reasonable timeframe, most of our international contracts for aeromedical equipment include the issuance of an export license as a "force majure" exception for any contract penalties or liquidated damages.

Employees

On February 24, 2006, we had 223 full-time employees, of which four were employed in executive positions, 76 were engineers, engineering designers, or draftspeople, 52 were administrative (sales, sales support, accounting, etc.) and clerical personnel, and 91 were engaged principally in production, operations and field support.

Item 1A. Risk Factors

RISKS PARTICULAR TO OUR BUSINESS

Our business is subject to numerous risks and uncertainties which could cause our actual operating results and developments to be materially different from those expressed or implied in any of our public announcements or filings including this Annual Report on Form 10-K for the year ended February 24, 2006. These risks and uncertainties include the following items. This list is not inclusive of all the risks and uncertainties associated with our business.

We have major litigation and claims in process and these require a significant amount of management time and effort. Additionally, legal costs are a major portion of our general and administrative spending, thus redirecting funds from other operating activities.

Legal and claims costs in fiscal 2006 were $1.5 million or 16% of total general and administrative spending. It is expected that this spending level will increase in fiscal 2007 as open litigation nears the trial stage. Please see Item 3 (Legal Proceedings) for further information on our litigation.

There is a risk of an unfavorable outcome in litigation and resulting potential negative financial impact on our operating results.

In one of the cases of commercial litigation currently in progress, we have been counter-sued for an amount in excess of $65 million. While we believe we have valid defenses to each of the counterclaims and intend to vigorously defend ourselves against these counterclaims, an unfavorable outcome could result in an adverse material effect on our financial position. With respect to the claim against the U.S. government, recoveries have usually exceeded the carrying value of claims. However, these claims require significant management time and effort and normally take multiple years to resolve. Also, there is no assurance that we will always have positive experience with regard to recoveries for our contract claims, whether at the carrying values of the claims or amounts in excess of the carrying values of the claims.

Our sources of revenues are not consistent; in any given fiscal year a substantial portion of our revenues is derived from a small number of customers that may not be recurring customers in future years.

In any given fiscal year, a substantial portion of our revenues is typically derived from a small number of customers. For example, in fiscal 2006 we generated approximately 30% of our revenues from sales to two customers, L-3 Communications and the Pakistan Air Force. In fiscal 2005, we generated approximately 36% of our revenues from sales to four customers, the Royal Malaysian Air Force, the United Kingdom Ministry of Defense, the Army Corp of Engineers, and a domestic customer. In fiscal 2004, we generated approximately 22% of our revenues from sales to two customers, the Royal Malaysian Air Force and the United Kingdom Ministry of Defense. We cannot be certain that our most significant customers will continue to order our products and services at the same level at which they have ordered them in the past. Due to the expensive nature and highly specialized market for our products and services, if any of these customers stops purchasing our products and services and we are unable to identify new customers in a timely manner, our business will be adversely affected.

Our significant debt could adversely affect our financial resources and prevent us from satisfying our debt service obligations.

We have a significant amount of indebtedness. Additionally, we will have to pay a 6% dividend payment on the $3,000,000 of preferred stock which we issued to Mr. Lenfest on April 7, 2006. We may also incur additional indebtedness in the future. We may not generate sufficient cash flow from operations, or have future borrowings available to us, sufficient to pay our debt. During fiscal 2006, we experienced a negative cash flow of $8.5 million. At May 12, 2006, our total indebtedness was approximately $16.1 million, we had $3,000,000 of outstanding preferred stock, and our total stockholders' equity was approximately $17.6 million.

Our ability to make debt payments depends on future performance, which, to a certain extent, is subject to general economic, financial, competitive and other factors, some of which are beyond our control. Based upon our current level of operations and anticipated growth, we believe that cash on hand and borrowings under our equity line agreement with H.F. Lenfest will be adequate to meet our financial needs. There can be no assurance, however, that our business will generate sufficient cash flow from operations to enable us to pay our debts or to make necessary capital expenditures, or that any refinancing of debt would be available on commercially reasonable terms or at all.

Our substantial indebtedness could have important consequences including:

- our ability to obtain additional financing for working capital, capital expenditures, acquisitions or other purposes may be impaired or unavailable;
- a portion of cash flow will be used to pay interest expense, which will reduce the funds that would otherwise be available for operations and future business opportunities;
- a substantial decrease in net operating cash flows or an increase in expenses could make it difficult for us to meet our debt service requirements and force us to reduce or modify our operations;
- our significant debt may make us more leveraged than our competitors, which may place us at a competitive disadvantage;
- our significant debt may make us more vulnerable to a downturn in our business or in the economy generally;
- some of our existing debt contains financial and restrictive covenants that limit our ability to borrow additional funds, acquire and dispose of assets, and pay cash dividends; and
- our subordinated debt bears a relatively high interest rate, reflecting the unsecured nature and correspondingly higher risk associated with this type of financing. This results in higher interest expense and use of cash.
- Although currently none of our debt bears interest at rates that vary with the prime rate of interest, it is expected that any additional debt which we might incur would carry a floating rate. If this were the case, any increases in the applicable prime rate of interest would reduce our earnings.

See the Liquidity and Capital Resources section of the Annual Report to Stockholders attached as Exhibit 13 to this Annual Report on Form 10-K.

We do not currently have a bank facility which can be used to borrow funds for operating purposes. Additionally, covenants and restrictions in our credit facility, and any additional changes in the facility amount or structure, could limit our ability to take certain actions and fund our operations.

On May 19, 2006 we signed an amendment to our bank agreement with PNC Bank, National Association extending the termination date to June 30, 2006. This $5,000,000 facility is restricted to use for issuing letters of credit. As of May 12, 2006, we had used approximately $2,900,000 million of this facility for international letters of credit. We may need to obtain additional sources of capital in order to continue growing and operating our business. This capital may be difficult to obtain and the cost of this additional capital is likely to be relatively high.

Our subordinated debt agreement with Mr. Lenfest contains significant financial and operating covenants that limit the discretion of our management with respect to certain business matters. These covenants include, among others, restrictions on our ability to:

- declare or pay dividends or any other distributions to our securities holders;
- redeem or repurchase capital stock;
- incur certain additional debt;

- place liens on our assets;
- make certain payments and investments;
- sell or otherwise dispose of assets; and
- acquire or be acquired by other entities.

We must also meet certain financial ratios and tests under our agreement. If we do not comply with the obligations set forth in the agreement, it could result in an event of default, and possibly the acceleration of the related debt. Negative operating results would impact our future compliance with these covenants and could adversely affect our business.

Our liquidity and capitalization improved subsequent to fiscal year end when we signed an equity line agreement with H.F. Lenfest, a Director, significant shareholder and holder of our subordinated debt. Under certain conditions, we will have access to up to $15 million in cash to support operations. However, given our low beginning sales backlog and ongoing difficulty in obtaining new contracts, we may need to obtain additional sources of capital in order to continue growing and operating our business. Because we have established businesses in many markets, significant fixed assets including a building, and other business assets which can be used for security, we believe that we will be able to locate such additional sources of capital, although there is no assuredness that we will be successful in this endeavor.

See the Liquidity and Capital Resources section of the Annual Report to Stockholders attached as Exhibit 13 to this Annual Report on Form 10-K.

Our operations involve rapidly evolving products and technological change.

The rapid change of technology is a key feature of all of the industries in which our businesses operate. To succeed in the future, we will need to continue to design, develop, manufacture, assemble, test, market and support new products and enhancements on a timely and cost-effective basis. Historically, our technology has been developed through both customer-funded and internally funded research and development, and we expect this practice will continue to be required in the future. We cannot guarantee that we will continue to maintain comparable levels of research and development nor that this development will be customer-funded in the same ratio going forward. Reinvestment of operating funds and profits in an amount greater than currently earned may be required. Even so, we cannot assure you that we will successfully identify new opportunities and continue to have the financial resources required to develop new products profitably. At the same time, products and technologies developed by others may render our products and systems obsolete or non-competitive.

Delays in the delivery of our products may prevent us from invoicing our costs and estimated earnings on uncompleted contracts.

In accordance with generally accepted accounting principles for long-term contracts, we record an asset for our costs and estimated earnings that exceed the amount we are able to bill our customers on uncompleted contracts. At February 24, 2006, $3.2 million or 93% of our costs and estimated earnings that exceeded our billings on uncompleted contracts related to contracts with two different customers. We are not able to bill these amounts unless we meet certain contractual milestones related to the production, delivery and integration of our products. Normally there will be a lag ranging from 24 to 36 months between performance and associated costs for these types of projects and billing and collection of payments. Our failure to meet these milestones by delivering and integrating our products in a timely manner may impact our ability to recover our costs and estimated earnings that exceeded our billings on uncompleted contracts, which could severely impact our cash flow.

In the event we suffer production delays, we may be required to pay certain customers substantial liquidated damages and other penalties.

The variety and complexity of our high technology product lines require us to deal with suppliers and subcontractors supplying highly specialized parts, operating highly sophisticated equipment and performing highly technical calculations. The processes of planning and managing production, inventory levels and delivery schedules are also highly complex and specialized. Many of our products must be custom designed and manufactured, which is not only complicated and expensive, but can also require long periods of time to accomplish. Slight errors in design, planning and managing production, inventory levels, delivery schedules, or manufacturing can result in unsatisfactory products that may not be correctable. If we are unable to meet our delivery schedules, we may be subject to penalties, including liquidated damages that are included in some of our customer contracts. While our actual losses have been minimal, we may incur substantial liquidated damages in the future in connection with product delays.

If the commercial simulation business conducted by our Aircrew Training Systems Segment declines, our sales will decrease.

We have no assurance that our commercial simulation business will continue to succeed. Although our commercial simulation business was minimal in fiscal 2006, this segment historically contributes to our gross revenues in each fiscal year. This business is subject to many risks including:

- the uncertainty of economic conditions;
- increased competition;
- changes in technology; and
- the need for timely performance by subcontractors located throughout the world on contracts for which we are the prime contractor.

If we do not adequately address these risks, then our commercial simulation business may decline which will adversely affect our business.

Our fixed-price and cost-reimbursable contracts may commit us to unfavorable terms.

We provide our products and services primarily through fixed-price or cost-reimbursable contracts. Fixed-price contracts provided approximately 94% of our sales for the fiscal year ended February 24, 2006. Under a fixed-price contract, we agree to perform the scope of work required by the contract for a predetermined contract price. Although a fixed-price contract generally permits us to retain profits if the total actual contract costs are less than the estimated contract costs, we bear the risk that increased or unexpected costs may reduce our profit or cause us to sustain losses on the contract. Therefore, unless there are customer-requested changes in scope or other changes in specifications which are reimbursable, we fully absorb cost overruns on fixed-price contracts and this reduces our profit margin on the contract. These cost overruns may result in us recognizing a loss on the contract. A further risk associated with fixed-price contracts is the difficulty of estimating sales and costs that are related to performance in accordance with contract specifications. Our failure to anticipate technical problems, estimate costs accurately or control costs during performance of a fixed-price contract may reduce our profitability or cause a loss.

We did not have any sales for cost-reimbursable contracts for the fiscal year ended February 24, 2006. On a cost-reimbursable contract, we are paid up to predetermined funding levels determined by our customers on allowable incurred costs and generally a fee representing a profit on those costs, which can be fixed or variable depending on the contract's pricing arrangement. Therefore, on a cost-reimbursable contract we do not bear the risks of unexpected cost overruns. U.S. Government regulations require that we notify our customer of any cost overruns or under runs on a cost-reimbursable contract on a timely basis. Should we be awarded any cost-reimbursable contracts in the future and incur costs in excess of the funding limitation specified in the cost-reimbursable contracts, we may not be able to recover those cost overruns.

Cost estimates used to account for contracts under the percentage of completion method may vary over time and impact future performance under these contracts.

We record sales and profits on a significant portion of our contracts using the percentage-of-completion method of accounting. This means that we calculate a ratio of costs incurred to costs expected to be incurred for each fixed-price job and then multiply that same ratio by the fixed-price contract value to determine total revenue to be recognized to date for each fixed-price job. As a result, contract price and cost estimates on fixed-price contracts are reviewed periodically as the work progresses, and adjustments are reflected in income in the period when the estimates are revised. To the extent that these adjustments result in a loss, reduction or elimination of previously reported profits, we would recognize a charge against current earnings, which could be material and have a negative effect on our business, financial condition or results of operations. Although we believe that adequate provisions for losses for our fixed-prices contracts are recorded in our financial statements as required under accounting principles generally accepted in the United States of America, we cannot assure you that our contract loss provisions, which are based on estimates, will be adequate to cover all actual future losses.

Our contracts and subcontracts that are funded by the U.S. government or foreign governments are subject to government regulations and audits and other requirements.

Government contracts require compliance with various contract provisions and procurement regulations. The adoption of new or modified procurement regulations could have a material adverse effect on our business, financial condition or results of operations or increase the costs of competing for or performing government contracts. If we violate any of these regulations, then we may be subject to termination of these contracts, imposition of fines or exclusion from government contracting and government-approved subcontracting for some specific time period. In addition, our contract costs and revenues are subject to adjustment as a result of audits by government auditors. We reflect any adjustments required by government auditors in our financial statements. Although we have thus far not been required to make any material audit adjustments, adjustments may be required in the future. In connection with our government contracts, we have been required to obtain bonds, letters of credit or similar credit enhancements. We cannot assure you that we will be successful in obtaining these types of credit enhancements or that the credit enhancements available will be affordable in the future.

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Our contracts that are funded by the U.S. government or foreign governments are subject to a competitive bidding process that may affect our ability to win contract awards or renewals in the future.

Government contracts generally are awarded to us through a formal competitive bidding process in which we may have many competitors. Upon expiration, government contracts may be subject, once again, to the competitive bidding process. We cannot assure you that we will be successful in winning contract awards or renewals in the future. Our failure to renew or replace government contracts when they expire could have a material adverse effect on our business, financial condition or results of operations. Our contracts with domestic or foreign government agencies are subject to competition and are awarded on the basis of technical merit, personnel qualifications, experience and price. Our business, financial condition and results of operations could be materially adversely affected to the extent that government agencies believe our competitors offer a more attractive combination of the foregoing factors. In addition, new government contract awards also are subject to protest by competitors at the time of award that can result in the re-opening of the competition or evaluation process, the award of a contract to a competitor, or the re-opening of the competitive bidding process. We consider bid protests to be a customary element in the process of procuring government contracts. Other characteristics of the government contract market that may affect our operating results include the complexity of designs, the difficulty of forecasting costs and schedules when bidding on developmental and highly sophisticated technical work, and the speed with which product lines become obsolete due to technological advances and other factors characteristic of the market. Our earnings may vary materially on some contracts depending upon the types of government long-term contracts undertaken, the costs incurred in their performance, and the achievement of other performance objectives.

Our commercial contracts are subject to competition and strict performance and other requirements.

Although significant portions of our revenues are generated from the sale of our services and products in commercial markets, we cannot assure you that we will continue to compete successfully in these markets. Many of our commercial contracts contain fixed pricing. This subjects us to substantial risks relating to unexpected cost increases and other factors outside of our control. We may fail to anticipate technical problems, estimate costs accurately, or control costs during performance of a fixed-price contract. Any of these failures may reduce our profit or cause a loss under our commercial contracts. In addition, a significant portion of our revenues on fixed-price contracts (72% in fiscal 2006) is recognized on a percentage-of-completion basis. This means that we calculate a ratio of costs incurred to costs expected to be incurred for each fixed-price job and then multiply that same ratio by the fixed-price contract value to determine total revenue to be recognized to date for each fixed-price job. As a result, contract price and cost estimates on fixed-price contracts are reviewed periodically as the work progresses, and adjustments are reflected in income in the period when the estimates are revised. To the extent that these adjustments result in a loss, reduction or elimination of previously reported profits, we would recognize a charge against current earnings, which could be material and have a negative effect on our business, financial condition or results of operations.

In connection with certain commercial contracts, we have been required to obtain bonds, letters of credit, or similar credit enhancements. We cannot assure you that we will be successful in obtaining these types of credit enhancements or that the credit enhancements available will be affordable in the future.

Under the terms of our commercial contracts, we typically must agree to meet strict performance obligations and project milestones, which we may not be able to satisfy. If we fail to meet these performance obligations and milestones, the other party may terminate the contract and, under certain circumstances, recover liquidated damages or other penalties from us which could have a negative effect on our business, financial condition or results of operations.

There are certain risks inherent in our international business activities, which constitute a significant portion of our business.

Our international business activities expose us to a variety of risks. Our international business including that from our foreign subsidiaries, accounted for approximately 53% of our sales in fiscal 2006 and 47% of our sales in fiscal 2005. We expect that international sales will continue to be a significant portion of our overall business in the foreseeable future. Our international business experiences many of the same risks our domestic business encounters as well as additional risks such as:

- the effects of terrorism;
- exchange rate fluctuations;

- a longer and more complicated collections cycle;
- a high degree of corruption in some countries;
- a general decline in the strength of the global economy;
- the effect of foreign military or political conflicts and turmoil;
- U.S. foreign policy decisions;
- the extent, if any, of anti-American sentiment;
- changes in foreign governmental trade, monetary and fiscal policies and laws;
- export controls; and
- political and economic instability.

The majority of our contracts are denominated in U.S. dollars. Although we may be exposed to currency fluctuations, we are not engaged in any material hedging activities to offset this risk. With respect to currency risk, where we have a contract which is denominated in a foreign currency, we often establish local in-country bank accounts and fund in-country expenses in the local currency, thus creating a "natural" currency hedge for a portion of the contract.

Our international transactions frequently involve increased financial and legal risks arising from stringent contractual terms and conditions and widely differing legal systems, customs and standards in foreign countries. In addition, our international sales often include sales to various foreign government armed forces, with many of the same inherent risks associated with U.S. government sales discussed in this Annual Report on Form 10-K.

Legislative actions, higher director and officer insurance costs and potential new accounting pronouncements are likely to cause our general and administrative expenses to increase and impact our future financial condition and results of operations.

In order to comply with the Sarbanes-Oxley Act of 2002, as well as changes to the American Stock Exchange listing standards and rules adopted by the Securities and Exchange Commission, we have been required to strengthen our internal controls, hire additional personnel and retail additional outside legal, accounting and advisory services, all of which have caused and will continue to cause our general and administrative costs to increase. These and other costs of operating as a public company will continue to be a significant element of our general and administrative costs. Although we have not experienced any director and officer liability claims, insurers have increased and are likely to continue to increase premiums as a result of the (i) high claims rates they have incurred with other companies over the past years (ii) the high stock ownership position of some of our non-affiliated shareholders, and (iii) our reduced operating performance, and so our premiums for our directors' and officers' insurance policies are likely to continue to increase. Changes in the accounting rules and auditing standards, including legislative and other proposals to account for employee stock options as a compensation expense among others, could materially increase the expenses that we incur and report under generally accepted accounting principles and adversely affect our operating results.

Our fiscal 2006 new contract bookings and fiscal 2007 opening backlog is significantly lower than any comparable fiscal period for the most recent prior periods. Additionally, our sales backlog is not necessarily indicative of revenues that we will actually realize in fiscal year 2006 or at all.

Our new contract bookings for fiscal 2006 were approximately $13.7 million as compared to an average of $27.2 million for the last four fiscal years. Our opening backlog for fiscal 2007 is approximately $9.9 million. The opening backlog for fiscal years 2002 through 2005 was in excess of approximately $20 million for each year. Although our open proposal base remains strong, there is no assurance that we will be able to bring a significant amount of these contracts to award status. Additionally, we may not actually generate revenues in fiscal 2007 for all items included in our estimated backlog at the end of our 2006 fiscal year. While we estimate that approximately 94% of this $9.9 million backlog is expected to be completed prior to the end of our 2007 fiscal year, we are not certain that these projects will be completed so that we can record these revenues by such date, or at all. During fiscal 2006, we shipped approximately 82% of our February 25, 2005 backlog. Our backlog includes the total value of all contracts less the revenue earned on those contracts through the measurement date. Many of our government contracts are multi-year contracts and contracts with option years, and portions of these contracts are carried forward from one year to the next as part of our backlog. Certain of our large contracts provide that we will not receive payment until the services under those contracts are requested and performed. We cannot assure that cancellations or adjustments in the terms of these contracts might not occur.

