

UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, DC 20549

FORM 10-Q

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

For the quarterly period ended August 24, 2012

Commission file no: 1-10655

ENVIRONMENTAL TECTONICS CORPORATION

Pennsylvania  
(State of incorporation)

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

County Line Industrial Park  
125 James Way  
Southampton, Pennsylvania 18966  
(Address of principal executive offices)

Registrant's telephone number: (215) 355-9100

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 whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes  No

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

Large Accelerated Filer  Accelerated Filer   
Non-Accelerated Filer  (Do not check if a smaller reporting company) Smaller Reporting Company

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes  No

As of October 4, 2012, there were 9,148,010 shares of the registrant's Common Stock issued and outstanding.

## Index

PART I – FINANCIAL INFORMATION	3
Item 1. <a href="#">Financial Statements (unaudited)</a>	3
Item 2. <a href="#">Management’s Discussion and Analysis of Financial Condition and Results of Operations</a>	16
Item 3. <a href="#">Quantitative and Qualitative Disclosures about Market Risk</a>	27
Item 4. <a href="#">Controls and Procedures</a>	27
PART II – OTHER INFORMATION	28
Item 1. <a href="#">Legal Proceedings</a>	28
Item 1A. <a href="#">Risk Factors</a>	28
Item 2. <a href="#">Unregistered Sales of Equity Securities and Use of Proceeds</a>	28
Item 3. <a href="#">Defaults upon Senior Securities</a>	28
Item 4. <a href="#">Mine Safety Disclosures</a>	28
Item 5. <a href="#">Other Information</a>	28
Item 6. <a href="#">Exhibits</a>	29
<a href="#">Signatures</a>	30
EXHIBIT 31.1	31
EXHIBIT 31.2	32
EXHIBIT 32	33

When used in this Quarterly Report on Form 10-Q, except where the context otherwise requires, the terms “we”, “us”, “our”, “ETC”, and the “Company” refer to Environmental Tectonics Corporation and its subsidiaries.

**PART I – FINANCIAL INFORMATION**

**Item 1. Financial Statements (unaudited)**

**Environmental Tectonics Corporation**  
**Consolidated Statements of Income and Comprehensive Income**  
**(unaudited)**  
**(in thousands, except per share information)**

	Thirteen weeks ended		Twenty-six weeks ended	
	August 24, 2012	August 26, 2011	August 24, 2012	August 26, 2011
Net sales	\$ 16,502	\$ 15,851	\$ 32,572	\$ 32,125
Cost of goods sold	10,405	9,932	20,027	19,708
Gross profit	<u>6,097</u>	<u>5,919</u>	<u>12,545</u>	<u>12,417</u>
Operating expenses:				
Selling and marketing	1,277	1,336	2,617	2,627
General and administrative	2,022	1,788	3,905	3,875
Research and development	337	136	647	381
	<u>3,636</u>	<u>3,260</u>	<u>7,169</u>	<u>6,883</u>
Operating income	<u>2,461</u>	<u>2,659</u>	<u>5,376</u>	<u>5,534</u>
Other expenses:				
Interest expense, net	231	207	445	357
Other (income) expense, net	(61)	(24)	(64)	84
	<u>170</u>	<u>183</u>	<u>381</u>	<u>441</u>
Income before income taxes	2,291	2,476	4,995	5,093
Provision for income taxes	<u>994</u>	<u>952</u>	<u>2,008</u>	<u>1,944</u>
Net income	1,297	1,524	2,987	3,149
Loss (gain) attributable to non-controlling interest	1	(2)	6	(18)
<b>Net income attributable to Environmental Tectonics Corporation</b>	<b><u>\$ 1,298</u></b>	<b><u>\$ 1,522</u></b>	<b><u>\$ 2,993</u></b>	<b><u>\$ 3,131</u></b>
Foreign currency translation adjustment	<u>(101)</u>	<u>137</u>	<u>55</u>	<u>(80)</u>
Comprehensive income	<u>\$ 1,197</u>	<u>\$ 1,659</u>	<u>\$ 3,048</u>	<u>\$ 3,051</u>
Preferred Stock dividend	<u>(552)</u>	<u>(552)</u>	<u>(1,104)</u>	<u>(1,104)</u>
Income attributable to common and participating shareholders	<u>\$ 746</u>	<u>\$ 970</u>	<u>\$ 1,889</u>	<u>\$ 2,027</u>
Per share information:				
Basic earnings per common and participating share:				
Distributed earnings per share:				
Common	<u>\$ -</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ -</u>
Preferred	<u>\$ 0.05</u>	<u>\$ 0.05</u>	<u>\$ 0.10</u>	<u>\$ 0.10</u>
Undistributed earnings per share:				
Common	<u>\$ 0.04</u>	<u>\$ 0.05</u>	<u>\$ 0.09</u>	<u>\$ 0.10</u>
Preferred	<u>\$ 0.04</u>	<u>\$ 0.05</u>	<u>\$ 0.09</u>	<u>\$ 0.10</u>
<b>Diluted earnings per share</b>	<b><u>\$ 0.04</u></b>	<b><u>\$ 0.05</u></b>	<b><u>\$ 0.09</u></b>	<b><u>\$ 0.10</u></b>
Basic weighted average common and participating shares:				
Common weighted average number of shares	9,142	9,106	9,139	9,106
Participating preferred shares	11,095	11,095	11,095	11,095
Total basic weighted average common and participating shares	<u>20,237</u>	<u>20,201</u>	<u>20,234</u>	<u>20,201</u>
Diluted weighted average shares:				
Basic weighted average common and participating shares	20,237	20,201	20,234	20,201