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Our operations could be hurt by terrorist attacks, war, disease and other activities or occurrences that make air travel difficult or reduce the willingness of our commercial airline customers to purchase our simulation products.

The demand for our various commercial simulation products and services is heavily dependent upon new orders from our commercial airline customers. In the event terrorist attacks, war, disease or other activities or occurrences make air travel difficult or reduce the demand or willingness of our customers to purchase our commercial simulation products, our revenue may decline.

Geo-political and other factors may also limit or restrict our employees' ability to gain entrance to foreign locations to sell products or perform contract services.

There is limited trading activity in our common stock which could make it more difficult for our investors to sell their shares of our common stock.

Our common stock is listed on the American Stock Exchange. Our average daily trading volume on the American Stock Exchange during fiscal 2006 was 4,362 shares. This limited trading activity may make it more difficult for investors to sell larger blocks of our common stock at prevailing prices as there are generally a small number of participants in the market for our common stock and such sales may lower the market price of our common stock.

The market price of our common stock may be volatile.

The market price of securities of thinly traded public companies has historically faced significant volatility. Although our common stock is traded on the American Stock Exchange, it does not experience a significant average daily trading volume. Accordingly, if one stockholder elects to either purchase or sell a block of our common stock, it may have a significant effect on the price of our common stock. In addition, the stock market in recent years has experienced significant price and volume fluctuations that often have been unrelated or disproportionate to the operating performance of particular companies. Many factors that have influenced trading prices will vary from period to period, including:

- actual or anticipated operating results;
- changes in estimates by analysts;
- market conditions in the industry;
- announcements by competitors;
- results of litigation;
- regulatory actions; and
- general economic conditions.

Any of these events would likely affect the market price of our common stock.

Our quarterly operating results may vary significantly from quarter to quarter.

Our revenues and earnings may fluctuate from quarter to quarter based on factors that include the following:

- the number, size and scope of our projects;
- equipment purchases and other expenditures required for our business;
- the number of bid and proposal efforts undertaken;
- delays in sales or production;
- the level of employee productivity;
- the adequacy of our provisions for losses;
- the accuracy of our estimate of resources required to complete ongoing projects; and
- general economic conditions.

Demand for our products and services in each of the markets we serve can vary significantly from quarter to quarter due to revisions in customer budgets or schedules and other factors beyond our control. Due to all of the foregoing factors, our results of operations may fall below the expectations of securities analysts and investors in a particular period. In this event, the price of our common stock may decline.

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Our officers and directors own a significant amount of our common stock which permits them to exert significant influence over the direction of our business and affairs.

As of May 11, 2006, our directors and executive officers own an aggregate of approximately 44.8% on a fully converted basis of our outstanding common stock. Given our equity line agreement with H.F. Lenfest and the lack of a bank facility, it is expected that this percentage will increase as we request additional funds and issue additional preferred stock under this agreement. Accordingly, these persons, if they act together, will be able to exert control over the direction of our business and affairs.

Item 2. Properties

We own our executive offices and principal production facilities located on a five 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 of the building is devoted to manufacturing and 15,000 square feet of this building is devoted to office space. The original building was erected in 1969 and additions were most recently made in 2001. As of February 24, 2006, this property was pledged as collateral to secure the performance of our obligations under our revolving credit facility with PNC Bank, National Association and our subordinated debt financing with H.F. Lenfest. Additionally, we rent office space at various sales and support locations throughout the world and at ETC-PZL Aerospace Industries, our Polish subsidiary.

We consider our machinery and plant to be in satisfactory operating condition. Increases in the level of operations beyond what we expect in the current fiscal year might require us to obtain additional facilities and equipment.

Item 3. Legal Proceedings

In April 2003, Boenning & Scattergood, Inc. ("B&S") filed suit against the Company in the Court of Common Pleas in Philadelphia, Pennsylvania, seeking payment of $901,843.46 for financing fees allegedly due to B&S pursuant to the terms of an agreement for investment banking services, which was entered into with a predecessor of B&S (the "B&S Agreement"). B&S alleged that it contacted the investors in the Company's February 2003 financing transaction and that it earned the claimed financing fees pursuant to the terms of the B&S Agreement. On August 17, 2005 the Company entered into an agreement to settle this litigation. The agreement was entered into for the purpose of resolving contested claims and disputes as well as avoiding the substantial costs, expenses and uncertainties associated with protracted and complex litigation, and was not an admission of fault or liability by either party. Under the guidance of FASB Statement No.5, an amount representing a probable settlement had been accrued in a prior period, so the payment under the settlement had no material impact on the Company's results of operations for the fiscal second quarter.

In June 2003, Entertainment Technology Corporation ("EnTCo"), our wholly-owned subsidiary, filed suit against Walt Disney World Co. and other entities ("Disney") in the United States District Court for the Eastern District of Pennsylvania, alleging breach of contract for, among other things, failure to pay all amounts due under contract for the design and production of the amusement park ride "Mission: Space" located in Disney's Epcot Center. In response, in August 2003, Disney filed counterclaims against both EnTCo and us (under a guarantee) for, among other things, alleged failures in performance and design in the contract. Disney is seeking damages in excess of $65 million plus punitive damages. Both EnTCo and we believe that we have valid defenses to each of Disney's counterclaims and intend to vigorously defend ourselves against these counterclaims. Discovery has been completed and the parties participated in a structured mediation in early December 2005, with no agreement forthcoming as of the date of this Annual Report on Form 10-K. The case is not currently scheduled for trial. Neither EnTCo nor we are able to predict the outcome of this matter.

Certain other claims, suits, and complaints arising in the ordinary course of business have been filed or are pending against us. In our opinion, after consultation with legal counsel handling these specific maters, 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 our financial position or results of operations if disposed of unfavorably.

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

No matters were presented to our stockholders during the fourth quarter of fiscal 2006.

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PART II

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

On April 7, 2006, ETC entered into a Preferred Stock Purchase Agreement (the “Agreement”) with H. F. “Gerry” Lenfest, a Director, significant shareholder and holder of our subordinated debt. The Agreement permits us to unilaterally draw down up to $15 million over the next eighteen (18) months in exchange for shares of our newly-created Series B Cumulative Convertible Preferred Stock (“Preferred Stock”). The Preferred Stock provides for a dividend equal to six (6) percent per annum. After three (3) years, the Preferred Stock will be convertible, at Mr. Lenfest’s request, into ETC common shares at a conversion price (the “Conversion Price”) which will be set on the day of each draw down. The Conversion Price will be equal to the closing price of our common stock on the trading day immediately preceding the day in which the draw down occurs, subject to a floor price of $4.95 per common share. Drawdowns will not be permitted on any day when the Conversion Price would be less than this floor price. On the sixth anniversary of the Agreement, any issued and outstanding Preferred Stock will be mandatorily converted into ETC common stock at each set Conversion Price. The Agreement also allows us to redeem any outstanding Preferred Stock any time within the six (6) year term of the Agreement. The Preferred Stock will vote with the ETC common stock on an as converted basis.

In connection with the execution of the Agreement, we drew down $3 million by issuing 3,000 shares of Preferred Stock with a Conversion Price equal to $4.95 per share. The proceeds are being used for general corporate purposes.

Additionally, see information appearing under the heading “Market for the Registrant’s Common Stock and Related Stockholder Matters and Issuer Purchases of Equity Securities” in the Annual Report to Stockholders attached hereto as Exhibit 13 and incorporated herein by reference.

Item 6. Selected Consolidated Financial Data

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

Item 7A. Quantitative and Qualitative Disclosures About Market Risk

We are exposed to various market risks, including changes in interest rates. Market risk is the potential loss arising from adverse changes in market rates and prices, such as interest rates and foreign currency exchange rates. We do not enter into derivatives or other financial instruments for trading or speculative purposes. We also have not entered into financial instruments to manage and reduce the impact of changes in interest rates and foreign currency exchange rates although we may enter into such transactions in the future. Although currently none of our debt bears interest at rates that vary with the prime rate of interest, it is expected that any additional debt which we might incur would carry a floating rate. If this were the case, any increases in the applicable prime rate of interest would reduce our earnings. With respect to currency risk, where we have a contract which is denominated in a foreign currency, we often establish local in-country bank accounts and fund in-country expenses in the local currency, thus creating a “natural” currency hedge for a portion of the contract.

Item 8. Financial Statements and Supplementary Data

See the information appearing under the headings “Consolidated Financial Statements” and “Notes to Consolidated Financial Statements” in the Annual Report to Stockholders 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.

Item 9A. Controls and Procedures

Under the supervision and with the participation of our management, including our chief executive officer and chief financial officer, we have evaluated the effectiveness of the design and operation of our disclosure controls and procedures as of February 24, 2006 (the “Evaluation Date”), and, based on this evaluation, our chief executive officer and chief financial officer have concluded that these controls and procedures were effective as of the Evaluation Date. There were no significant changes in our internal controls or in other factors that could significantly affect these controls subsequent to the Evaluation Date.

Disclosure controls and procedures (as defined in Rules 13a-14(c) and 15(d)-14(c) under the Securities Exchange Act of 1934, as amended) are our internal controls and other procedures that are designed to ensure that information we are required to disclose in the reports that we file or submit under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission's rules and forms. Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed by us in the reports that we file under the Exchange Act is accumulated and communicated to our management, including our chief executive officer and chief financial officer, as appropriate to allow timely decisions regarding required disclosure.

A control system, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the internal control system are met. Because of the inherent limitations of any internal control system, no evaluation of controls can provide absolute assurance that all control issues, if any, within a company have been detected.

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PART III

Item 10. Directors and Executive Officers of the Registrant

The following table sets forth certain information, as of May 12, 2006, with respect to our directors and executive officers:

Name	Age	Served as Director or Officer Since (1)	Positions and Offices
William F. Mitchell (2)	64	1969	Chairman of the Board, President and Director
Howard W. Kelley (3)	64	2002	Director
George K. Anderson, M.D. (4)	60	2003	Director
H.F. Lenfest (5)	76	2003	Director
Alan M. Gemmill (6)	59	2006	Director
Duane D. Deaner (7)	58	1996	Chief Financial Officer

(1) Directors are elected for one-year terms.

(2) Mr. Mitchell has been our Chairman of the Board, President and Chief Executive Officer since 1969, except for the period from January 24, 1986 through January 24, 1987, when he was engaged principally in soliciting sales for our products in the overseas markets. Mr. Mitchell received a Bachelor of Science degree in physics from Drexel University and has completed graduate work in mechanical and electrical engineering. He is a member of the ASME and Drexel University engineering advisory boards. Additionally, he is a member of the Society of Automotive/Aerospace Engineering, the International Society of Pharmaceutical Engineering, the Undersea and Hyperbaric Medical Society, the Aerospace Medical Association, the American Society of Mechanical Engineering and the Institute of Environmental Sciences.

(3) Mr. Kelley is President of Sally Corporation, Jacksonville, Florida, which is one of the oldest and largest designers and fabricators of animation robotics and dark ride attractions used worldwide in theme parks, museums and entertainment attractions. Mr. Kelley is also Chairman of the Board of American Access Technologies, Inc. (NASDAQ:AATK). AAT is a Florida-based manufacturer of zone cabling and wireless equipment. He previously spent over 25 years in the broadcasting industry, including ten years in television management as a news director and later as Vice President and General Manager of Channel 12 WTLV (NBC) in Jacksonville, Florida. He is the former Chairman of the Board of Tempus Software, a medical software development firm located in Jacksonville, Florida. He has also previously served as broadcast strategic planner for a major U.S. communications company and as director of several U.S. technology firms with international business activities. In the academic arena, Mr. Kelley serves as an executive professor at the University of North Florida College of Business Administration, and is a college adjunct instructor on Internet technology and E-commerce on the Internet. He is a graduate of the University of Florida and Harvard Business School PMD.

(4) Dr. Anderson is an experienced physician executive. He served in the Air Force as a flight surgeon, aerospace medicine staff officer, and commander of several medical organizations in Korea, Germany, and United States. He retired from active duty in the grade of Major General. Following his thirty years of military service, he transitioned to executive positions in the private sector. He served as Chief Executive Officer of the Koop Foundation from 1997 to 1998 and as Chief Executive Officer at Oceania, Inc., a medical software company, from 1999 to 2001. A period of practice as an independent medical technology consultant was followed by his current role as Executive Director of the Association of Military Surgeons of the United States (AMSUS). AMSUS, the nonprofit Society of the Federal Health agencies, operates from a headquarters located in Bethesda, Maryland."

(5) Mr. Lenfest practiced law with Davis Polk & Wardwell before joining Triangle Publications, Inc., in Philadelphia as Associate Counsel in 1965. In 1970, Mr. Lenfest was placed in charge of Triangle's Communications Division, serving as Editorial Director and Publisher of Seventeen Magazine and President of the CATV Operations. In 1974, Mr. Lenfest, with the support of two investors, formed Lenfest Communications, Inc., which purchased Suburban Cable TV Company and Lebanon Valley Cable TV Company from Triangle with a total of 7,600 subscribers. In January 2000, Mr. Lenfest sold his cable television operations, which by then served 1.2 million subscribers, to Comcast Corporation but still retains interests in companies principally involved in national satellite promotion of cable programming and software for marketing cable advertising and marketing promotions. Additionally, Mr. Lenfest is the owner of various other businesses in Pennsylvania and Maryland and is active in many philanthropic activities including as Chairman of the Board of the Philadelphia Museum of Art and the Lenfest Foundation. Mr. Lenfest is a graduate of Washington and Lee University and Columbia Law School.

(6) Mr. Gemmill is a retired U.S. Navy Rear Admiral. He graduated from the University of Arizona with a B.S. in Aerospace Engineering and was commissioned through Aviation Officer Candidate School. He began his career flying F-4 Phantoms before graduating first in his class from U.S. Naval Test Pilot School in Patuxent River, Maryland in 1974. After a brief stint as a test pilot and instructor, Mr. Gemmill then served numerous positions in Fighter Squadrons and on various ships including two deployments to the Arabian Gulf during Desert Shield and Desert Storm. From 1995 through 1999 he served as Deputy for Readiness and Deputy for Operations for the U.S. Pacific Command and as Assistant Deputy Chief of Staff for Aviation, U.S. Marine Corps. He was promoted to Rear Admiral on October 30, 1997. His last assignment before retirement from the Navy was as Head, Aircraft Carriers Program and Head, Naval Aviation Training. Rear Admiral Gemmill has almost 4,000 flight hours and 1,000 carrier landings. He has a Master of Science in Systems Management from the University of Southern California. His personal decorations include the Defense Superior Service Medal, Legion of Merit, Meritorious Service Medal, the Strike/Flight Air Medal and the Navy Commendation Medal. He is currently Director of Marketing and Sales for LSA Incorporated, a small business in Arlington, Virginia and Exton, Pennsylvania.

(7) Mr. Deaner has served as our Chief Financial Officer since January 1996. Mr. Deaner served as Vice President of Finance for Pennfield Precision Incorporated from September 1988 to December 1995. Mr. Deaner received an MBA in Finance from Temple University and a B.A. in Mathematics from Millersville University in Pennsylvania.

Committees of the Board of Directors

During the fiscal year ended February 24, 2006, the Board of Directors held three meetings. All members of the Board of Directors attended all of the meetings of the Board of Directors held while they were members of the Board of Directors.

During the fiscal year ended February 24, 2006, we had an Audit Committee consisting of Messrs. Kelley, Gemmill and Anderson. Mr. Kelley serves as the Chairman and the “financial expert” (as defined by the American Stock Exchange) and has been designated as the Audit Committee Financial Expert as defined by the rules of the Securities and Exchange Commission. In addition, all members of the Audit Committee meet the financial literacy requirements of the American Stock Exchange and are independent under the rules of the American Stock Exchange. The Audit Committee held two meetings during the year ended February 24, 2006. Among other responsibilities, the Audit Committee meets (via face-to face or via telephone) with the external auditors to review and make recommendations to management concerning (if appropriate) the quarterly and annual financial results and the reports on Forms 10-Q and 10-K. The Audit Committee is directly responsible for the appointment, compensation, retention and oversight of our independent accountants in their preparation or issuance of an audit report or the performance of other audit and review services.

Messrs. Kelley, Gemmill and Anderson also served on our Compensation Committee during the year ended February 24, 2006, with Mr. Gemmill serving as Chairman. The Compensation Committee is charged with reviewing the compensation and incentive plans of officers and key personnel. This Committee met for its annual review in September 2005.

Messrs. Kelley, Gemmill and Anderson also served on our Nominating and Governance Committee during the year ended February 24, 2006, with Dr. Anderson serving as Chairman. The Nominating and Governance Committee is charged with finding and recommending new Board members and with ensuring our compliance with all regulatory governance requirements. This Committee met for its annual review in February 2006.

Messrs. Kelley and Anderson also served on our Committee to Recommend Directors Compensation. During fiscal 2006, our directors who did not serve as officers were paid a fee of $2,000 (either in cash or equivalent value of common stock of the Company) per quarter for attending Board of Directors and committee meetings. Additionally, under a plan approved by the shareholders in September 2005, non-employee directors may be awarded options to purchase common stock of the Company at fair market value.

Code of Ethics

We have adopted a Code of Ethics, which applies to our chief executive officer, chief financial officer, controller and other senior financial officers. We have also adopted a Company Code of Conduct that applies to our directors, officers and all employees. The Code of Ethics and the Company Code of Conduct were each approved and adopted by our Board of Directors in April 2004. The Code of Ethics and the Company Code of Conduct are posted on our website, which is located at *www.etcusa.com.* We will also disclose any amendments or waivers to the Code of Ethics or the Company Code of Conduct on our website.

In addition, we have adopted a Whistleblower Policy and an Insider Trading Policy, both of which are posted on our website.

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Compliance With Section 16(a) of the Exchange Act

Section 16(a) of the Securities Exchange Act of 1934 requires our officers and directors, and persons who own more than ten percent of a registered class of our 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 regulations to furnish us with copies of all Section 16(a) reports they file. The rules of the SEC regarding the filing of Section 16(a) reports require that "late filings" of Section 16(a) reports be disclosed in our proxy statement.

Based solely on our review of the copies of such forms which we received, or written representations from reporting persons that no Section 16(a) reports were required for those persons, Messrs. Mitchell, Kelley, Anderson and Gemmill each had one late filing. We believe that our greater than ten percent beneficial owners complied with all applicable filing requirements.

Item 11. Executive Compensation

SUMMARY COMPENSATION TABLE

The following table sets forth the compensation we paid to our Chief Executive Officer for services rendered during fiscal years 2006, 2005 and 2004. There are no other executive officers whose total annual salary and bonus exceeds $100,000. The footnotes to the table provide additional information concerning our compensation and benefit programs.

		Annual Compensation			
Name and Principal Position	Fiscal Year	Salary ($)	Bonus ($)(1)	Other Annual Compensation (2)	All Other Compensation ($)(3)
William F. Mitchell,	2006	225,000	0	—	4,378
President and Chief	2005	225,000	0	—	4,958
Executive Officer	2004	225,000	9,172	—	4,707

(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 2004, 2005 or 2006 were paid. No deferred bonus amounts from fiscal 1999 were paid in fiscal 2005 or 2006.

(2) Our executive officers receive certain perquisites. For fiscal years 2004, 2005 and 2006, 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 our contribution for Mr. Mitchell to ETC's Retirement Savings Plan.

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Item 12. Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters

The following table sets forth, as of May 11, 2006, the number of shares and percentage of our common stock owned beneficially by each director, each executive officer named in the Summary Compensation Table, and each person holding, to our knowledge, more than 5% of our 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 (1)	Percent of Common Stock
William F. Mitchell (2) c/o Environmental Tectonics Corporation County Line Industrial Park Southampton, PA 18966	1,271,398(3)	14.1%
Howard W. Kelley (4) c/o Sally Corporation 745 West Forsyth Street Jacksonville, FL 32204	29,598(5)	*
George K. Anderson, M.D. (4) 8 Little Harbor Way Annapolis, MD 21403	51,100(6)	1.0%
H.F. Lenfest (4) c/o The Lenfest Group Fire Tower Bridge-Suite 460 300 Barr Harbor Drive West Conshohocken, PA 19428	3,801,121(7)	33.2%
Alan M. Gemmill (4) 941 Upper Hastings Way Virginia Beach, VA 23452	5,200(8)	*
T. Todd Martin, III 50 Midtown Park East Mobile, AL 36606	1,710,330(9)	18.9%
Emerald Advisors, Inc. 1703 Oregon Pike Suite 101 Lancaster, PA 17601	953,648(10)	10.6%
Pete L. Stephens, M.D. 31 Ribaut Drive Hilton Head Island, SC 29926	693,500(11)	7.7%
All directors and executive officers as a group (6 persons)	5,173,043(12)	44.8%

* less than 1%

(1) Beneficial ownership has been determined in accordance with Rule 13d-3 under the Securities Exchange Act of 1934. Unless otherwise noted, we believe that all persons named in the table have sole voting and investment power with respect to all shares of our common stock beneficially owned by them.

(2) Chairman of the Board, President and Director of the Corporation.

(3) Includes 133,200 shares of common stock held by Mr. Mitchell's wife.

(4) Director of the Company.

(5) Includes 25,000 shares of common stock which may be acquired upon the exercise of options granted under our Non-Employee Director Stock Option Plan that are presently exercisable.

(6) Includes 50,000 shares of common stock which may be acquired upon the exercise of options granted under our Non-Employee Director Stock Option Plan that are presently exercisable.

(7) Includes 1,818,181 shares of common stock issuable upon conversion of a promissory note in the principal amount of $10,000,000

and 606,060 shares of common stock issuable upon conversion of 3,000 shares of Preferred Stock issued on April 6, 2006.

(8) Includes 5,000 shares of common stock which may be acquired upon the exercise of options granted under our Non-Employee Director Stock Option Plan that are presently exercisable.

(9) Includes 1,165,320 shares of common stock owned by Advanced Technology Asset Management, LLC (formerly ETC Asset Management, LLC) ("ATAM"), a limited liability company of which T. Todd Martin, III is manager. Also includes 473,610 shares of common stock owned by Mr. Martin, 26,900 shares owned by Allied Williams Co, Inc., a corporation of which Mr. Martin is an officer and director, 17,000 shares owned by Equity Management, LLC, a limited liability company of which Mr. Martin is manager, 14,300 shares owned by Mr. Martin jointly with his spouse, 7,000 shares owned by trusts of which Mr. Martin is trustee, and 6,200 shares owned by Perdido Investors, LLC, of which Mr. Martin is the manager.

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(10) Emerald Advisors, Inc., has sole voting power with respect to 489,648 shares of common stock and sole dispositive power over 953,648 shares of common stock.

(11) Includes 292,330 shares of common stock held by or for the benefit of Dr. Stephens' wife and two of his children.

(12) Includes 80,000 shares of common stock which may be acquired by Members of the Board upon the exercise of options granted under our Non-Employee Director Stock Option Plan that are presently exercisable, 1,818,181 shares of common stock issuable upon conversion of a promissory note in the principal amount of $10,000,000 and 606,060 shares of common stock issuable upon conversion of 3,000 shares of Preferred Stock issued on April 6, 2006, both of which may be acquired by Mr. Lenfest, and 14,626 shares of common stock which may be acquired by Duane Deaner, our chief financial officer, upon the exercise of options granted under our Incentive Stock Option Plan that are presently exercisable.

For information regarding our equity compensation plans, please see the Equity Compensation Plan Information section of the Annual Report to Stockholders attached hereto as Exhibit 13 and incorporated herein by reference.

Item 13. Certain Relationships and Related Transactions

On February 19, 2003, we completed a refinancing of our indebtedness with the PNC Bank, National Association and H.F. Lenfest in the aggregate amount of $29,800,000. Pursuant to the terms of a Convertible Note and Warrant Purchase Agreement, dated February 18, 2003, between us and Mr. Lenfest, we issued to Mr. Lenfest (i) a 10% senior subordinated convertible promissory note in the original principal amount of $10,000,000 and (ii) warrants to purchase 803,048 shares of our common stock. As a condition to closing the financing, we appointed Mr. Lenfest to our Board of Directors. On October 25, 2004, Mr. Lenfest executed a Limited Guaranty Agreement which guaranteed the Company's $5 million Letter of Credit facility with PNC, and in connection therewith, we issued a Stock Purchase Warrant to Mr. Lenfest pursuant to which Mr. Lenfest was entitled to purchase up to 200,000 shares of our common stock at an exercise price equal to the lesser of $4.00 per share or 2/3 of the average daily high and low closing price of our common stock during the 25 day trading period immediately preceding the date of exercise. On February 14, 2005 Mr. Lenfest exercised all of his outstanding warrants and received 1,003,048 shares of unregistered common stock and purchased an additional 373,831 shares of unregistered common stock for approximately $2 million. Under the American Stock Exchange listing rules, shareholder approval was required for this transaction and was included as a proxy item at our annual meeting in 2005. Shareholder approval was received at our 2005 annual meeting.

On April 6, 2006, the Company entered into a Preferred Stock Purchase Agreement (the "Agreement") with Mr. Lenfest. The Agreement permits us to unilaterally draw down up to $15 million over the next eighteen (18) months in exchange for shares of the Company's newly-created Series B Cumulative Convertible Preferred Stock ("Preferred Stock"). The Preferred Stock provides for a dividend equal to six (6) percent per annum. After three (3) years, the Preferred Stock will be convertible, at Mr. Lenfest's request, into ETC common shares at a conversion price (the "Conversion Price") which will be set on the day of each draw down. The Conversion Price will be equal to the closing price of the Company's common stock on the trading day immediately preceding the day in which the draw down occurs, subject to a floor price of $4.95 per common share. Drawdowns will not be permitted on any day when the Conversion Price would be less than this floor price. On the sixth anniversary of the Agreement, any issued and outstanding Preferred Stock will be mandatorily converted into ETC common stock at each set Conversion Price. The Agreement also allows for the Company to redeem any outstanding Preferred Stock any time within the six (6) year term of the Agreement. The Preferred Stock will vote with the ETC common stock on an as converted basis.

In connection with the execution of the Agreement, the Company drew down $3 million by issuing 3,000 shares of Preferred Stock with a Conversion Price equal to $4.95 per share.

For a more detailed description of the financing provided by Mr. Lenfest and PNC, see the Liquidity and Capital Resources section of the Annual Report to Stockholders attached as Exhibit 13 to this Annual Report on Form 10-K and incorporated herein by reference.

Prior to the consummation of the February 19, 2003 refinancing, ATAM, a shareholder and a holder of warrants to purchase 332,820 shares of our common stock, consented to the financing transactions with PNC and Mr. Lenfest including the below market issuance of warrants to Mr. Lenfest. As a result of its consent, ATAM waived, solely in connection with such issuance, the anti-dilution rights contained in its warrant. In exchange for ATAM's consent and waiver, we issued to ATAM warrants to purchase an additional 105,000 shares of common stock. Except for the number of shares issuable upon exercise of the warrants, the new ATAM warrants had substantially the same terms as the warrants issued to Mr. Lenfest. As of the date that these warrants were issued to ATAM, it was the beneficial owner of greater than 5% of our common stock as determined in accordance with Rule 13d-3 under the Securities Exchange Act of 1934. In fiscal year 2005, ATAM exercised all its warrants and received a total of 437,820 shares of our common stock.

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Item 14. Principal Accounting Fees and Services

Under the Company's Bylaws and the charter of the Audit Committee of the Board of Directors, authority to select the Company's auditors rests with the Audit Committee of the Board of Directors. Such selection is made through formal act of the Audit Committee. It has not been and is not the Company's policy to submit selection of its auditors to the vote of the shareholders because there is no legal requirement to do so. Grant Thornton LLP, an independent registered public accounting firm, was the Company's auditor for the fiscal year ended February 24, 2006. Auditors have not been selected for the current fiscal year. A representative of Grant Thornton is expected to be present at the Annual Meeting and will be given an opportunity to make a statement to the shareholders, if he or she desires to do so. Grant Thornton's representative will also be available to answer appropriate questions from shareholders.

Set forth below is information relating to the aggregate Grant Thornton LLP fees for professional services provided to the Company for the fiscal year ended February 24, 2006:

Audit Fees

The following table presents fees for professional audit services rendered by Grant Thornton LLP for the audit of the Company's annual financial statements for the fiscal years ended February 24, 2006 and February 25, 2005, respectively, and fees billed for other services rendered by Grant Thornton LLP.

	FY 2006	FY 2005
Audit Fees	$ 98,508	$ 96,500
Audit related fees (1)	$ 54,276	$ 29,000
Audit and audit related fees	$ 152,784	$ 125,500
Tax fees (2)	$ 23,805	$ 52,757
Total fees	$ 176,589	$ 178,257

(1) Audit related fees consist primarily of employee benefit plan audits and assistance with foreign statutory financial statements.

(2) Tax fees consist of tax compliance services and other consultations on miscellaneous tax matters.

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PART IV

Item 16. Exhibits and Financial Statement Schedules.

(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.
3.1(i)	Statement with respect to shares of Series B Convertible Preferred Stock, filed as Exhibit 3(i) 1, to Registrant's Form 8-K dated April 6, 2006, and incorporated herein by reference.
3.2	Registrant's amended and restated By-Laws were filed as Exhibit 3.2 to Registrant's Form 8-K dated May 25, 2005, and are incorporated herein by reference.
4.1	$10,000,000 Senior Subordinated Convertible Note, dated February 18, 2003, issued by the Registrant in favor of H.F. Lenfest was filed on February 25, 2003 as Exhibit 4.1 to Form 8-K and is incorporated herein by reference.
4.2	Stock Purchase Warrant, dated February 18, 2003, issued by the Registrant in favor of H.F. Lenfest was filed on February 25, 2003 as Exhibit 4.2 to Form 8-K and is incorporated herein by reference.
4.3	Stock Purchase Warrant, dated February 18, 2003, issued by the Registrant in favor of ETC Asset Management, LLC was filed on February 25, 2003 as Exhibit 4.3 to Form 8-K and is 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, was 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. *
10.4	Stock Purchase Warrant dated as of December 26, 2001, issued by the Registrant to the Registrant Asset Management, LLC was filed as Exhibit 10.7 to the Registrant's Form 10-K for the fiscal year ended February 22, 2002 and is incorporated herein by reference.
10.5	Credit Agreement, dated as of February 18, 2003 between the Registrant and PNC Bank, National Association was filed on February 25, 2003 as Exhibit 10.1 to Form 8-K and is incorporated herein by reference.
10.6	Amendment to Credit Agreement, dated as of April 30, 2003, between the Registrant and PNC Bank was filed as Exhibit 10.6 to the Registrant's Form 10-K for the fiscal year ended February 28, 2003 and is incorporated herein by reference.
10.7	Amended and Restated Revolving Credit Note, dated April 30, 2003, issued by the Registrant in favor of PNC Bank was filed as Exhibit 10.6 to the Registrant's Form 10-K for the fiscal year ended February 28, 2003 and is incorporated herein by reference.
10.8	Security Agreement, made and entered into as of February 18, 2003, by and between the Registrant, Entertainment Technology Corporation, ETC Delaware, Inc. and PNC Bank was filed on February 25, 2003 as Exhibit 10.3 to Form 8-K and is incorporated herein by reference.
10.9	Pledge Agreement, dated as of February 18, 2003, made by the Registrant in favor of PNC Bank was filed on February 25, 2003 as Exhibit 10.4 to Form 8-K and is incorporated herein by reference.
10.10	Pledge Agreement (Bank Deposits), dated as of February 18, 2003, made by the Registrant in favor of PNC Bank was filed on February 25, 2003 as Exhibit 10.5 to Form 8-K and is incorporated herein by reference.
10.11	Guaranty, dated as of February 18, 2003, made by Entertainment Technology Corporation and ETC Delaware, Inc. in favor of PNC Bank was filed on February 25, 2003 as Exhibit 10.6 to Form 8-K and is incorporated herein by reference.
10.12	Open-End Mortgage and Security Agreement, made as of February 18, 2003, by the Registrant in favor of PNC Bank was filed on February 25, 2003 as Exhibit 10.7 to Form 8-K and is incorporated herein by reference.

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Number	Item
10.13	Convertible Note and Warrant Purchase Agreement, dated February 18, 2003, by and between the Registrant and Lenfest was filed on February 25, 2003 as Exhibit 10.8 to Form 8-K and is incorporated herein by reference.
10.14	Registration Rights Agreement, dated as of February 18, 2003, by and between the Registrant and H.F. Lenfest was filed on February 25, 2003 as Exhibit 10.9 to Form 8-K and is incorporated herein by reference.
10.15	Security Agreement, made and entered into as of February 18, 2003, by and among the Registrant, Entertainment Technology Corporation, ETC Delaware, Inc. and H.F. Lenfest was filed on February 25, 2003 as Exhibit 10.10 to Form 8-K and is incorporated herein by reference.
10.16	Guaranty, dated as of February 18, 2003, made by Entertainment Technology Corporation and ETC Delaware, Inc. in favor of H.F. Lenfest was filed on February 25, 2003 as Exhibit 10.11 to Form 8-K and is incorporated herein by reference.
10.17	Open-End Mortgage and Security Agreement, made as of February 18, 2003, by the Registrant in favor of H.F. Lenfest was filed on February 25, 2003 as Exhibit 10.12 to Form 8-K and is incorporated herein by reference.
10.18	Subordination and Intercreditor Agreement, dated as of February 18, 2003, among PNC Bank, H.F. Lenfest and the Registrant was filed on February 25, 2003 as Exhibit 10.13 to Form 8-K and is incorporated herein by reference.
10.19	Amendment to Credit Agreement, dated as of August 24, 2004, between the Registrant and PNC Bank, National Association, was filed on September 10, 2004 as Exhibit 10.1 to Form 8-K and is incorporated herein by reference.
10.20	Second Amended and Restated Revolving Credit Note, dated as of August 24, 2004, between the Registrant and PNC Bank, National Association, was filed on September 10, 2004 as Exhibit 10.2 to Form 8-K and is incorporated herein by reference.
10.21	Limited Guaranty Agreement, dated as of August 24, 2004, of H.F. Lenfest in favor of PNC Bank, National Association, was filed on September 10, 2004 as Exhibit 10.3 to Form 8-K and is incorporated herein by reference.
10.22	Stock Purchase Warrant, dated as of September 7, 2004, between the Registrant and H.F. Lenfest, was filed on September 10, 2004 as Exhibit 4.1 to Form 10-K and is incorporated herein by reference.
10.23	Amendment to Credit Agreement, dated as of October 18, 2004, between the Registrant and PNC Bank, National Association, was filed on January 10, 2005 as Exhibit 10.1 to Form 10-Q and is incorporated herein by reference.
10.24	Subscription Agreement, dated as of February 14, 2005, between the Registrant and H.F. Lenfest, was filed on February 16, 2005 as Exhibit 10.1 to Form 8-K and is incorporated herein by reference.
10.25	2005 Non-employee Director Stock Option Plan, incorporated by reference to Annex A of Registrant's Definitive Proxy Statement on Schedule 14A filed on August 16, 2005 and incorporated herein by reference. *
10.26	Preferred Stock Purchase Agreement between the Registrant and H.F. Lenfest, dated as of April 6, 2006, filed as Exhibit 10.1 to Registrant's Form 8-K dated April 6, 2006, and incorporated herein by reference.
10.27	Registration Rights Agreement between the Registrant and H.F. Lenfest, dated as of April 6, 2006, filed as Exhibit 10.2 to Registrant's Form 8-K dated April 6, 2006, and incorporated herein by reference.
13	Portions of Registrant's 2006 Annual Report to Shareholders which are incorporated by reference into this Form 10-K
21	Subsidiaries of the Registrant.
23	Consent of Grant Thornton LLP.
31.1	Certification dated May 25, 2006 pursuant to Rule 13a-14(a) under the Securities Exchange Act of 1934 made by William F. Mitchell, Chief Executive Officer.
31.2	Certification dated May 25, 2006 pursuant to Rule 13a-14(a) under the Securities Exchange Act of 1934 made by Duane D. Deaner, Chief Financial Officer.
32	Certification dated May 25, 2006 pursuant to 18 U.S.C. Section 1350 as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 made by William F. Mitchell, Chief Executive Officer and Duane D. Deaner, Chief Financial Officer.

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

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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 (Principal Executive Officer)	May 25, 2006
/s/ Duane D. Deaner Duane D. Deaner	Chief Financial Officer (Principal Financial and Accounting Officer)	May 25, 2006
/s/ Howard W. Kelley Howard W. Kelley	Director	May 25, 2006
/s/ H.F. Lenfest H.F. Lenfest	Director	May 25, 2006
/s/ George K. Anderson George K. Anderson, M.D.	Director	May 25, 2006
/s/ Alan M. Gemmill Alan M. Gemmill	Director	May 25, 2006

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EXHIBIT INDEX

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32	Certification dated May 25, 2006 pursuant to 18 U.S.C. Section 1350 as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 made by William F. Mitchell, Chief Executive Officer and Duane D. Deaner, Chief Financial Officer.

EXHIBIT 13

PORTIONS OF
ENVIRONMENTAL TECTONICS CORPORATION
2006
ANNUAL REPORT TO STOCKHOLDERS

FINANCIAL REVIEW

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

Fiscal Year End	2006	2005	2004	2003	2002
Net sales	$ 25,069	$ 27,814	$ 25,995	$ 43,123	$ 32,527
Gross profit	5,350	6,176	9,943	14,198	11,465
Operating (loss)/income	(4,719)	(7,130)	131	4,116	2,873
Net (loss)/income	(6,714)	(8,113)	(793)	2,493	1,741
(Loss)/earnings per common share:					
Basic	(0.74)	(1.06)	(.11)	.35	.24
Diluted	(0.74)	(1.06)	(.11)	.33	.23
Working capital	19,820	29,818	29,907	31,216	30,683
Long-term obligations	8,376	12,087	12,157	12,643	16,688
Total assets	33,667	47,909	48,696	47,698	48,482
Total stockholders' equity	17,553	24,355	25,054	25,907	20,782
Weighted average common shares:					
Basic	9,021,000	7,656,000	7,163,000	7,153,000	7,143,000
Diluted	9,021,000	7,656,000	7,163,000	7,497,000	7,499,000

No cash dividends have ever been paid on the Company's common stock, and the Company is prohibited from declaring any cash dividends on its common stock under the terms of its existing credit facilities.

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

FORWARD-LOOKING STATEMENTS

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

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

The Company cautions that the foregoing list of important factors is not exclusive. The Company does not undertake to update any forward-looking statement, whether written or oral, that may be made from time to time by or on behalf of the Company.

Overview

We are principally engaged in the design, manufacture and sale of software driven products used to create and monitor the physiological effects of motion on humans and equipment and to control, modify, simulate and measure environmental conditions. These products include aircrew training systems, entertainment products, sterilizers, environmental and hyperbaric chambers and other products that involve similar manufacturing techniques and engineering technologies.