Dilutive effect of stock warrants and options	154	294	152	305
Total diluted weighted average shares	<u>20,391</u>	<u>20,495</u>	<u>20,386</u>	<u>20,506</u>

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

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

	<u>August 24, 2012</u>	<u>February 24, 2012</u>
	(unaudited)	
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents	\$ 3,096	\$ 3,425
Restricted cash	6,159	6,000
Accounts receivable, net	6,427	10,695
Costs and estimated earnings in excess of billings on uncompleted long-term contracts	21,633	18,766
Inventories, net	4,227	4,145
Deferred tax assets, current	3,961	4,170
Prepaid expenses and other current assets	1,079	830
<b>Total current assets</b>	<b>46,582</b>	<b>48,031</b>
Property, plant, and equipment, net	14,870	14,860
Capitalized software development costs, net	533	666
Deferred tax assets, non-current, net	2,560	4,190
Other assets	4	39
<b>Total assets</b>	<b>\$ 64,549</b>	<b>\$ 67,786</b>
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>		
Current liabilities:		
Current portion of long-term debt obligations	\$ -	\$ 8
Accounts payable, trade	4,656	5,639
Billings in excess of costs and estimated earnings on uncompleted long-term contracts	4,815	6,519
Customer deposits	3,610	3,425
Accrued taxes	339	148
Accrued interest and dividends	1,016	941
Other accrued liabilities	3,235	3,565
<b>Total current liabilities</b>	<b>17,671</b>	<b>20,245</b>
Long-term debt obligations, less current portion:		
Credit facility payable to bank	14,043	16,716
<b>Total long-term debt obligations, less current portion</b>	<b>14,043</b>	<b>16,716</b>
<b>Total liabilities</b>	<b>31,714</b>	<b>36,961</b>
Commitments and contingencies		
Shareholders' equity:		
Cumulative convertible participating Preferred Stock, Series D, \$0.05 par value, 11,000 shares authorized; 386 shares outstanding at August 24, 2012 and February 24, 2012	386	386
Cumulative convertible participating Preferred Stock, Series E, \$0.05 par value, 25,000 shares authorized; 21,741 shares outstanding at August 24, 2012 and February 24, 2012	21,741	21,741
Common Stock, \$0.05 par value, 50,000,000 shares authorized; 9,148,010 and 9,134,403 shares issued and outstanding at August 24, 2012 and February 24, 2012, respectively	457	456
Additional paid-in capital	9,963	9,892
Retained earnings (Accumulated deficit)	703	(1,186)
Accumulated other comprehensive loss	(450)	(505)
<b>Total shareholders' equity before non-controlling interest</b>	<b>32,800</b>	<b>30,784</b>
Non-controlling interest	35	41
<b>Total shareholders' equity</b>	<b>32,835</b>	<b>30,825</b>
<b>Total liabilities and shareholders' equity</b>	<b>\$ 64,549</b>	<b>\$ 67,786</b>