The following factors had an adverse impact on our performance for the fiscal year ended February 24, 2006:

- unfavorable global economic and political conditions for our aeromedical products;

Historically our ATS open contract mix has included one large order (e.g., a centrifuge or an order for an entire training center of equipment), a few medium-priced simulators, and other low-end trainers. Large dollar contracts have tended to be received every 18 months to two years, although some significant events such as September 11, 2001, and the action in Iraq have disrupted this cycle. The ATS product line is especially sensitive to global economic and political pressures including anti-American sentiment. Fiscal 2006 saw a continuation of the new contract delays due to budget constraints and other issues of our customers located throughout the world. Most of our ATS sales are to international government defense customers.

Our continuing development of the Advanced Tactical Flight Simulation ("ATFS") technology is a response to these changing world conditions. Fiscal 2006 saw the continuation of our education and marketing efforts to introduce our ATFS to the U.S. military. Although the cost of developing and marketing this technology is high, the evolution of these exciting and state-of-the-art technologies is an important step in our goal of integrating flight and aeromedical training in a simulator device. This technology allows a fighter pilot to practice tactical air combat maneuvers such as dodging enemy missiles, ground fire and aircraft obstacles while experiencing the real life environment of a high-G Force fighter aircraft. These flight trainers provide a low cost and extremely less risky alternative to actual air flight. We believe that armed forces agencies of various governments will appreciate the efficiency of these technologies, especially in this time of fiscal conservatism and budgetary constraints throughout the world.

- continued development of flexibility and functionality in our Advanced Disaster Management Senario product line;

  We have made significant progress in advancing and enhancing our ADMS line of products. Graphics are sharper and more realistic, interactivity and connectivity of objects is tighter, additional disaster scenarios have been added, and we have made the hardware configuration more user friendly. However, this effort has put pressure on our gross margins. Also, until recently our marketing efforts were not focused and ineffective. Late in the fiscal year we began a telemarketing campaign and added experienced marketing staff. Although these actions will initially increase operating expenses, early responses from the market imply that these marketing efforts will result in an increased order flow for this line.

- limited revenue generation coupled with high development costs in our low-end entertainment products;

  Certain actions by a former major entertainment customer have effectively closed the high-end amusement market to us. Our low-end products have encountered customer resistance due to pricing and those units under a revenue share contract have failed to generate sufficient income to justify an expansion of this line. Consequently, this line has suffered from high development costs with low payback. We consider this line to be an opportunistic business and will plan our development accordingly.

- higher costs of capital and amortization of deferred finance charges;

  Interest expense for fiscal 2006 was $1,857,000 or 7.4% of sales. This included approximately $1,100,000 million of non-cash charges for amortization/write-off of deferred finance and debt discount expenses. We anticipate that this number will decrease significantly going forward.

- Higher bad debt and inventory reserves;

  During fiscal 2006 we significantly increased both our accounts receivable and inventory reserves. We fully reserved for a large international receivable which has been adjudicated in our favor but which may be difficult to collect. In inventory, we partially reserved for some of our mid-line trainers which have experienced slow sales in the most recent periods.

- litigation and claims costs;

  Although down significantly from fiscal 2005, these costs continue to be a major component of our general, administrative and selling costs.

- cash flow;

  One of the greatest challenges we face is adequately funding the cash requirements of large, long-term multi-year projects. Although these contracts normally incorporate milestone payments, the cash flows associated with production and material requirements tend to vary significantly over time. These projects are usually cash positive in the early stages and cash negative during the production phase. Funding these contracts requires a significant amount of operating funds and may hamper other types of business. On May 19, 2006 we signed an amendment to our bank agreement with PNC Bank, National Association extending the termination date to June 30, 2006. This $5,000,000 facility is restricted to use for issuing letters of credit. As of May 12, 2006, we had used approximately $2,900,000 million of this facility for international letters of credit. However, we may have access to funds under an equity line agreement executed on April 7, 2006 with H.F. Lenfest, holder of the Company's subordinated debt. Under certain conditions, we will have access to up to $15 million in cash to support operations. Given our low beginning sales backlog and ongoing difficulty in obtaining new contracts, we may need to obtain additional sources of capital in order to continue growing and operating our business. Because we have established businesses in many markets, significant fixed assets including a building, and other business assets which can be used for security, we believe that we will be able to locate such additional sources of capital, although there is no assuredness that we will be successful in this endeavor.

We face the following challenges and business goals in order to make fiscal 2007 a successful year:

Aircrew Training Systems

- Market all the aeromedical products we technologically enhanced in the prior fiscal years.
- We have heavily invested in enhancing functionality and product capability of three ATS products: our centrifuge-based flight simulator, our General Aviation Trainer (GAT), and our Gyro-IPT. Repeat sales of these state-of-the-art simulators will allow us to recoup the costs of our non-recurring engineering and design effort.
- Continue to evolve Advanced Tactical Flight Simulation (ATFS). Our challenge will be to find funding to continue this critical development objective, either through federal, state or local government grants or a customer order.

NASTAR

- In fiscal 2006, we began construction of the National AeroSpace Training and Research Center (NASTAR Center). This center, set to open in January 2007, will offer a complete range of aviation training and research support for military and civil aviation as well as space travel and tourism. The NASTAR Center will house state of the art equipment including the ATFS-400, GYROLAB GL-2000 Advanced Spatial Disorientation Trainer, Hypobaric Chamber and Night Vision and Night Vision Goggle Training System. These products represent 37 years of pioneering development and training solutions for the most rigorous stresses encountered during high performance aircraft flight including the effects of altitude exposure, High G exposure, spatial disorientation and escape from a disabled aircraft. Our challenge for fiscal 2007 is to locate outside funding to support this initiative.

Environmental

- Our product emphasis in this line has been the automotive industry, an industry which has been hit with huge losses and financial pressure. We will need to revisit products we marketed for other applications in the past to support the overhead of this group.

ADMS

- In prior years, we have spent significant time and funds to develop and refine this technology. In fiscal 2007, we need to emphasize our sales and marketing efforts for this product group. Demonstrations, exhibiting at trade shows, tele-marketing, visiting potential customer sites: These and other approaches need to be explored to develop awareness for this simulation product. An additional objective for fiscal 2007 is to facilitate customer's utilizing Homeland Security funds to purchase our products.

Claims/Litigation

- Continue to pursue outstanding commercial litigation and the Company's claim against the U.S. government with a goal of mediation or settlement.

ETC-PZL

- During fiscal 2006, ETC-PZL performed under a significant contract from L-3 Communications. This contract was virtually complete at the end of fiscal 2006. ETC-PZL will need to replace this revenue with other contracts, either in or outside of Poland.

At February 24, 2006, we were involved in major commercial and government litigation which will require a significant amount of our time and effort. These activities will potentially detract from other business issues and require significant funding.

Liquidity

- We do not currently have a bank facility which can be used to borrow funds for operations.

  On May 19, 2006 we signed an amendment to our bank agreement with PNC Bank, National Association extending the termination date to June 30, 2006. This $5,000,000 facility is restricted to use for issuing letters of credit. As of May 12, 2006, we had used approximately $2,900,000 million of this facility for international letters of credit. On April 7, 2006, we entered into a Preferred Stock Purchase Agreement (the "Agreement") with H. F. "Gerry" Lenfest, a Director, significant shareholder and holder of our subordinated debt. The Agreement permits us to unilaterally draw down up to $15 million over the next eighteen (18) months in exchange for shares of our newly-created Series B Cumulative Convertible Preferred Stock ("Preferred Stock"). The Preferred Stock provides for a dividend equal to six (6) percent per annum. After three (3) years, the Preferred Stock will be convertible, at Mr. Lenfest's request, into ETC common shares at a conversion price (the "Conversion Price") which will be set on the day of each draw down. The Conversion Price will be equal to the closing price of the Company's common stock on the trading day immediately preceding the day in which the draw down occurs, subject to a floor price of $4.95 per common share. Drawdowns will not be permitted on any day when the Conversion Price would be less than this floor price. On the sixth anniversary of the Agreement, any issued and outstanding Preferred Stock will be mandatorily converted into ETC common stock at each set Conversion Price. The Agreement also allows for us to redeem any outstanding Preferred Stock any time within the six (6) year term of the Agreement. The Preferred Stock will vote with the ETC common stock on an as converted basis.

In connection with the execution of the Agreement, we drew down $3 million by issuing 3,000 shares of Preferred Stock with a Conversion Price equal to $4.95 per share.

Revenue Recognition

We currently market our products and services primarily through our sales offices and employees. In addition, we also utilize the services of approximately 100 independent sales agents and organizations in seeking foreign orders for our products.

We generally customize our products using our proprietary software based on specifications provided by our customers. Many of these products are capital intensive and take more than one year to manufacture and deliver to the customer. In the ATS segment, we sell our Aircrew Training Devices to military and commercial airline operators both in the United States and internationally. We sell our Entertainment products to amusement parks, zoos and museums. We sell our Disaster Management Simulation products to state and local governments. In our Industrial Group, we sell our sterilizers to pharmaceutical and medical device manufacturers. We sell our Environmental systems primarily to commercial automobile manufacturers and heating, ventilation and air conditioning (HVAC) manufacturers and our Hyperbaric products to the military (mainly larger chambers) and hospitals and clinics (mainly monoplace chambers). To a lesser degree, we provide upgrade, maintenance and repair services for our products and for products manufactured by other parties.

We recognize revenue using three methods:

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

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

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

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

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

Critical Accounting Policies

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

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

Revenue Recognition on Long-Term Contracts

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

We account for some of our largest contracts, including our contracts with the U.S. and other foreign governments, using the percentage-of-completion method. If we do not accurately estimate the total cost to be incurred on this type of contract, or if we are unsuccessful in the ultimate collection of associated contract claims, estimated gross margins may be significantly impacted or losses may need to be recognized in future periods. Any resulting reductions in margins or contract losses could be material to our results of operations and financial position.

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

Accounts Receivable

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

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

Results of Operations

We have historically experienced significant variability in our quarterly revenue, earnings and other operating results, and our performance may fluctuate significantly in the future.

Fiscal 2006 versus Fiscal 2005

Summary Table of Results

	52 weeks ended Feb. 24, 06	52 weeks ended Feb. 25, 05	Variance $	Variance %
	(amounts in thousands)		( ) = Unfavorable	
Sales:				
Domestic	$ 9,140	$ 11,998	$ (2,858)	(23.8%)
US Government	2,586	2,904	(318)	(11.0%)
International	13,343	12,912	431	3.3%
Total Sales	25,069	27,814	(2,745)	(9.9%)
Gross Profit	5,350	6,176	(826)	(13.4%)
Selling, general & administrative	9,625	12,450	2,825	22.7%
Research & development	422	856	434	50.7%
Impairment expense	22	—	—	n/a
Operating loss	(4,719)	(7,130)	2,411	33.8%
Interest expense, net	1,857	1,792	(65)	(3.6%)
Other expense, net	7	308	301	97.7%
Income taxes	136	(1,117)	(1,253)	(1,021.3%)
Minority Interest	17	—	(17)	n/a
Net loss	$ (6,714)	$ (8,113)	$ 1,399	17.2%
Net loss per common share	$ (0.74)	$ (1.06)	$ 0.32	30.2%

Net Loss.

The Company had a net loss of $6,714,000 or ($0.74) per share (diluted) in 2006 versus a net loss of $8,113,000 or ($1.06) per share (diluted) in fiscal 2005, an improvement of $1,399,000 or 17.2%. Operating loss was $4,719,000 versus an operating loss of $7,130,000 in 2005, an improvement of $2,411,000 or 33.8%. The improvement in operating loss resulted from lower selling, general and administrative costs and research and development costs which were only partially offset by reduced gross profit. Net loss in fiscal 2006 did not have any income tax benefit offset. (See the section on income taxes following.)

Sales.

For the fiscal year ended February 24, 2006, total sales were $25,069,000, a decrease of $2,745,000 or 9.9% from fiscal 2005. The reduction reflected a significant ($7,041,000, 26.3%) decrease in our domestic operation which was only partially offset by a correspondingly significant ($4,417,000, 577.4%) increase in our Polish subsidiary, ETC-PZL. Product line sales in ETC Southampton in the current period were down in all categories except sterilizers versus the prior period. The decrease in Aircrew Training Systems (ATS) sales in ETC Southampton ($4,327,000, 32.6%) reflected completion of a centrifuge device for Malaysia in the prior period and revenue for the aforementioned claim settlement. Hyperbaric was down reflecting, again in the prior period, the near completion of two large chambers destined for a Middle Eastern navy. Entertainment was down $1,168,000, 85.6%, reflecting reduced sales of the Wild Earth amusement ride. The increase in sterilizers ($1,522,000, 82.6%) primarily reflected increased sales for mid-size steam units.

Geographically, domestic sales were $9,140,000, down $2,858,000, or 23.8%, from fiscal 2005, and represented 36.5% of total sales, down from 43.1% in fiscal 2005, primarily reflecting reduced activity for hyperbaric, entertainment and PTS. U.S. government sales decreased to $2,586,000, as compared to $2,904,000 in fiscal 2005, and represented 10.3% of total sales, down from 10.4% in fiscal 2005. International sales, including those in the Company's foreign subsidiaries, were $13,343,000, up $431,000 or 3.3%, and represented 53.2% of total sales, up from 46.4% in fiscal 2005, primarily reflecting significantly increased sales in ETC-PZL. Throughout our history, most of the sales for ATS products have been made to international customers.

In fiscal 2006 two customers represented individually 10% or more of total sales, L-3 Communications and the Pakistan Air Force, which together generated $7,509,000 or 30% of total sales. International sales totaling at least $500,000 per country were made to customers in Pakistan, Japan and China. Fluctuations in sales to international countries from year to year primarily reflect percentage of completion revenue recognition on the level and stage of development and production on multi-year long-term contracts. Open orders for two international customers and one domestic customer represented 47.4% of our backlog at February 24, 2006. For a discussion of the additional risks associated with our international operations, see "Risks Particular to Our Business—There are certain risks inherent in our international business activities, which constitute a significant portion of our business," in our Annual Report on Form 10-K.

We have historically experienced significant variability in our sales performance. This reflects the existing sales backlog, product and the nature of contract (size and performance time) mix, the manufacturing cycle and amount of time to effect installation and customer acceptance, and certain factors not in our control such as customer delays and the time required to obtain U.S. Government export licenses. One or a few contract sales may account for a substantial percentage of our quarterly revenue.

Domestic Sales.

Overall, domestic sales in fiscal 2006 were $9,140,000 as compared to $11,998,000 in fiscal 2005, a decrease of $2,858,000 or 23.8%, reflecting reduced activity for all product types except sterilizers. Most significantly, hyperbaric (down $1,828,000, 67.6%) suffered from the near completion in the prior year period on a POC revenue basis of a contract for two large chambers destined for a foreign navy. Entertainment sales were down from the prior period as fiscal 2005 reflected significant revenue for the first year orders of "Wild Earth" and "Monster Truck" amusement rides. ATS sales were down as the prior period included a sale of a Gyro-IPT. Domestic sales represented 36.5% of our total sales in fiscal 2006, down from 43.1% in fiscal 2005. Sales to the U.S. Government in fiscal 2006 were $2,586,000 as compared $2,904,000 in fiscal 2005, and represented 10.3% of total sales in fiscal 2006 versus 10.4% in fiscal 2005.

International Sales.

International sales in fiscal 2006, including those in our foreign subsidiaries, were $13,343,000 as compared to $12,912,000 in fiscal 2005, an increase of $431,000 or 3.3%, and represented 53.2% of total sales as compared to 46.4% in fiscal 2005. Throughout our history, most of the sales for ATS have been made to international customers. In fiscal 2006 international sales totaling at least ten percent of total international sales were made in our Polish subsidiary to L-3 Communications ($4,599,000) and to a government customer in Pakistan ($2,910,000). In fiscal 2005 international sales totaling at least ten percent of total international sales were made to government or commercial accounts in Malaysia ($3,388,000) and Egypt ($2,309,000). Fluctuations in sales to international countries from year to year primarily reflect revenue recognition on the level and stage of development and production on multi-year long-term contracts.

Segment Sales.

Segment Sales ($000 except for %)

	Aircrew Training Systems		Industrial Group		Total	
	$	%	$	%	$	%
Fiscal 2006	15,100	60.2	9,969	39.8	25,069	100.0
Fiscal 2005	16,787	60.3	11,027	39.7	27,814	100.0

On a segment basis, sales of our ATS products, which create and monitor the physiological effects of motion (including spatial disorientation and centrifugal forces) on humans and equipment for medical, training, research and entertainment markets, were $15,100,000 in fiscal 2006, a decrease of $1,687,000, or 10.1% from fiscal 2005. Sales of these products accounted for 60.2% of our sales versus 60.3% in fiscal 2005. Sales in our other segment, the Industrial Group, which designs and produces chambers that create environments that are used for sterilization, research and medical applications, decreased $1,058,000 to $9,969,000, a decrease of 9.6%, and constituted 39.8% of our total sales compared to 39.7% in fiscal 2005.

Significant claims outstanding at February 24, 2006 and February 25, 2005 included a claim with the U.S. Navy for a submarine decompression chamber ($3.0 million recorded). We have settled two international claims in the last two fiscal years. On February 8, 2005, we reached an agreement totaling $4.7 million on an international claim and effective February 27, 2004 we reached an agreement totaling $10.5 million on another international claim. Although recorded as a current asset in the financial statements, all remaining claim revenues may not be received in full during fiscal 2007. For a more complete discussion of outstanding claims, see “Note 3. Accounts Receivable” to our consolidated financial statements in the Annual Report to Stockholders following.

Gross Profit.

Gross profit for fiscal 2006 decreased by $826,000 or 13.4% from fiscal 2005 reflecting the sales decrease and a slight (0.9 percentage point) decrease in the gross profit rate as a percent of sales. The dollar decrease primarily resulted from the aforementioned sales reductions in our domestic operation’s ATS, hyperbaric and entertainment product areas coupled with an increase in inventory reserves. The reduction in the rate as a percent of sales primarily reflected reduced margin performance in ETC-PZL and the impact of additional reserves as the margin rates for most product areas in our domestic operation were favorable versus the prior period, most significantly double digit increases in environmental, PTS and simulation. Acting as a partial offset was increased gross profit dollars at a slightly better rate. This improvement reflected the aforementioned significant increase in sales primarily for mid-sized steam units. Both PTS and simulation margin performance reflected continued additional product development costs, both to enhance functionality of existing products and to develop product extensions, which negatively impacted gross profit as these costs are primarily charged directly to the cost of sales for specific orders.

Selling and Administrative Expenses.

Selling and administrative expenses decreased $2,825,000, or 22.7%, from fiscal 2005. The major difference during the periods was reduced legal and claim expenses. During fiscal 2005, we incurred significant legal costs and claims expenses to support an international claim which was settled on February 8, 2005. Acting as a partial offset were additional bad debt reserves. As a percentage of sales, selling and administrative expenses were 38.4% in fiscal 2006 compared to 44.8% in fiscal 2005.

Research and Development Expenses.

Research and development expenses decreased $434,000 or 50.7% in fiscal 2006 as compared to fiscal 2005. This decrease reflected both reduced spending and the timing of reimbursement for government grants in our Turkish subsidiary under a government research award for two projects. Most of our research efforts, which were and continue to be a significant cost of our business, are included in cost of sales for applied research for specific contracts, as well as research for feasibility and technology updates. Capitalized software development costs for fiscal 2006 were $850,000 compared to $1,466,000 in fiscal 2005. Amortization of software costs, which was charged to cost of sales, was $1,224,000 and $988,000 for fiscal 2006 and fiscal 2005, respectively.

Impairment Expense.

Impairment expense resulted from the write-off of goodwill associated with our European subsidiary located in the United Kingdom. Although this subsidiary performs sales and service support for us, as of fiscal year end there were no open local contracts which would generate sufficient income to justify the carrying value of goodwill.

Operating Loss.

Operating loss was $4,719,000 compared to an operating loss of $7,130,000 in 2005, an improvement of $2,411,000 or 33.8%. This improvement primarily reflected reduced general and administrative spending partially offset by a reduced gross profit.

On a segment basis, ATS had an operating loss of $3,555,000, an improvement of $1,213,000 or 25.4% over fiscal 2005, while the Industrial Group had an operating loss of $362,000 in fiscal 2006, a reduction in operating loss of $1,156,000 from fiscal 2005. These segment operating results were offset, in part, by unallocated corporate expenses of $780,000, a decrease of $66,000 from fiscal 2005.

The decrease in operating loss for the ATS segment in fiscal 2006 reflected lower operating expenses, primarily claims and legal expenses, as both sales and corresponding gross profit were down from fiscal 2005.

The Industrial Group segment's improved performance in fiscal 2006 reflected a higher gross margin despite the sales decrease coupled with slightly lower (down 9.8%) operating expenses.

Interest Expense.

Interest expense (net of interest income) increased $65,000 or 3.6% in fiscal 2006 from fiscal 2005 primarily reflecting additional deferred finance charges resulting from a settlement of a lawsuit which was partially offset by reduced interest expense on lower debt including the redemption on August 1, 2005, of our long-term bonds. Interest expense includes interest on our debt, amortization of debt discount resulting from the beneficial conversion option of our subordinated debt and associated warrants issued with the debt, amortization of deferred financing costs from our previous Refinancing, and amortization of debt discount resulting from the additional warrants issued to H.F. Lenfest in exchange for his guarantee on a portion of the bank facility in August 2004.

Bank Fees.

Bank fees decreased $308,000 or 76.8% in fiscal 2006 versus fiscal 2005 reflecting significantly reduced charges for bank agreement amendments and covenant violation waivers.

Letter of Credit Fees.

Letter of credit fees increased $39,000 or 76.5% in fiscal 2006 versus fiscal 2005 reflecting additional international contracts banking charges.

Other Income, net.

Other income, net, increased $55,000 or 38.5% in fiscal 2006 versus fiscal 2005 reflecting higher exchange gain in our Polish subsidiary, ETC-PZL.

Provision for/(Benefit from) Income Taxes.

Income tax expense in fiscal 2006 represented income taxes on pre-tax earnings in ETC-PZL and the establishment of a reserve for prior income tax benefits accrued on intercompany transactions losses. Although we reported a pre-tax consolidated operating loss during fiscal 2006, no offsetting income tax benefit and corresponding deferred tax asset was recorded, due to the uncertain nature of their ultimate realization based on past performance and the potential that sufficient taxable income may not be generated in the near future. We will recognize these benefits only as reassessment demonstrates that they are realizable. Realization is entirely dependent upon future earnings in specific tax jurisdictions.

The fiscal 2005 tax benefit reflects the realization of tax loss carry backs resulting from the fiscal 2005 loss. During fiscal 2006, we applied for and received refunds approximating $580,000.

Reflecting the Company's significant losses in the current and prior fiscal years, the Company has approximately $12.6 million of federal and $17.9 million of state net loss carry forwards available to offset future income tax liabilities, expiring in 2025. However, due to the uncertain nature of their ultimate realization based on past performance, and the potential that sufficient taxable income may not be generated in the near future, we have established a full valuation allowance of the same amount against these carry forward benefits and will recognize these benefits only as reassessment demonstrates that they are realizable. Realization is entirely dependent upon future earnings in specific tax jurisdictions. While the need for this valuation allowance is subject to periodic review, if the allowance is reduced, the tax benefits of the carry forwards will be recorded in future operations as a reduction of our income tax expense.

Fiscal 2005 versus Fiscal 2004

	Summary Table of Results			
	52 weeks ended Feb. 25, 05	52 weeks ended Feb. 27, 04	Variance $	Variance %
	(amounts in thousands)		( ) =Unfavorable	
Sales:				
Domestic	$ 11,998	$ 8,856	$ 3,142	35.5%
US Government	2,904	1,717	1,187	69.1%
International	12,912	15,422	(2,510)	(16.3%)
Total Sales	27,814	25,995	1,819	7.0%
Gross Profit	6,176	9,943	(3,767)	(37.9%)
Selling, general & administrative	12,450	9,454	(2,996)	(31.7%)
Research & development	856	358	(498)	(139.1%)
Operating (loss)/income	(7,130)	131	(7,261)	(5,642.8%)
Interest expense, net	1,792	1,606	(186)	(11.6%)
Other expense, net	308	130	(178)	(136.9%)
Income taxes	(1,117)	(810)	307	37.9%
Minority Interest	—	(2)	(2)	(100.0%)
Net loss	$ (8,113)	$ (793)	$ (7,320)	(923.1%)
Net loss per common share	$ (1.06)	$ (0.11)	$ (0.95)	(863.6%)

Net Loss.

The Company had a net loss of $8,113,000 or $1.06 per share (diluted) in 2005 versus a net loss of $793,000 or $.11 per share (diluted) in fiscal 2004. Operating loss was $7,130,000 versus an operating income of $131,000 in 2004. This decrease was primarily the result of reduced gross profits primarily in sterilizers, Pilot Training Systems (PTS) and simulation coupled with higher expenses in all spending categories. Acting as a partial offset were the increased sales volume and a higher income tax benefit.

Sales.

Total sales in fiscal 2005 were $27,814,000, an increase of $1,819,000 or 7.0% over 2004, representing significant increases in environmental ($2,143,000 or 102.6%), hyperbaric ($1,510,000 or 81.3%) and entertainment ($1,031,000 or 308.8%) partially offset by a significant ($2,731,000 or 59.7%) decrease in sterilizer sales. ATS sales were basically flat between the years. Environmental sales benefited from a $1,907,000 or 158.1% increase in domestic sales primarily for automotive applications. Hyperbaric equipment sales were up domestically primarily due to a large multi-place chamber sale from a domestic customer destined for a Middle Eastern navy. Entertainment sales reflected the first year orders of our “Wild Earth” and “Monster Truck” amusement rides. The decrease in sterilizer sales domestically primarily reflected reduced activity for a large Ethylene Oxide (“ETO”) project. Geographically, domestic sales were up $3,142,000 or 35.5%, and represented 43.1% of total sales, up from 34.1% in fiscal 2004, primarily reflecting the increased activity as noted above. U.S. government sales increased to $2,904,000, as compared to $1,717,000 in fiscal 2004, and represented 10.4% of total sales, up from 6.6% of total sales in fiscal 2004. International sales, including those from the Company’s foreign subsidiaries, were down $2,510,000 or 16.3%, and represented 46.5% of total sales, down from 59.3% in fiscal 2004, primarily reflecting significantly reduced sales for ATS. Throughout the Company’s history, most of the sales for Aircrew Training Systems products have been made to international customers.

Only one customer represented 10% or more of sales in fiscal 2005, the Royal Malaysian Air Force, which generated $3,388,000 or 12.2% of total sales. In fiscal 2005, international sales totaling at least $500,000 per country were made to customers in Malaysia, the United Kingdom, Egypt, the Czech Republic, Australia, China, Italy and the United Arab Emirates. 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 two international customers represented 24.2% of the Company’s backlog at February 25, 2005. For a discussion of the additional risks associated with our international operations, see “Risks Particular to Our Business—There are certain risks inherent in our international business activities, which constitute a significant portion of our business,” in our Annual Report on Form 10-K.

We have historically experienced significant variability in our sales performance. This reflects the existing sales backlog, product and the nature of contract (size and performance time) mix, the manufacturing cycle and amount of time to effect installation and customer acceptance, and certain factors not in our control such as customer delays and the time required to obtain U.S. Government export licenses. One or a few contract sales may account for a substantial percentage of our quarterly revenue.

Domestic Sales.

Overall, domestic sales in fiscal 2005 were $11,998,000 as compared to $8,856,000 in fiscal 2004, an increase of $3,142,000 or 35.5%, reflecting increases in all product types except sterilizers and simulation. Environmental benefited from a 258.1% increase in domestic sales primarily for automotive applications. Hyperbaric was up domestically primarily due to a large multi-place chamber sale. Entertainment sales reflected the first year orders of “Wild Earth” and “Monster Truck” amusement rides. The decrease in sterilizer sales domestically primarily reflected reduced activity for a large EtO project. Domestic sales represented 43.1% of the Company’s total sales in fiscal 2005, up from 34.1% in fiscal 2004. Sales to the U.S. Government in fiscal 2005 were $2,904,000 as compared $1,717,000 in fiscal 2004, and represented 6.4% of total sales in fiscal 2005 versus 6.6% in fiscal 2004.

International Sales.

International sales in fiscal 2005 were $12,912,000 as compared to $15,422,000 in the fiscal 2004, a decrease of $2,510,000 or 16.3%, and represented 46.4% of total sales as compared to 59.3% in fiscal 2004. Throughout our history, most of the sales for ATS have been made to international customers. In fiscal 2005 international sales totaling at least ten percent of total international sales were made to customers in Malaysia ($3,388,000) and Egypt ($2,309,000). In fiscal 2004 international sales totaling at least ten percent of total international sales were made to government or commercial accounts in Malaysia ($2,874,000) and the United Kingdom ($3,658,000). Fluctuations in sales to international countries from year to year primarily reflect revenue recognition on the level and stage of development and production on multi-year long-term contracts.

Segment Sales.

Segment Sales ($000 except for %)

	Aircrew Training Systems		Industrial Group		Total	
	$	%	$	%	$	%
Fiscal 2005	16,787	60.3	11,027	39.7	27,814	100.0
Fiscal 2004	15,880	61.1	10,115	38.9	25,995	100.0

On a segment basis, sales of the Company’s ATS products, which create and monitor the physiological effects of motion (including spatial disorientation and centrifugal forces) on humans and equipment for medical, training, research and entertainment markets, were $16,787,000 in fiscal 2005, an increase of $907,000, or 5.7% over fiscal 2004. Sales of these products accounted for 60.3% of the Company’s sales compared to 61.1% in fiscal 2004. The increase in ATS product sales primarily reflected the increased activity in the entertainment area. 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 $912,000 to $11,027,000, an increase of 9.0%, and constituted 39.7% of the Company’s total sales compared to 38.9% in fiscal 2004.

Significant claims outstanding at February 25, 2005 included a claim with the U.S. Navy for a submarine decompression chamber ($3.0 million recorded). Significant claims outstanding at February 27, 2004 included $2.9 million for the aforementioned U.S. Navy claim and $2.6 million for an international customer. Effective February 27, 2004 the Company reached an agreement totaling $10.5 million on a prior international claim. This settlement was paid to the Company in March 2004. On February 8, 2005, the Company reached an agreement totaling $4.7 million on the remaining international claim. This settlement was paid to the Company in February 2005. Although recorded as a current asset in the financial statements, all remaining claim revenues may not be received in full during fiscal 2006. For a more complete discussion of outstanding claims, see “Note 3. Accounts Receivable” to our consolidated financial statements in the Annual Report to Stockholders following.

Gross Profit.

Gross profit for fiscal 2005 decreased by $3,767,000 or 37.9% from fiscal 2004 reflecting significant reductions in most product categories, most notably sterilizer, PTS and simulation. Sterilizers suffered from the aforementioned significant sales decrease and a reduction of the gross profit rate as a percent of sales on a product mix shift to smaller steam sterilizers. Although sales for PTS were basically flat between the periods, the prior period reflected higher claims settlement revenue which resulted in a higher gross profit rate as a percent of sales. Simulation sales were also basically flat between the periods although the current period included additional product development costs, both to enhance functionality of existing products and to develop product extensions, which negatively impacted gross profit as these costs are primarily charged directly to the cost of sales for specific orders. Acting as a partial offset was an improvement in environmental gross profit rates as a percent of sales, although additional budget revisions for cost overruns primarily for international projects resulted in continued negative rates.

Operating Loss.

Operating loss was $7,130,000 vs. an operating income of $131,000 in 2004. This decrease was primarily the result of reduced gross profits primarily in sterilizers, Pilot Training Systems (PTS) and simulation coupled with higher expenses in all spending categories. Acting as a partial offset were the increased sales volume.

On a segment basis, ATS had an operating loss of $4,768,000, a decrease of $5,999,000 or 487.3% from fiscal 2004, while the Industrial Group had an operating loss of $1,518,000 in fiscal 2005, a decrease of $1,270,000 from fiscal 2005. These segment operating results were offset, in part, by unallocated corporate expenses of $846,000, a decrease of $6,000 from fiscal 2004.

The decrease in operating income for the ATS segment in fiscal 2005 reflected lower gross margins, both dollar-wise and as a percent of revenues, for all product categories coupled with higher operating expenses, primarily legal and claims expenses. Acting as a partial offset was an increase in sales between the periods.

The Industrial Group segment's decrease in operating income in fiscal 2005 reflected lower gross margins, primarily for sterilizers and parts and service, coupled with a slight increase in operating expenses. Acting as a partial offset was an improved gross profit, both dollar-wise and as a percent of revenue, for the environmental group.

Selling and Administrative Expenses.

Selling and administrative expenses increased $2,996,000 or 31.7% from fiscal 2004. During fiscal 2005 we incurred significant legal costs and claims expenses to support an international claim (which claim was settled on February 8, 2005) and the lawsuit against Disney, which is in the discovery phase. Approximately 44% of selling and administrative costs in fiscal 2005 were related to legal and accounting fees, claim costs and sales commissions. In fiscal 2004, these costs comprised approximately 30% of selling and administrative costs. As a percentage of sales, selling and administrative expenses were 44.8% in fiscal 2005 compared to 36.4% in fiscal 2004.

Research and Development Expenses.

Research and development expenses increased $498,000 or 139.1% in fiscal 2005 as compared to fiscal 2004. This increase reflected both additional spending and the timing of reimbursement for government grants in our Turkish subsidiary under a government research award for two projects. Most of the Company's research efforts, which were and continue to be a significant cost of its business, are included in cost of sales for applied research for specific contracts, as well as research for feasibility and technology updates. Capitalized software development costs for fiscal 2005 were $1,466,000 compared to $1,716,000 in fiscal 2004. Amortization of software costs, which was charged to cost of sales, was $988,000 and $851,000 for fiscal 2005 and fiscal 2004, respectively.

Interest Expense.

Interest expense (net of interest income) increased $186,000 or 11.6% in fiscal 2005 from fiscal 2004 primarily reflecting increased amortization of both deferred finance expenses from the Company's February 2003 refinancing and subordinated debt discount associated with the Company's subordinated debt. Acting as a partial offset was reduced interest expense for the Company's subordinated debt as the rate was temporarily reduced by two percentage points.

Bank Fees.

Bank fees increased $72,000 or 21.9% in fiscal 2005 over fiscal 2004 primarily reflecting additional charges for bank agreement covenant violation waivers.

Letter of Credit Fees.

Letter of credit fees decreased $76,000 or 59.8% in fiscal 2005 versus fiscal 2004 reflecting reduced international contracts and the timing of letter of credit fees.

Other Income/Expense, net.

Other income/expense, net, decreased 182,000 or 55.8% in fiscal 2005 versus fiscal 2004 as the prior period included the proceeds of an insurance reimbursement for a stolen simulator.

(Benefit from)/Provision for Income Taxes.

The fiscal 2005 tax benefit reflects the realization of tax loss carry backs of the current year's loss. During fiscal 2005 the Company applied for and received refunds approximating $900,000 of these carry backs; at February 25, 2005 an additional $536,000 remained as an income tax receivable reflecting the balance of these carry backs.

Reflecting the Company's significant losses in the current fiscal year, the Company has approximately $7.2 million of federal and $12.5 million of state net loss carry forwards available to offset future income taxes, expiring in 2025. However, due to the uncertain nature of their ultimate realization based on past performance, and the potential that sufficient taxable income may not be generated in the near future, the Company has established a full valuation allowance of the same amount against these carry forward benefits and will recognize these benefits only as reassessment demonstrates that they are realizable. Realization is entirely dependent upon future earnings in specific tax jurisdictions. While the need for this valuation allowance is subject to periodic review, if the allowance is reduced, the tax benefits of the carry forwards will be recorded in future operations as a reduction of the Company's income tax expense.

Liquidity and Capital Resources

During fiscal 2006, we used $7,849,000 of operating cash. This cash was used to fund the operating loss, a build-up of inventories, a reduction in customer deposits and payments to vendors (accounts payable and accrued liabilities). These requirements for cash were partially offset by cash generation from non-cash expenses (depreciation and amortization of software and deferred finance charges), collections in accounts and income tax receivables, and an increase in reserves for receivables and inventory.

Our investing activities used $832,000 in fiscal 2006 and consisted of purchases of capital equipment ($343,000) and capitalized software ($489,000). Given the nature of our market and products, the continued development of generic control and core software and software tools is a critical objective of management.

Our financing activities generated $318,000 of cash during fiscal 2008. This primarily reflected the net cash impact of utilizing our restricted cash to redeem, on August 1, 2005, all outstanding long-term bonds. An additional smaller amount was received from the issuance of common stock.

Refinancing

We have historically financed operations through a combination of cash generated from operations, equity offerings, subordinated borrowings and bank debt. On February 19, 2003, we refinanced its operations (the "Refinancing"). The Refinancing was effected through the issuance of subordinated, convertible notes to H.F. Lenfest and a credit agreement (the "PNC Agreement") with PNC Bank, National Association ("PNC"). The total proceeds from this refinancing were $29,800,000.

Bank Credit and Facility

Since inception, the PNC Agreement has had numerous amendments. As of fiscal year end, the facility total was $5,000,000 and use of this amount was restricted to the issuance of international letters of credit. This line was secured by all of our assets as well as a $5,000,000 personal guarantee by Mr. Lenfest.

On May 19, 2006 we signed an amendment to our bank agreement with PNC Bank, National Association extending the termination date to June 30, 2006. This $5,000,000 facility is restricted to use for issuing letters of credit.

As of May 12, 2006 we had used approximately $2,900,000 of the facility for international letters of credit.

Equity Line

On April 7, 2006, ETC entered into a Preferred Stock Purchase Agreement (the "Agreement") with H. F. "Gerry" Lenfest, a Director, significant shareholder and holder of our subordinated debt. The Agreement permits us to unilaterally draw down up to $15 million over the next eighteen (18) months in exchange for shares of our newly-created Series B Cumulative Convertible Preferred Stock ("Preferred Stock"). The Preferred Stock provides for a dividend equal to six (6) percent per annum. After three (3) years, the Preferred Stock will be convertible, at Mr. Lenfest's request, into ETC common shares at a conversion price (the "Conversion Price") which will be set on the day of each draw down. The Conversion Price will be equal to the closing price of our common stock on the trading day immediately preceding the day in which the draw down occurs, subject to a floor price of $4.95 per common share. Drawdowns will not be permitted on any day when the Conversion Price would be less than this floor price. On the sixth anniversary of the Agreement, any issued and outstanding Preferred Stock will be mandatorily converted into ETC common stock at each set Conversion Price. The Agreement also allows us to redeem any outstanding Preferred Stock any time within the six (6) year term of the Agreement. The Preferred Stock will vote with the ETC common stock on an as converted basis.

In connection with the execution of the Agreement, we drew down $3 million by issuing 3,000 shares of Preferred Stock with a Conversion Price equal to $4.95 per share. The proceeds are being used for general corporate purposes.

Subordinated Convertible Debt

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

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

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

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

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

Under the Note, we must meet certain financial covenants including a Leverage Ratio, a Fixed Charge Ratio and a Tangible Net Worth Ratio. At February 24, 2006 we failed to meet any of these financial covenants but have obtained a waiver from Mr. Lenfest. This waiver applies to the period through February 25, 2007. Except as specified, the waiver does not constitute a modification or alteration of any other terms or conditions in the Note, or a release of any of the lender's rights or remedies, all of which are reserved, nor does it release us or any guarantor from any duties, obligations, covenants or agreements including the consequences of any Event of Default, except as specified.