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

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

	<b>Twenty-six weeks ended</b>	
	<b>August 24, 2012</b>	<b>August 26, 2011</b>
<b>Cash flows from operating activities:</b>		
Net income	\$ 2,987	\$ 3,149
Adjustments to reconcile net income to net cash provided by (used in) operating activities:		
Depreciation and amortization	914	770
Deferred tax assets	1,839	1,348
Increase in allowances for accounts receivable and inventories, net	2	156
Accretion of loan origination deferred charge	50	105
Stock compensation expense	51	49
Changes in operating assets and liabilities:		
Accounts receivable	4,268	(1,817)
Costs and estimated earnings in excess of billings on uncompleted long-term contracts	(2,867)	(6,387)
Inventories	(84)	(2,613)
Prepaid expenses and other assets	(264)	(607)
Accounts payable, trade	(983)	468
Billings in excess of costs and estimated earnings on uncompleted long-term contracts	(1,704)	207
Customer deposits	185	61
Accrued taxes	191	813
Accrued interest and dividends	75	94
Other accrued liabilities	(330)	402
<b>Net cash provided by (used in) operating activities</b>	<b>4,330</b>	<b>(3,802)</b>
<b>Cash flows from investing activities:</b>		
Acquisition of property, plant, and equipment	(766)	(944)
Capitalized software development costs	(25)	(146)
<b>Net cash used in investing activities</b>	<b>(791)</b>	<b>(1,090)</b>
<b>Cash flows from financing activities:</b>		
(Repayments) borrowings under line of credit	(2,673)	9,389
Payment of Preferred Stock dividends	(1,104)	(1,104)
Increase in restricted cash	(159)	(18)
Payments of other debt obligations	(8)	(61)
Issuance of Common Stock	21	28
<b>Net cash (used in) provided by financing activities</b>	<b>(3,923)</b>	<b>8,234</b>
Effect of exchange rate changes on cash	55	(80)
Net (decrease) increase in cash	(329)	3,262
Cash at beginning of period	3,425	1,423
<b>Cash at end of period</b>	<b>\$ 3,096</b>	<b>\$ 4,685</b>
<b>Supplemental schedule of cash flow information:</b>		
Interest paid	\$ 310	\$ 153
Income taxes paid	\$ 69	\$ -
<b>Supplemental information on non-cash operating and investing activities:</b>		
Accrued dividends on Preferred Stock	\$ 552	\$ 552

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

**ENVIRONMENTAL TECTONICS CORPORATION**  
**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS**  
**(Unaudited)**  
**(Dollars in thousands, except per share information)**

***Description of Business***

ETC is principally engaged in the design, manufacture, and sale of software driven products and services used to recreate and monitor the physiological effects of motion on humans, and the design, manufacture, and sale of equipment to control, modify, simulate, and measure environmental conditions. These products and services include; (1) software driven products and services used to create and monitor the physiological effects of flight, including high performance jet tactical flight simulation, upset recovery and spatial disorientation, and both suborbital and orbital commercial human spaceflight; (2) altitude (hypobaric) chambers; (3) the Advanced Disaster Management Simulator (“ADMS”); (4) steam and gas sterilizers; (5) environmental testing and simulation devices; and (6) hyperbaric (100% oxygen) chambers. ETC focuses on software enhancements, product extensions, new product development, and new marketplace applications.

We operate in two primary business segments, Aerospace Solutions (“Aerospace”) and Commercial/Industrial Systems (“CIS”). Aerospace encompasses the design, manufacture, and sale of; (1) software driven products and services used to create and monitor the physiological effects of flight, including high performance jet tactical flight simulation, upset recovery and spatial disorientation, and both suborbital and orbital commercial human spaceflight; collectively, Aircrew Training Systems (“ATS”); (2) altitude (hypobaric) chambers; (3) hyperbaric chambers for multiple persons (multiplace chambers); and (4) ADMS, as well as integrated logistics support for customers who purchase these products. These products and services provide customers with an offering of comprehensive solutions for improved readiness and reduced operational costs. Sales of our Aerospace products are made principally to U.S. and foreign government agencies. The CIS segment encompasses the design, manufacture, and sale of; (1) steam and gas (ethylene oxide) sterilizers; (2) environmental testing and simulation devices; (3) hyperbaric chambers for one person (monoplace chambers); and (4) parts and service support. Sales of our CIS products are made principally to the healthcare, pharmaceutical, and automotive industries.

The Company’s fiscal year is the 52- or 53-week annual accounting period ending the last Friday in February. Certain amounts from prior consolidated financial statements have been reclassified to conform to the presentation in fiscal 2013.

**1. Summary of Significant Accounting Policies**

*Basis of Presentation*

The accompanying interim consolidated financial statements include the accounts of ETC, our 95%-owned subsidiary, ETC-PZL Aerospace Industries SP. Z 0.0, (“ETC-PZL”), and our 99%-owned subsidiary, Environmental Tectonics Corporation (Europe) Limited (“ETC-Europe”). The Company’s corporate headquarters and main production plant are located in Southampton, Pennsylvania, USA. ETC-PZL manufactures simulators and provides software to support our domestic products. ETC-Europe functions as a sales office in the United Kingdom. All significant inter-company accounts and transactions have been eliminated in consolidation.

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

In accordance with industry practices, costs and estimated earnings in excess of billings on uncompleted long-term contracts are classified as current even though a portion of these amounts may not be realized within one year.