Long-Term Bonds

On March 15, 2000, we issued approximately $5,500,000 of unregistered Taxable Variable Rate Demand/Fixed Rate Revenue Bonds (Series of 2000). Net proceeds from these bonds were used to repay a $4,100,000 advance taken on our revolving credit facility and to finance construction of an addition to our main plant in Southampton, Pennsylvania. The bonds were secured by a $5,000,000 irrevocable direct pay Letter of Credit issued by PNC which was scheduled to expire on February 17, 2006 and which was secured by all assets of the Company. At February 25, 2005 the bonds were fully cash collateralized. The bonds carried a maturity

date of April 1, 2020, bore a variable interest rate which adjusted each week to a rate required to remarket the bonds at full principal value with a cap of 17%, and were subject to mandatory redemption of $275,000 per year for 19 years and $245,000 for the 20th year.

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

Liquidity

Given our inability to borrow cash under the amended PNC Agreement and certain restrictions in the Equity Agreement, we may need to obtain additional sources of capital in order to continue growing and operating our business. This capital may be difficult to obtain and the cost of this additional capital is likely to be relatively high. However, because we have established businesses in many markets, significant fixed assets including a building, and other valuable business assets which can be used for security, we believe that we will be able to locate such additional capital and that the actions by PNC will not have a long-term material adverse effect on our business.

We believe that existing cash balances at February 24, 2006, cash generated from operating activities as well as future availability under the Equity Agreement will be sufficient to meet its future obligations through at least February 25, 2007.

In reference to our outstanding claims with the U.S. Navy, to the extent we are unsuccessful in recovering a significant portion of recorded claim contract costs, and to the extent that significant additional legal expenses are required to bring the dispute to resolution, such events could have a material adverse effect on our liquidity and results of operations. Historically, we have had a favorable experience in that recoveries have exceeded recorded claims, including significant settlement agreements in fiscal 2003, 2004 and 2005. (See Note 3 to the Consolidated Financial Statements, Accounts Receivable).

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

	Payments Due by Period (in thousands)				
	Total	Less Than 1 Year	1-3 Years	4-5 Years	After 5 Years
			(in thousands)		
Long-term debt, including current maturities	$ 8,376	$ —	$ 8,376	$ —	$ —
Operating leases	663	128	338	197	—
Total	$ 9,039	$ 128	$ 8,714	$ 197	$ —

- Long-term debt is reported net of unamortized discount of $1,624,000 on the Company's subordinated debt. See "Note 7. Long-Term Obligations and Credit Arrangements" to the Consolidated Financial Statements.

Backlog

Our sales backlog at February 24, 2006 and February 25, 2005, for work to be performed and revenue to be recognized under written agreements after such dates, was $8,132,000 and $19,084,000 respectively. In addition, our training, maintenance and upgrade contracts backlog at February 24, 2006 and February 25, 2005, for work to be performed and revenue to be recognized after such dates under written agreements, was $1,774,000 and $2,232,000, respectively. Of the February 24, 2006 backlog, we have contracts for approximately $5,371,000 for aircrew training systems and maintenance support, including $2,243,000 for the Japanese Defense Agency, $975,000 for the Pakistan Air Force, and $798,000 for Singapore. We expect to complete approximately 94% of the February 24, 2006 backlog prior to February 23, 2007, the end of our 2007 fiscal year. Of the February 25, 2005 backlog, we completed approximately 82% by February 24, 2006.

Our order flow does not follow any seasonal pattern as we receive orders in each fiscal quarter of our fiscal year.

Off-Balance Sheet Arrangements

There were no off-balance sheet arrangements during the fiscal year ended February 24, 2006 that have or are reasonably likely to have a current or future effect on our financial condition, changes in financial condition, revenues or expenses, results of operations, liquidity, capital expenditures or capital resources that is material to our investors.

Recent Accounting Pronouncements

Accounting for Share-Based Payments

In December 2004, the Financial Accounting Standards Board (FASB) issued FASB Statement No. 123(R), Share-Based Payments. Statement No. 123(R) requires that the costs of employee share-based payments be measured at fair value on the awards' grant date using an option-pricing model and recognized in the financial statements over the requisite service period. Statement No. 123(R) does not change the accounting for stock ownership plans, which is subject to American Institute of Certified Public Accountants SOP 93-6, "Employer's Accounting for Employee Stock Ownership Plans." Statement No. 123(R) supercedes Opinion 25, Accounting for Stock Issued to Employees and its related interpretations, and eliminates the alternative to use Opinion 25's intrinsic value method of accounting, which we currently use.

Statement 123(R) allows for two alternative transition methods. The first method is the modified prospective application whereby compensation cost for the portion of awards for which the requisite service has not yet been rendered that are outstanding as of the adoption date will be recognized over the remaining service period. The compensation cost for that portion of awards will be based on the grant-date fair value of those awards as calculated for pro forma disclosures under Statement No. 123, as originally issued. All new awards and awards that are modified, repurchased, or cancelled after the adoption date will be accounted for under the provisions of Statement No. 123(R). The second method is the modified retrospective application, which requires that we restate prior period financial statements. The modified retrospective application may be applied either to all prior periods or only to prior interim periods in the year of adoption of Statement No. 123(R). We adopted SFAS 123(R) effective February 25, 2006 utilizing the modified prospective application described above. Adoption of this statement did not have a significant impact on our financial position, results of operations, EPS or cash flows.

Accounting for Inventory Costs

In November 2004, the FASB issued FASB Statement 151, Inventory Costs, an amendment of ARB No. 43, Chapter 4. While retaining the general principle that inventories are presumed to be stated at cost, Statement 151 amends ARB No. 43 to clarify that:

- abnormal amounts of idle facilities, freight, handling costs, and spoilage should be recognized as charges of the current period.
- allocation of fixed production overheads to inventories should be based on the normal capacity of the production facilities.

Statement 151 defines normal capacity as the production expected to be achieved over a number of periods or seasons under normal circumstances, taking into account the loss of capacity resulting from planned maintenance.

Statement 151 is effective for inventory costs incurred during fiscal years beginning after June 15, 2005 and should be applied prospectively. Early application is permitted. The Company is not able at this time to determine what impact, if any, adoption of Statement 151 will have on the results of operations.

Market for the Registrant's Common Stock, Related Security Holder Matters and Issuer Purchases of Equity Securities

Our common stock is traded on the American Stock Exchange under the symbol "ETC." As of May 11, 2006, the Company had 281 shareholders of record.

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

	Sale Prices	
	High	Low
Fiscal 2006		
First Quarter	$ 6.05	$ 4.70
Second Quarter	5.85	4.85
Third Quarter	5.52	4.89
Fourth Quarter	5.22	4.75
Fiscal 2005		
First Quarter	$ 10.05	$ 7.25
Second Quarter	8.24	6.47
Third Quarter	7.95	6.18
Fourth Quarter	6.80	5.10

On May 11, 2006, the closing price of our common stock was $5.00. We have never paid any cash dividends on our common stock and do not anticipate that any cash dividends will be declared or paid in the foreseeable future. Our current credit facilities prohibit the payment of any dividends without the lender's prior written consent.

Equity Compensation Plan Information

Plan Category	Number of securities to be issued upon exercise of outstanding options, warrants and rights	Weighted-average exercise price of outstanding options, warrants and rights	Number of securities remaining available for future issuance under equity compensation plans (excluding securities reflected in column (a))
	(a)	(b)	(c)
Equity compensation plans approved by security holders	327,939	$ 6.77	1,243,521
Equity compensation plans not approved by security holders	—	N/A	204,629
Total	327,939	$ 6.77	1,448,150

The following plans have not been approved by our shareholders:

Employee Stock Purchase Plan

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

Report of Independent Registered Public Accounting Firm

Board of Directors and Shareholders
Environmental Tectonics Corporation

We have audited the accompanying consolidated balance sheets of Environmental Tectonics Corporation and Subsidiaries as of February 24, 2006 and February 25, 2005 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 24, 2006. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement. The Company is not required to have, nor were we engaged to perform an audit of its internal control over financial reporting. Our audit included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the consolidated financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall consolidated 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 24, 2006 and February 25, 2005, and the consolidated results of their operations and their cash flows for the each of the three fiscal years in the period ended February 24, 2006, in conformity with accounting principles generally accepted in the United States of America.

We have also audited the accompanying Schedule II of Environmental Tectonics Corporation and Subsidiaries as of February 24, 2006 and February 25, 2005 and for each of the three fiscal years in the period ended February 24, 2006. In our opinion, this schedule presents fairly, in all material respects, the information required to be set forth herein.

/s/ Grant Thornton LLP
Philadelphia, Pennsylvania
May 15, 2006

Environmental Tectonics Corporation
Consolidated Balance Sheets (amounts in thousands, except share information)

	February 24, 2006	February 25, 2005
ASSETS		
Cash and cash equivalents	$ 3,566	$ 12,041
Restricted cash	16	4,680
Accounts receivable, net	6,021	8,018
Costs and estimated earnings in excess of billings on uncompleted long-term contracts	3,480	3,333
Inventories	10,734	7,928
Deferred tax asset	1,558	1,786
Prepaid expenses and other current assets	564	1,668
Total current assets	25,939	39,454
Property, plant and equipment, net	4,392	4,331
Software development costs, net of accumulated amortization of $9,882 and $8,658 in 2006 and 2005, respectively	2,832	3,567
Goodwill, net	455	477
Other assets, net	49	80
Total assets	$ 33,667	$ 47,909
LIABILITIES		
Current portion of long-term obligations	$ —	$ 275
Accounts payable – trade	2,111	2,893
Billings in excess of costs and estimated earnings on uncompleted long-term contracts	1,118	1,533
Customer deposits	877	2,247
Other accrued liabilities	2,013	2,688
Total current liabilities	6,119	9,636
Long-term obligations, less current portion:		
Credit facility payable to banks	—	—
Long term bonds	—	4,095
Subordinated convertible debt	8,376	7,992
	8,376	12,087
Deferred tax liability	1,558	1,786
Total liabilities	16,053	23,509
Commitments and contingencies	—	—
Minority interest	61	45
STOCKHOLDERS' EQUITY		
Common stock - authorized 20,000,000 shares, $.05 par value; 9,024,804 and 9,019,376 shares issued and outstanding in 2006 and 2005, respectively	451	450
Capital contributed in excess of par value of common stock	16,584	16,561
Accumulated other comprehensive loss	(249)	(137)
Retained earnings	767	7,481
Total stockholders' equity	17,553	24,355
Total liabilities and stockholders' equity	$ 33,667	$ 47,909

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

Environmental Tectonics Corporation
Consolidated Statements of Operations (amounts in thousands, except share information)

	52 Weeks Ended February 24, 2006	52 Weeks Ended February 25, 2005	52 Weeks Ended February 27, 2004
Net sales	$ 25,069	$ 27,814	$ 25,995
Cost of goods sold	19,719	21,638	16,052
Gross profit	5,350	6,176	9,943
Operating expenses:			
Selling and administrative	9,625	12,450	9,454
Research and development	422	856	358
Impairment expense	22	—	—
	10,069	13,306	9,812
Operating (loss) income	(4,719)	(7,130)	131
Other expenses:			
Interest expense, net	1,857	1,791	1,606
Bank fees	93	401	329
Letter of credit fees	90	51	127
Other, net	(198)	(143)	(326)
	1,842	2,100	1,736
Loss before provision for (benefit from) income taxes and minority interest	(6,561)	(9,230)	(1,605)
Provision for (benefit from) income taxes	136	(1,117)	(810)
Loss before minority interest	(6,697)	(8,113)	(795)
Income (loss) attributable to minority interest	17	—	(2)
Net loss	$ (6,714)	$ (8,113)	$ (793)
Per share information:			
Loss per common share:			
Basic	$ (0.74)	$ (1.06)	$ (.11)
Diluted	$ (0.74)	$ (1.06)	$ (.11)
Weighted average common shares:			
Basic	9,021,000	7,656,000	7,163,000
Diluted	9,021,000	7,656,000	7,163,000

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

Environmental Tectonics Corporation
Consolidated Statements of Changes in Stockholders' Equity (amounts in thousands, except share information)

For the years ended February 24, 2006, February 25, 2005 and February 27, 2004

	Common Stock		Capital contributed in excess of par value of common stock	Accumulated other comprehensive loss	Retained earnings	Total stockholders' equity
	Shares	Amount				
Balance, February 28, 2003	7,157,239	358	9,331	(169)	16,387	25,907
Net loss for the year	—	—	—	—	(793)	(793)
Foreign currency translation adjustment				(160)	—	(160)
Total comprehensive loss						(953)
Exercise of employee stock options	19,313	1	99	—	—	100
Balance, February 27, 2004	7,176,552	359	9,430	(329)	15,594	25,054
Net loss for the year	—	—	—	—	(8,113)	(8,113)
Foreign currency translation adjustment				192	—	192
Total comprehensive loss						(7,921)
Value of warrants issued in connection with issuance of guarantee			571			571
Exercise of warrants	1,440,868	72	4,406			4,478
Issuance of common stock	373,831	19	1,981			2,000
Exercise of employee stock options and Board of Director's compensation	28,125	—	173	—	—	173
Balance, February 25, 2005	9,019,376	450	16,561	(137)	7,481	24,355
Net loss for the year					(6,714)	(6,714)
Foreign currency translation adjustment				(112)		(112)
Total comprehensive loss						(6,826)
Exercise of employee stock options and Board of Director's compensation	5,428	1	23	—	—	24
Balance, February 24, 2006	9,024,804	$ 451	$ 16,584	$ (249)	$ 767	$ 17,553

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

Environmental Tectonics Corporation
Consolidated Statements of Cash Flows (amounts in thousands)

	52 Weeks Ended February 24, 2006	52 Weeks Ended February 25, 2005	52 Weeks Ended February 27, 2004
Cash flows from operating activities:			
Net loss	$ (6,714)	$ (8,113)	$ (793)
Adjustments to reconcile net loss to net cash (used in) provided by operating activities			
Depreciation and amortization	2,570	2,414	1,847
Accretion of debt discount	384	326	275
Increase (decrease) in allowance for accounts receivable and inventory	780	274	(149)
(Income) loss attributable to minority interest	17	—	(2)
Impairment expense	22	—	—
Deferred income taxes (benefit)	—	(165)	(168)
Changes in operating assets and liabilities:			
(Increase) decrease in assets			
Accounts receivable	1,518	11,108	(2,973)
Costs and estimated earnings in excess of billings on uncompleted long-term contracts	(147)	2,000	108
Inventories	(3,468)	1,554	(1,763)
Prepaid expenses and other current assets	480	318	(720)
Impairment expense	22	—	—
Other assets	(48)	—	(103)
Increase (decrease) in liabilities:			
Accounts payable	(782)	462	653
Billings in excess of costs and estimated earnings on uncompleted long-term contracts	(415)	588	(518)
Customer deposits	(1,370)	(1,410)	657
Accrued income taxes	76	266	(247)
Other accrued liabilities	(774)	101	1,032
Net cash (used in) provided by operating activities	(7,849)	9,723	(2,864)
Cash flows from investing activities:			
Acquisition of equipment	(343)	(285)	(475)
Software development costs	(489)	(1,272)	(1,220)
Net cash used in investing activities	(832)	(1,557)	(1,695)
Cash flows from financing activities:			
Borrowings under credit facility	—	—	2,514
Payments under credit facility	—	(30)	(3,084)
Payments on long-term bonds	(4,370)	(275)	(275)
Decrease (increase) in restricted cash	4,664	(3,896)	2,405
Net (decrease) increase in other long-term obligations	—	(133)	120
Issuance of common stock/warrants	24	6,651	100
Net cash provided by financing activities	318	2,317	1,780
Effect of exchange rates on cash	(112)	192	(160)
Net (decrease) increase in cash and cash equivalents	(8,475)	10,675	(2,939)
Cash and cash equivalents at beginning of year	12,041	1,366	4,305
Cash and cash equivalents at end of year	$ 3,566	$ 12,041	$ 1,366
Supplemental schedule of cash flow information:			
Interest paid	$ 886	$ 909	$ 854
Income taxes paid	$ —	$ 5	$ 78

Supplemental information on non-cash operating, investing and financing activities:

During the years ended February 24, 2006 and February 25, 2005 the Company reclassified $361,000 and $194,000, respectively, from inventory to capitalized software. Additionally, during the year ended February 25, 2005 the Company recorded $571,000 in deferred finance charges and credited a corresponding amount to additional paid in capital associated with the issuance of a common stock purchase warrant to H.F. Lenfest. As of February 24, 2006, this amount had been fully amortized to operations.

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

1. 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.

2. Summary of Significant Accounting Policies:

Principles of Consolidation:

The consolidated financial statements include the accounts of Environmental Tectonics Corporation, its wholly owned subsidiaries Entertainment Technology Corporation, ETC Delaware, and 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 in consolidation. 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, claims receivable, inventories and computer software costs.

Total claims outstanding at February 24, 2006 were approximately $5.6 million based on costs incurred through April 2005. However, following generally accepted accounting principles, the Company had recorded only $3.0 million or 53.6% of this amount on its books.

Significant claims outstanding at February 25, 2005 included a claim with the U.S. Navy for a submarine decompression chamber ($3.0 million recorded). Significant claims outstanding at February 27, 2004 included $2.9 million for the aforementioned U.S. Navy claim and $2.6 million for an international customer. Effective February 27, 2004 the Company reached an agreement totaling $10.5 million on a prior international claim. This settlement was paid to the Company in March 2004. On February 8, 2005, the Company reached an agreement totaling $4.7 million on the remaining international claim. This settlement was paid to the Company in February 2005.

Although recorded as a current asset in the financial statements, all remaining claim revenues may not be received in full during fiscal 2007. For a more complete discussion of outstanding claims, see “Note 3. Accounts Receivable” to our consolidated financial statements in the Annual Report to Stockholders following.

Revenue Recognition:

Revenue is recognized on long-term contracts over $250,000 in value and six months in length 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 a current asset. Amounts billed to customers in excess of revenue recognized on uncompleted long-term contracts are reflected as a current liability. When it is estimated that a contract will result in a loss, the entire amount of the estimated 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 $250,000 or to be completed in less than six months, and where there are no post-shipment services included in the contract, and revenue on parts and services, are recognized as shipped or when the service is provided. 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 upon customer acceptance. Revenue for service contracts is recognized ratably over the life of the contract with related material costs expensed as incurred.

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 $100,000. During each fiscal year, the Company periodically has cash and cash equivalents in excess of insured amounts. However, significant portions of the Company's funds are with one financial institution, which has had no experience of significant customer losses to date.

Restricted Cash:

Restricted cash at February 24, 2006 represents a cash deposit in a foreign bank which is being held as security to assure the Company's performance under a maintenance contract in that country. Restricted cash at February 25, 2005 primarily represented cash deposited in an interest bearing account with PNC Bank, National Association which served as security for their irrevocable direct pay letter of credit issued in the bondholder's favor to secure the Company's long-term bonds. This cash was utilized to redeem the bonds on August 1, 2005.

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.

Goodwill:

Goodwill of $662,000 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 $300,000 cash, bringing the Company's total ownership to 95%. Goodwill of $24,000 was recorded in fiscal 2001 for the Company's purchase of 99% of ETC Europe. The Company did not record any amortization expense in fiscal years 2006, 2005 and 2004, respectively. Based on a test of impairment, the Company did not reduce the net carrying values of goodwill for the purchase of ETC-PZL for fiscal years 2006 and 2005. However, based upon the impairment test at February 24, 2006, the Company charged off to the operating statement the remaining $22,000 of goodwill associated with the purchase of ETC Europe.

The following summarizes the goodwill and associated amortization of the elements of goodwill at February 24, 2006:

(Amounts in thousands)	ETC-PZL
Goodwill	662
Amortization	207
Net	455

On February 23, 2002, we adopted Statement of Financial Accounting Standards No. 142 "Goodwill and Intangible Assets". SFAS No. 142 includes requirements to annually test goodwill and indefinite lived intangible assets for impairment rather than amortize them. Accordingly, we no longer amortize goodwill.

Capitalized Software Development Costs:

The Company capitalizes the qualifying costs of developing software contained in certain products. Capitalization of costs requires that technological feasibility has been established. When the software is fully documented and tested, capitalization of development costs cease and amortization commences on a straight-line basis over a period ranging from 36 to 60 months, depending upon the life of the product, which, at a minimum, approximates estimated sales. Realization of capitalized software costs is subject to the Company's ability to market the related product in the future and generate cash flows to support future operations. Capitalized software costs totaled $850,000 and $1,466,000 respectively, for the fiscal years ended February 24, 2006 and February 25, 2005. Related software amortization totaled $1,224,000, $988,000 and $851,000, respectively, for fiscal 2006, 2005 and 2004.

Research and Development:

Research and development expenses are charged to operations as incurred. During fiscal 2006, 2005 and 2004, the Company incurred research and development costs of approximately $422,000, $856,000 and $358,000, respectively.

Deferred Financing Costs:

Capitalized costs relating to the Company's bond issuance on March 15, 2000, costs associated with the February 2003 PNC/Lenfest financing and costs associated with the issuance in fiscal 2005 of a common stock warrant have been amortized over the relevant term. Amortization expense relating to deferred financing costs was $703,000, $587,000 and $321,000 in fiscal 2006, 2005 and 2004, respectively. At February 24, 2006, the Company had no deferred financing costs.

See "Note 7. Long-Term Obligations and Credit Arrangements" to the Consolidated Financial Statements.

Income Taxes:

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

Long-Lived Assets:

In accordance with SFAS No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets", the company periodically evaluates the period of depreciation or amortization for long-lived assets to determine whether current circumstances warrant revised estimates of useful lives. The company reviews its property and equipment for impairment whenever events or changes in circumstances indicate the carrying value of an asset may not be recoverable. Recoverability is measured by a comparison of the carrying amount to the net undiscounted cash flows expected to be generated by the asset. An impairment loss would be recorded for the excess of net book value over the fair value of the asset impaired. The fair value is estimated based on expected discounted future cash flows.

The results of impairment tests are subject to management's estimates and assumptions of projected cash flows and operating results.

Stock Options:

The Company accounts for stock options under the alternate provisions of SFAS No. 123 (discussed below), "Accounting for Stock-Based Compensation," as amended by SFAS No. 148, which contains a fair value-based method for valuing stock-based compensation that entities may use, which measures compensation cost at the grant date based on the fair value of the award. Compensation is then recognized over the service period, which is usually the vesting period. Alternatively, SFAS No. 123 permits entities to continue accounting for employee stock options and similar equity instruments under Accounting Principles Board (APB) Opinion 25, "Accounting for Stock Issued to Employees." Entities that continue to account for stock options using APB Opinion No. 25 are required to make pro-forma disclosures of net income and earnings per share, as if the fair value-based method of accounting defined in SFAS No. 123 had been applied.

Statement 123(R) allows for two alternative transition methods. The first method is the modified prospective application whereby compensation cost for the portion of awards for which the requisite service has not yet been rendered that are outstanding as of the adoption date will be recognized over the remaining service period. The compensation cost for that portion of awards will be based on the grant-date fair value of those awards as calculated for pro forma disclosures under Statement No. 123, as originally issued. All new awards and awards that are modified, repurchased, or cancelled after the adoption date will be accounted for under the provisions of Statement No. 123(R). The second method is the modified retrospective application, which requires that we restate prior period financial statements. The modified retrospective application may be applied either to all prior periods or only to prior interim periods in the year of adoption of Statement No. 123(R).

At February 24, 2006, the Company had two stock-based compensation plans, one for employees and one for non-employee members of the Board of Directors.

Employee Stock Plan:

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 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 24, 2006, there were 723,521 shares available to be granted under the Plan.

Non-employee Director Stock Plan:

In September 2005 the Company adopted subsequent to shareholder approval a stock option plan which allows for the granting to non-employee members of ETC's Board of Directors of options to purchase up to 600,000 shares of common stock. The plan provides that option price shall not be less than 100% of the current market price of the stock on the date of the grant. The amount of each individual award and the vesting period are determined by the Board or its appointed committee. Granted options have a maximum term of 10 years. The Plan shall remain in effect until terminated by the Board. At February 24, 2006, there were 520,000 shares available to be granted under the plan.

The Company accounts for both of these plans under the recognition and measurement principles of APB Opinion No. 25, *Accounting for Stock Issued to Employees,* and related Interpretations. No stock-base compensation cost is reflected in net income, as all options granted under these plans had an exercise price equal to the market value of the underlying common stock on the date of grant. The following table illustrates the effect on net income and earnings per share if the Company had applied the fair value recognition provisions of SFAS No. 123, *Accounting for Stock-Based Compensation,* to stock-based compensation.

	52 Weeks Ended February 24, 2006	52 Weeks Ended February 25, 2005	52 Weeks Ended February 27, 2004
Net loss, as reported	$ (6,714)	$ (8,113)	$ (793)
Deduct: Total stock-based employee compensation expense determined under fair value based method for all awards, net of related tax effects	(91)	(30)	(27)
Pro forma net loss	$ (6,805)	$ (8,143)	$ (820)
Loss per share:			
Basic–as reported	$ (0.74)	$ (1.06)	$ (0.11)
Basic–pro forma	$ (0.75)	$ (1.06)	$ (0.11)
Diluted–as reported	$ (0.74)	$ (1.06)	$ (0.11)
Diluted–pro forma	$ (0.75)	$ (1.06)	$ (0.11)

The fair value of each option grant is estimated on the date of grant using the Black-Scholes options-pricing model with the following weighted average assumptions used for grants in fiscal 2005: expected volatility of 30.2%; risk-free interest rate of 4.14%; and an expected life of 10 years. There were no grants in fiscal 2004 and fiscal 2006.

Advertising Costs:

The Company expenses advertising costs, which include trade shows, as incurred. Advertising expense was $302,000, $310,000 and $324,000 in fiscal 2006, 2005, and 2004, respectively.

Earnings Per Common Share:

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

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

	Fiscal Year ended February 24, 2006		
	Loss amount (amounts in thousands) (numerator)	Weighted average shares (denominator)	Per share
Net loss	$ (6,714)		
Basic loss per share			
Loss applicable to common stockholders	(6,714)	9,021,000	(0.74)
Effective of dilutive securities			
Stock options		—	
Convertible Debt		—	
Diluted loss per share			
Loss applicable to common stockholders plus effect of dilutive securities	$ (6,714)	9,021,000	$ (0.74)

At February 24, 2006, options to purchase the Company’s common stock totaling 327,939 shares were outstanding, none of which were included in the computation of diluted earnings per share as the effect of such inclusion would be anti-dilutive. There was subordinated debt with a face value of $10,000,000, which was convertible at an exercise price of $6.05 per share, equating to 1,652,893 shares of common stock if fully converted. Upon each conversion of the subordinated note, the holder would be entitled to receive a warrant to purchase additional shares of common stock equal to ten percent of the shares issued pursuant to such conversion. If the entire face value of the subordinated note is converted into shares of common stock, then warrants to purchase an additional 165,289 shares of common stock will be issued, bringing the total shares of common stock to be issued to 1,818,182. None of these shares were included in the computation of diluted earnings per share as the effect would be anti-dilutive.

	Fiscal Year ended February 25, 2005		
	Loss amount (amounts in thousands) (numerator)	Weighted average shares (denominator)	Per share
Net loss	$ (8,113)		
Basic loss per share			
Loss applicable to common stockholders	(8,113)	7,656,000	(1.06)
Effective of dilutive securities			
Stock options		—	
Convertible Debt		—	
Stock warrants		—	
Diluted loss per share			
Loss applicable to common stockholders plus effect of dilutive securities	$ (8,113)	7,656,000	$ (1.06)

At February 25, 2005, there were stock options to purchase the Company's common stock totaling 276,162 shares that were not included in the computation of diluted loss per share as the effect of such would be anti-dilutive. Additionally, there was subordinated debt with a face value of $10,000,000, which was convertible at an exercise price of $6.05 per share, equating to 1,652,893 shares of common stock if fully converted. Upon each conversion of the subordinated note, the holder would be entitled to receive a warrant to purchase additional shares of common stock equal to ten percent of the shares issued pursuant to such conversion. If the entire face value of the subordinated note is converted into shares of common stock, then warrants to purchase an additional 165,289 shares of common stock will be issued, bringing the total shares of common stock to be issued to 1,818,182. None of these shares were included in the computation of diluted earnings per share as the effect would be anti-dilutive.

	Fiscal Year ended February 27, 2004		
	Loss amount (amounts in thousands) (numerator)	Weighted average shares (denominator)	Per share
Net loss	$ (793)		
Basic loss per share			
Loss applicable to common stockholders	$ (793)	7,163,000	$ (.11)
Effective of dilutive securities			
Stock options		—	
Convertible Debt		—	
Stock warrants		—	
Diluted loss per share			
Loss applicable to common stockholders plus effect of dilutive securities	$ (793)	7,163,000	$ (.11)

At February 27, 2004, there were stock options to purchase the Company's common stock totaling 376,002 shares that were not included in the computation of diluted loss per share as the effect of such would be anti-dilutive. Additionally, there was subordinated debt with a face value of $10,000,000, which was convertible at an exercise price of $6.05 per share, equating to 1,652,893 shares of common stock if fully converted. Upon each conversion of the subordinated note, the holder would be entitled to receive a warrant to purchase additional shares of common stock equal to ten percent of the shares issued pursuant to such conversion. If the entire face value of the subordinated note is converted into shares of common stock, then warrants to purchase an additional 165,289 shares of common stock will be issued, bringing the total shares of common stock to be issued to 1,818,182. Additionally, at February 27, 2004, there were outstanding warrants to purchase the Company's stock totaling 1,240,868 shares. None of these shares were included in the computation of diluted earnings per share as the effect would be anti-dilutive.

3. Accounts Receivable:

The components of accounts receivable at February 24, 2006 and February 25, 2005 are as follows:

	(amounts in thousands)	
	2006	2005
U.S. government receivables billed and unbilled contract costs subject to negotiation	$ 3,346	$ 3,202
U.S. commercial receivables billed	2,297	2,331
International receivables billed	1,343	2,971
	6,986	8,504
Less allowance for doubtful accounts	(965)	(486)
	$ 6,021	$ 8,018

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

Unbilled contract costs subject to negotiation as of February 24, 2006, represent claims made against the U.S. Government under a contract for a submarine rescue decompression chamber project. These costs totaling $3,004,000 were recorded beginning in fiscal year 2002 and include $1,691,000 recorded during fiscal 2003, $833,000 recorded during fiscal year 2004 and $105,000 recorded during fiscal year 2005. In November 2003, the U.S. Government completed an audit of the claim, rejecting most of the items due to audit or engineering reasons. The Company has submitted a written rebuttal to the draft report. On July 22, 2004, the U.S. Government's Contracting Officer issued a final decision on the claim, denying the claim in full. The Company has updated the claim for additional costs expended on claimable items since the original submission and has converted the claim to a complaint, which was filed in the Court of Federal Claims in July 2005. This claim is currently in the discovery phase, specifically the mutual exchange of documents. The Company and the U.S. Government plan to hold a settlement conference in September 2006.

This U. S. Government claim has followed the typical process of claim notification, preparation, submittal, government audit and review by the contracting officer. Historically, the Company's experience has been that most claims are initially denied in part or in full by the contracting officer (or no decision is forthcoming, which is then taken to be a deemed denial) which then forces the Company to seek relief in a court of law.

The Company considers the recorded costs to be realizable due to the fact that the costs relate to customer caused delays, errors and changes in specifications and designs, disputed liquidated damages and other out of scope items. In the first quarter of fiscal 2005, the Company submitted a supplement to the claim incorporating additional cost items. The U.S. Government, citing failure to deliver the product within contract terms, has assessed liquidated damages but has not offset or withheld any progress payments due to the Company under the contract. The Company disputes the basis for these liquidated damages, noting that applicable U.S. Government purchasing regulations allow for a waiver of these charges if the delay is beyond the control and not due to the fault or negligence of the Company. However, following accounting principles generally accepted in the United States of America, the Company has reduced contract values and corresponding revenue recognition for an estimated amount of $330,000 to cover a delay through the extended delivery period.

International receivables billed:

International receivables billed include $700,000 at February 24, 2006 and February 25, 2005, respectively, related to a contract with the Royal Thai Air Force ("RTAF").

In October 1993, the Company was notified by the RTAF that the RTAF was terminating a $4,600,000 simulator contract with the Company. Although the Company had performed in excess of 90% of the contract, the RTAF alleged a failure to completely perform. In connection with this termination, the RTAF made a call on a $230,000 performance bond, as well as a draw on an approximately $1,100,000 advance payment letter of credit. Work under this contract had stopped while under arbitration, but on October 1, 1996, the Thai Trade Arbitration Counsel rendered 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 remained as stated in the original contract including the potential invoking of penalties or termination of the contract for delay. On December 22, 1997, the Company successfully performed acceptance testing and the unit passed with no discrepancy reports. Although the contract was not completed in the time allotted, the Company had requested an extension on the completion time due to various extenuating circumstances, including allowable "force majeure" events, one of which was a delay in obtaining an export license to ship parts required to complete the trainers. On August 30, 2001, the Company received a payment of $230,000 representing the amount due on the performance bond.

The open balance of $700,000 due on the contract represents the total gross exposure to the Company on this contract. On June 16, 2003, the Company filed for arbitration in Thailand seeking recovery of the open balance of $700,000 due on this contract. On March 23, 2006, the Arbitration panel awarded the Company $314,813 plus interest from March 1, 2006 in full settlement of this dispute. Although the award is final, the RTAF may challenge the court to withdraw the award with certain grounds within 90 days. At this time, the Company does not believe the RTAF has any legal grounds to challenge the award. If the RTAF does not honor the decision, the award will have to be enforced through the court system in Thailand, a process which may take a significant amount of time. The assets of the RTAF are not subject to enforcement. At this point, the Company is not able to determine what the ultimate result of this dispute will be. However, the Company has established sufficient receivable reserves so that any resolution will not have a material impact on the financial position or results of operations of the Company.

Historically, the Company has had positive experience with regard to its contract claims in that recoveries have exceeded the carrying value of claims. However, there is no assurance that the Company will always have positive experience with regard to recoveries for its contract claims.

Claim bookings and settlements had no impact in fiscal 2006; in fiscal 2005 they reduced operating income by $1,124,000 and in fiscal 2004 they increased operating income by $1,802,000.

Net claims receivables were $3,004,000 at February 24, 2006 and February 25, 2005, respectively.

4. Costs and Estimated Earnings on Uncompleted Contracts:

Unbilled costs

Amounts not billed or not yet billable totaled $10,221,000 at February 24, 2006. Under most of the Company's contracts, invoices are issued upon the attainment of certain contract milestones, for example upon receipt of order, upon engineering drawing submittal, upon design acceptance, or upon shipment. Service contracts are billed monthly or quarterly. Parts and service are billed as shipped or completed.

The following is a summary of long-term contracts in progress at February 24, 2006 and February 25, 2005:

	(amounts in thousands)	
	2006	2005
Costs incurred on uncompleted long-term contracts	$ 37,608	$ 31,884
Estimated earnings	7,744	6,824
	45,352	38,708
Less billings to date	(42,990)	(36,908)
	$ 2,362	$ 1,800

	2006	2005
Included in accompanying balance sheets under the following captions:		
Costs and estimated earnings in excess of billings on uncompleted long-term contracts	$ 3,480	$ 3,333
Billings in excess of costs and estimated earnings on uncompleted long-term contracts	(1,118)	(1,533)
	$ 2,362	$ 1,800

Included in billings in excess of costs and estimated earnings on uncompleted long-term contracts is a provision for anticipated losses on contracts of $200,000 in fiscal 2006, 2005 and 2004.

5. Inventories:

Inventories consist of the following:

	(amounts in thousands)			
	Raw Material	Work in Process	Finished Goods	Total
February 24, 2006	$ 158	$ 8,803	$ 1,773	$ 10,734
February 25, 2005	$ 290	$ 5,293	$ 2,345	$ 7,928

Inventory is presented above net of an allowance for obsolescence of $1,032,000 and $731,000 in fiscal 2006 and 2005, respectively.

6. Property, Plant and Equipment:

The following is a summary of property, plant and equipment, at cost, and estimated useful lives at February 24, 2006 and February 25, 2005:

	(amounts in thousands)		Estimated useful lives
	2006	2005	
Land	$ 100	$ 100	
Building and building additions	3,763	3,763	40 years
Machinery and equipment	10,008	9,304	3–5 years
Office furniture and equipment	1,195	1,195	10 years
Building improvements	1,460	1,460	5–10 years
	16,526	15,822	
Less accumulated depreciation	(12,134)	(11,491)	
Property, plant and equipment, net	$ 4,392	$ 4,331	

Depreciation expense for the fiscal years ended February 24, 2006, February 25, 2005 and February 27, 2004 was $643,000, $840,000 and $675,000, respectively.

7. Long-Term Obligations and Credit Arrangements:

Long-term obligations at February 24, 2006 and February 25, 2005 consist of the following:

	(amounts in thousands)	
	2006	2005
Credit facility payable to banks	$ —	$ —
Long term bonds	—	4,370
Subordinated convertible debt, net of unamortized discount of $1,624 and $2,008 for 2006 and 2005, respectively	8,376	7,992
	8,376	12,362
Less current portion	—	(275)
	$ 8,376	$ 12,087

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

2007	$ —
2008	—
2009	8,376
2010	—
2011 and thereafter	—
Total future obligations	$ 8,376

The approximate average loan balance, maximum aggregate borrowings outstanding at any month-end payable under the credit facility and subordinated debt during the fiscal years, and weighted average interest rate computed by the day's outstanding method as of February 24, 2006 and February 25, 2005 are as follows (amounts in thousands):

	2006	2005
Approximate average loan balance (face)	$ 10,000	$ 10,001
Maximum aggregate	$ 10,000	$ 10,030
Weighted average interest rate	8.00% *	7.85%

* The rate in the Company's subordinated debt agreement is 10%. However, Mr. Lenfest reduced the rate to 8% on a temporary basis for the period December 1, 2004 through November 30, 2006.

Refinancing

The Company has historically financed operations through a combination of cash generated from operations, equity offerings, subordinated borrowings and bank debt. On February 19, 2003, the Company refinanced its outstanding indebtedness (the "Refinancing"). The Refinancing was effected through the issuance of subordinated, convertible notes to H.F. Lenfest, an individual, and a credit agreement (the "PNC Agreement") with PNC Bank, National Association ("PNC"). The total proceeds from the Refinancing were $29,800,000.

Bank Credit and Facility

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

On May 19, 2006 we signed an amendment to our bank agreement with PNC Bank, National Association extending the termination date to June 30, 2006. This $5,000,000 facility is restricted to use for issuing letters of credit.

As of May 12, 2006 we had used approximately $2,900,000 of the facility for international letters of credit.

Equity Line

On April 7, 2006, the Company entered into a Preferred Stock Purchase Agreement (the "Equity Agreement") with H. F. "Gerry" Lenfest, a Director, significant shareholder and holder of the Company's subordinated debt. The Agreement permits ETC to unilaterally draw down up to $15 million over the next eighteen (18) months in exchange for shares of the Company's newly-created Series B Cumulative Convertible Preferred Stock ("Preferred Stock"). The Preferred Stock provides for a dividend equal to six (6) percent per annum. After three (3) years, the Preferred Stock will be convertible, at Mr. Lenfest's request, into ETC common shares at a conversion price (the "Conversion Price") which will be set on the day of each draw down. The Conversion Price will be equal to the closing price of the Company's common stock on the trading day immediately preceding the day in which the draw down occurs, subject to a floor price of $4.95 per common share. Drawdowns will not be permitted on any day when the Conversion Price would be less than this floor price. On the sixth anniversary of the Agreement, any issued and outstanding Preferred Stock will be mandatorily converted into ETC common stock at each set Conversion Price. The Agreement also allows for the Company to redeem any outstanding Preferred Stock any time within the six (6) year term of the Agreement. The Preferred Stock will vote with the ETC common stock on an as converted basis.

In connection with the execution of the Agreement, the Company drew down $3 million by issuing 3,000 shares of Preferred Stock with a Conversion Price equal to $4.95 per share.

Subordinated Convertible Debt

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

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

Subordinated Convertible Debt Discount

During fiscal 2003, the Company had recorded $2,609,000 in additional paid-in capital representing an allocation of the proceeds from the convertible debt element of its financing with PNC Bank and Lenfest. This allocation represents the value assigned to the beneficial conversion option of the Lenfest promissory note and the value of the associated warrants. Such values were derived pursuant to an independent appraisal of these financial instruments obtained by the Company. Accreted interest expense related to the beneficial conversion option and the warrants was $384,000 in fiscal 2006, $326,000 in fiscal 2005 and $275,000 in fiscal 2004.

The following table summarizes the subordinated convertible debt as of February 24, 2006 (amounts in thousands):

Face Value	$ 10,000
Less: Value of conversion feature	(1,400)
Less: Value of warrants	(1,209)
	7,391
Accretion 2006	384
Accretion 2005:	326
Accretion 2004:	275
Carrying value at February 24, 2006	$ 8,376

Interest expense recorded for these notes was $803,000 and $800,000 for fiscal 2006 and 2005, respectively.

Fair Value

The carrying value of these financial instruments approximates their fair values at February 24, 2006.

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

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

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

Under the Note, the Company must meet certain financial covenants including a Leverage Ratio, a Fixed Charge Ratio and a Tangible Net Worth Ratio. At February 24, 2006 the Company failed to meet any of these financial covenants but has obtained a waiver from Mr. Lenfest. This waiver applies to the period through February 25, 2007. Except as specified, the waiver does not constitute a modification or alteration of any other terms or conditions in the Note, or a release of any of the lender's rights or remedies, all of which are reserved, nor does it release the Company or any guarantor from any of its duties, obligations, covenants or agreements including the consequences of any Event of Default, except as specified.

Long-Term Bonds

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

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

Liquidity

Given the Company's inability to borrow cash under the amended PNC Agreement and certain restrictions in the Equity Agreement, the Company may need to obtain additional sources of capital in order to continue growing and operating its business. This capital may be difficult to obtain and the cost of this additional capital is likely to be relatively high. However, because we have established businesses in many markets, significant fixed assets including a building, and other valuable business assets which can be used for security, we believe that we will be able to locate such additional capital and that the actions by PNC Bank will not have a long-term material adverse effect on our business.

The Company believes that existing cash balances at February 24, 2006, cash generated from operating activities as well as future availability under its Equity Agreement will be sufficient to meet its future obligations through at least February 25, 2007.

In reference to the Company's outstanding claims with the U.S. Navy, to the extent the Company is unsuccessful in recovering a significant portion of recorded claim contract costs, and to the extent that significant additional legal expenses are required to bring the dispute to resolution, such events could have a material adverse effect on the Company's liquidity and results of operations. Historically, the Company has had a favorable experience in that recoveries have exceeded recorded claims, including significant settlement agreements in fiscal 2003, 2004 and 2005. (See Note 3 to the Consolidated Financial Statements, Accounts Receivable).

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 24, 2006 are $128,000 in 2007; $120,000 in 2008; $111,000 in 2009; $108,000 in 2010; and $197,000 in 2011 and thereafter.

Total rental expense for all operating leases for the fiscal years ended February 24, 2006, February 25, 2005 and February 27, 2004 was $173,000, $198,000 and $241,000, respectively.

9. Income Taxes:

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

	(amounts in thousands)		
	52 Weeks Ended February 24, 2006	52 Weeks Ended February 25, 2005	52 Weeks Ended February 27, 2004
Currently (receivable)/payable:			
Federal	$ —	$ (909)	$ (738)
State	—	—	—
Foreign taxes	136	(44)	96
	136	(953)	(642)
Deferred:			
Federal	—	(199)	(101)
State	—	34	(67)
	—	(165)	(168)
	$ 136	$ (1,118)	$ (810)

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

	52 Weeks Ended February 24, 2006	52 Weeks Ended February 25, 2005	52 Weeks Ended February 27, 2004
Statutory income tax	(34.0)%	(34.0)%	(34.0)%
State income tax, net of federal tax benefit	(4.6)%	0.2	(4.1)
Benefit of foreign sales corporation and extraterritorial income	(0.0)	(0.0)	(9.1)
Research and experimentation and other tax credits	(2.6)	(1.6)	(9.2)
Benefit of foreign and foreign-source income or loss	1.2	(0.3)	(0.0)
Change in valuation allowance	41.9	24.3	0.0
Other, net	0.1	(0.8)	6.0
	2.1%	(12.2%)	(50.4)%

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

	(amounts in thousands)		
	2006	2005	2004
Deferred tax assets:			
Vacation reserve	64	51	44
Inventory reserve	330	214	212
Receivable reserve	368	184	142
Warranty reserve	8	8	8
Compensation and other reserves	132	136	—
Net operating loss and credits	5,436	3,172	302
Other, net	200	252	629
	6,538	4,017	1,337
Valuation Reserve	(4,980)	(2,231)	—
Total current deferred tax asset	$ 1,558	$ 1,786	$ 1,337

Deferred tax liabilities:			
Amortization of capitalized software	$ 1,175	$ 1,419	$ 1,166
Depreciation	383	367	336
Total non-current deferred tax liability	$ 1,558	$ 1,786	$ 1,502

Reflecting the Company's significant losses in the current and prior fiscal years, the Company has approximately $12.6 million of federal and $17.9 million of state net loss carry forwards available to offset future income tax liabilities, expiring in 2025. However, due to the uncertain nature of their ultimate realization based on past performance, and the potential that sufficient taxable income may not be generated in the near future, the Company has established a full valuation allowance of the same amount against these carry forward benefits and will recognize these benefits only as reassessment demonstrates that they are realizable. Realization is entirely dependent upon future earnings in specific tax jurisdictions. While the need for this valuation allowance is subject to periodic review, if the allowance is reduced, the tax benefits of the carry forwards will be recorded in future operations as a reduction of the Company's income tax expense.

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 the Industrial Group. The ATS business produces devices which create and monitor the physiological effects of motion, including spatial disorientation and centrifugal forces for medical, training, research and entertainment markets. The Industrial Group business produces chambers that create environments that are used for sterilization, research and medical applications. The following segment information reflects the accrual basis of accounting.

	(amounts in thousands)		
	ATS	Industrial Group	Total
Fiscal 2006			
Net sales	$ 15,100	$ 9,969	$ 25,069
Interest expense	1,265	592	1,857
Depreciation and amortization	1,533	1,037	2,570
Operating loss	3,555	362	3,917
Income tax expense	136	—	136
Goodwill	455	—	455
Identifiable assets	15,809	7,407	23,216
Expenditures for segment assets	234	109	343
Fiscal 2005			
Net sales	$ 16,788	$ 11,026	$ 27,814
Interest expense	1,189	602	1,791
Depreciation and amortization	1,337	1,078	2,415
Operating loss	4,768	1,518	6,286
Income tax benefit	715	254	969
Goodwill	477	—	477
Identifiable assets	14,899	7,947	22,846
Expenditures for segment assets	228	57	285
Fiscal 2004			
Net sales	$ 15,880	$ 10,115	$ 25,995
Interest expense	1,293	313	1,606
Depreciation and amortization	881	966	1,847
Operating income/(loss)	1,231	(248)	983
Income tax provision/(benefit)	62	(318)	(256)
Goodwill	477	—	477
Identifiable assets	30,002	7,496	37,498
Expenditures for segment assets	380	95	475

	2006	2005	2004
Reconciliation to consolidated amounts:			
Corporate assets	10,451	25,063	10,721
Total assets	$ 33,667	$ 47,909	$ 48,696
Segment operating (loss)/income	$ (3,917)	$ (6,286)	$ 983
Less interest expense	(1,857)	(1,791)	(1,606)
Income tax (provision) benefit	(136)	969	256
Total loss for segments	(5,910)	(7,108)	(367)
Corporate home office expense	(780)	(846)	(852)
Interest and other expenses	(7)	(308)	(130)
Income tax benefit	—	149	554
Minority interest	(17)	—	2
Net loss	$ (6,714)	$ (8,113)	$ (793)

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

In fiscal 2006, international sales totaling at least ten percent of total international sales were made in the Company's Polish subsidiary to L-3 Communications ($4,599,000) and to a government customer in Pakistan ($2,910,000). In fiscal 2005, international sales totaling at least ten percent of total international sales were made to government or commercial accounts in Malaysia ($3,388,000) and Egypt ($2,309,000). Fluctuations in sales to international countries from year to year primarily reflect revenue recognition on the level and stage of development and production on multi-year long-term contracts.

Approximately 30% of sales totaling $7,509,000 in 2006 were made to two customers, one from our Polish subsidiary and one international customer from our domestic operation, in the ATS segment. Approximately 20% of sales totaling $5,697,000 in 2005 were made to two international customers in the ATS segment. Approximately 22% of sales totaling $5,714,000 in fiscal 2004 were made to two international customers in the ATS segment.

Included in the segment information for the year ended February 24, 2006, are export sales of $13,343,000. Of this amount, there are sales to or relating to governments or commercial accounts in Pakistan of $2,910,000. Sales to the U.S. government and its agencies aggregated $2,586,000 for the year ended February 24, 2006.

Included in the segment information for the year ended February 25, 2005, are export sales of $12,912,000. Of this amount, there are sales to or relating to governments or commercial accounts in Malaysia of $3,388,000 and Egypt of $2,309,000. Sales to the U.S. government and its agencies aggregated $2,904,000 for the year ended February 25, 2005.

Included in the segment information for the year ended February 27, 2004, are export sales of $15,421,000. Of this amount, there are sales to or relating to governments or commercial accounts in Malaysia of $2,874,000 and the United Kingdom of $2,840,000. Sales to the U.S. government and its agencies aggregated $1,717,000 for the year ended February 27, 2004.

11. Stock Options:

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

	February 24, 2006		February 25, 2005		February 27, 2004	
	Shares	Weighted average Exercise price	Shares	Weighted average exercise price	Shares	Weighted average exercise price
Outstanding at beginning of year	276,162	$ 7.30	376,002	$ 7.21	421,614	$ 7.20
Granted	—	—	33,586	7.24	—	—
Exercised	(1,600)	2.25	(25,700)	6.35	(17,800)	5.12
Forfeited	(26,623)	7.53	(107,726)	7.18	(27,812)	7.74
Outstanding at end of year	247,939	7.31	276,162	7.30	376,002	7.21
Options exercisable at year end	222,750		242,576		370,564	
Weighted average fair value of options granted during the year		—		$ 3.58		—

The following information applies to options outstanding at February 24, 2006:

	Options outstanding			Options exercisable	
Range of exercise prices	Number Outstanding at February 24, 2006	Weighted average remaining contractual life (years)	Weighted average exercise price	Number exercisable at February 24, 2006	Weighted average exercise price
$2.25 to $3.38	400	.45 years	$ 2.25	400	$ 2.25
$5.00 to $7.50	80,539	5.3 years	$ 6.29	55,350	$ 5.86
$7.81	167,000	3.01 years	$ 7.81	167,000	$ 7.81
Total	247,939			222,750	

12 Commitments and Contingencies:

Claims and Litigation:

In April 2003, Boenning & Scattergood, Inc. (“B&S”) filed suit against the Company in the Court of Common Pleas in Philadelphia, Pennsylvania, seeking payment of $901,843.46 for financing fees allegedly due to B&S pursuant to the terms of an agreement for investment banking services, which was entered into with a predecessor of B&S (the “B&S Agreement”). B&S alleged that it contacted the investors in the Company’s February 2003 financing transaction and that it earned the claimed financing fees pursuant to the terms of the B&S Agreement. On August 17, 2005 the Company entered into an agreement to settle this litigation. The agreement was entered into for the purpose of resolving contested claims and disputes as well as avoiding the substantial costs, expenses and uncertainties associated with protracted and complex litigation, and was not an admission of fault or liability by either party. Under the guidance of FASB Statement No.5, an amount representing a probable settlement had been accrued in a prior period, so the payment under the settlement had no material impact on the Company’s results of operations for the fiscal second quarter.

In June 2003, Entertainment Technology Corporation (“EnTCo”), our wholly-owned subsidiary, filed suit against Walt Disney World Co. and other entities (“Disney”) in the United States District Court for the Eastern District of Pennsylvania, alleging breach of contract for, among other things, failure to pay all amounts due under contract for the design and production of the amusement park ride “Mission: Space” located in Disney’s Epcot Center. In response, in August 2003, Disney filed counterclaims against both EnTCo and us (under a guarantee) for, among other things, alleged failures in performance and design in the contract. Disney is seeking damages in excess of $65 million plus punitive damages. Both EnTCo and we believe that we have valid defenses to each of Disney’s counterclaims and intend to vigorously defend ourselves against these counterclaims. Discovery has been completed and the parties participated in a structured mediation in early December 2005, with no agreement forthcoming as of the date of this Annual Report on Form 10-K. The case is not currently scheduled for trial. Neither EnTCo nor we are able to predict the outcome of this matter.

Certain other claims, suits, and complaints arising in the ordinary course of business have been filed or are pending against the Company. In the opinion of management, after consultation with legal counsel handling these specific maters, 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 $110,000, $106,000 and $107,000 in fiscal 2006, fiscal 2005, and fiscal 2004, respectively.

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

14. Quarterly Consolidated Financial Information (Unaudited):

Financial data for the interim periods of fiscal 2006, 2005 and 2004 were as follows (amounts in thousands):

	Quarter Ended			
Fiscal Year 2006	**May 27**	**August 26**	**November 25**	**February 24**
Net sales	$ 5,915	$ 6,255	$ 6,206	$ 6,693
Gross profit	1,482	1,253	1,367	1,248
Operating loss	(1,152)	(1,149)	(986)	(1,410)
Loss before income taxes	(1,726)	(1,619)	(1,317)	(1,899)
Minority interest	(3)	1	6	13
Net loss	$ (1,723)	$ (1,620)	$ (1,327)	$ (2,044)
Loss per common share:				
Basic	(.19)	(.18)	(.15)	(.23)
Diluted	(.19)	(.18)	(.15)	(.23)

Fiscal Year 2005	Quarter Ended May 28	Quarter Ended August 27	Quarter Ended November 26	Quarter Ended February 25
Net sales	$ 6,175	$ 6,523	$ 7,751	$ 7,365
Gross profit	994	1,021	1,637	2,524
Operating loss	(1,645)	(2,392)	(2,757)	(336)
Loss before income taxes	(2,074)	(2,819)	(3,254)	(1,082)
Minority interest	1	—	(1)	—
Net loss	$ (1,461)	$ (1,984)	$ (3,249)	$ (1,419)
Loss per common share:				
Basic	(.19)	(.26)	(.43)	(.18)
Diluted	(.19)	(.26)	(.43)	(.18)

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

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

Column A	Column B	Column C	Column D	Column E
Description	Balance at Beginning of Period	Charges/ (Credits) to Costs/ Expenses	Reductions (1)	Balance At End of Period
Fiscal year ended February 24, 2006				
Valuation and qualifying accounts related to:				
Accounts receivable	$ 486	$ 510	$ 31	$ 965
Inventory	$ 731	$ 823	$ 522	$ 1,032
Property, plant and equipment	$ 11,491	$ 643	$ —	$ 12,134
Software development costs	$ 8,658	$ 1,224	$ —	$ 9,882
Other assets	$ 1,180	$ 725	$ —	$ 455
Fiscal year ended February 25, 2005:				
Valuation and qualifying accounts related to:				
Accounts receivable	$ 379	$ 126	$ 19	$ 486
Inventory	$ 564	$ 300	$ 133	$ 731
Property, plant and equipment	$ 10,651	$ 840	$ —	$ 11,491
Software development costs	$ 7,670	$ 988	$ —	$ 8,658
Other assets	$ 434	$ 746	$ —	$ 1,180
Fiscal year ended February 27, 2004:				
Valuation and qualifying accounts related to:				
Accounts receivable	$ 446	$ 43	$ 110	$ 379
Inventory	$ 646	$ 200	$ 282	$ 564
Property, plant and equipment	$ 9,976	$ 675	$ —	$ 10,651
Software development costs	$ 6,819	$ 851	$ —	$ 7,670
Other assets	$ 113	$ 321	$ —	$ 434

(1) Amounts written off or retired

EXHIBIT 21

List of Subsidiaries

Name	Jurisdiction	% Ownership
Entertainment Technology Corporation	PA	100%
ETL International Corporation	Barbados	100%
ETC-PZL Aerospace Industries	Poland	95%
ETC-Europe	Great Britain	99%
ETC-Delaware	Delaware	100%
NASTAR Center Holdings Corporation	Delaware	100%
NASTAR Center LLC	Delaware	100%

EXHIBIT 23

CONSENT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

We have issued our report dated May 15, 2006, accompanying the consolidated financial statements and schedule incorporated by reference in the Annual Report of Environmental Tectonics Corporation and Subsidiaries on Form 10-K for the year ended February 24, 2006. We hereby consent to the incorporation by reference of said report in the Registration Statements of Environmental Tectonics Corporation and Subsidiaries on Forms S-8 (File No. 333-131322, effective January 27, 2006, File No. 333-65469, effective October 8, 1998 and File No. 2-92407, effective August 14, 1984), Form S-3A (File No. 333-29083, effective July 2, 1997) and Forms S-3 (File No. 333-29083, effective June 12, 1997 and File No. 33-42219, effective September 4, 1991).

/s/ Grant Thornton LLP
Philadelphia, Pennsylvania
May 15, 2006

EXHIBIT 31.1

CERTIFICATION PURSUANT TO RULE 13A-14(A) UNDER THE SECURITIES EXCHANGE ACT OF 1934

I, William F. Mitchell, certify that:

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

Date: May 25, 2006

By: /s/ William F. Mitchell

William F. Mitchell
President and Chief Executive Officer

EXHIBIT 31.2

CERTIFICATION PURSUANT TO RULE 13A-14(A) UNDER THE SECURITIES EXCHANGE ACT OF 1934

I, Duane D. Deaner, certify that:

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

Date: May 25, 2006

By: /s/ Duane D. Deaner

Duane D. Deaner
Chief Financial Officer

EXHIBIT 32

CERTIFICATION PURSUANT TO
18 U.S.C. SECTION 1350
AS ADOPTED PURSUANT TO
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002

In connection with the Annual Report on Form 10-K of Environmental Tectonics Corporation (the “Company”) for the fiscal year ended February 24, 2006 as filed with the Securities and Exchange Commission on the date hereof (the “Report”), I, William F. Mitchell, Chief Executive Officer of the Company, and I, Duane D. Deaner, Chief Financial Officer of the Company, certify, pursuant to 18 U.S.C. § 1350, as adopted pursuant to § 906 of the Sarbanes-Oxley Act of 2002, that:

(1) The Report fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934; and

(2) The information contained in the Report fairly presents, in all material respects, the financial condition and result of operations of the Company.

/s/ William F. Mitchell

William F. Mitchell
Chief Executive Officer

/s/ Duane D. Deaner

Duane D. Deaner
Chief Financial Officer
May 25, 2006

This certification accompanies the Report pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 and shall not, except to the extent required by the Sarbanes-Oxley Act of 2002, be deemed to be filed by the Company for purpose of Section 18 of the Securities Exchange Act of 1934, as amended.

A signed original of this written statement required by Section 906 has been provided to the Company and will be retained by the Company and furnished to the Securities and Exchange Commission or its staff upon request.