Certain information in footnote disclosures normally included in financial statements prepared in conformity with accounting principles generally accepted in the United States of America has been condensed or omitted pursuant to such rules and regulations and the financial results for the periods presented may not be indicative of the full year’s results; however, the Company believes that the disclosures are adequate to make the information presented not misleading. These financial statements should be read in conjunction with the financial statements and the notes thereto included in the Company’s Annual Report on Form 10-K for the 2012 fiscal year.

References to 2013 second quarter are references to the thirteen week period ended August 24, 2012. References to 2012 second quarter are references to the thirteen week period ended August 26, 2011. References to 2013 first half are references to the twenty-six week period ended August 24, 2012. References to 2012 first half are references to the twenty-six week period ended August 26, 2011. References to fiscal 2013 or the 2013 fiscal year are references to the fifty-two week period ending February 22, 2013. References to fiscal 2012 or the 2012 fiscal year are references to the fifty-two week period ended February 24, 2012.

*Significant Accounting Policies*

There have been no material changes in the Company’s significant accounting policies during fiscal 2013 as compared to what was previously disclosed in the Company’s Annual Report on Form 10-K for the 2012 fiscal year.

**Environmental Tectonics Corporation**  
**Notes to the Consolidated Financial Statements, continued**  
**(Dollars in thousands, except per share information)**

*Recent Accounting Pronouncements*

In June 2011, the Financial Accounting Standards Board (“FASB”) issued Accounting Standards Update (“ASU”) No. 2011-05, Comprehensive Income (Topic 220): Presentation of Comprehensive Income. ASU 2011-05 amends the FASB Accounting Standards Codification (Codification) to allow an entity the option to present the total of comprehensive income, the components of net income, and the components of other comprehensive income either in a single continuous statement of comprehensive income or in two separate but consecutive statements. In both choices, an entity is required to present each component of net income along with total net income, each component of other comprehensive income along with a total for other comprehensive income, and a total amount for comprehensive income. ASU 2011-05 eliminates the option to present the components of other comprehensive income as part of the statement of changes in shareholders’ equity. The amendments to the Codification in ASU 2011-05 do not change the items that must be reported in other comprehensive income or when an item of other comprehensive income must be reclassified to net income.

In December 2011, the FASB issued ASU No. 2011-12, Comprehensive Income (Topic 220): Deferral of the Effective Date for Amendments to the Presentation of Reclassifications of Items Out of Accumulated Other Comprehensive Income in Accounting Standards Update No. 2011-05. Among the new provisions in ASU 2011-05 was a requirement for entities to present reclassification adjustments out of accumulated other comprehensive income by component in both the statement in which net income is presented and the statement in which other comprehensive income is presented (for both interim and annual financial statements); accordingly, this requirement is indefinitely deferred by ASU 2011-12 and will be further deliberated by the FASB at a future date.

The Company adopted this guidance during the thirteen week period ended February 24, 2012, and chose to present other comprehensive income within the accompanying Consolidated Statements of Income and Comprehensive Income. The effect of this amended guidance has been retrospectively applied to all periods presented.

In July 2012, the FASB issued ASU No. 2012-02, Intangibles-Goodwill and Other (Topic 350): Testing Indefinite-Lived Intangible Assets for Impairment, which amends the guidance in ASC 350-30 on testing indefinite-lived intangible assets, other than goodwill, for impairment. Under ASU 2012-02, an entity testing an indefinite-lived intangible asset for impairment has the option of performing a qualitative assessment before calculating the fair value of the asset. If the entity determines, on the basis of qualitative factors, that the fair value of the indefinite-lived intangible asset is not more likely than not (i.e., a likelihood of more than 50 percent) impaired, the entity would not need to calculate the fair value of the asset. ASU 2012-02 does not revise the requirement to test indefinite-lived intangible assets annually for impairment. In addition, ASU 2012-02 does not amend the requirement to test these assets for impairment between annual tests if there is a change in events or circumstances; however, it does revise the examples of events and circumstances that an entity should consider in interim periods. ASU 2012-02 is effective for annual and interim impairment tests performed for fiscal years beginning after September 15, 2012; early adoption is permitted. The effect of this amended guidance is not expected to have a significant impact on the consolidated financial statements.

**2. Earnings per Share**

The Company utilizes the two-class method for computing and presenting earnings per share. The Company currently has one class of common stock (the “Common Stock”) and two classes of cumulative participating preferred stock, Series D and Series E (the “Preferred Stock”). Under its terms, the Preferred Stock is entitled to participate in any cash dividends on a one-for-one basis for the equivalent converted common shares if the Preferred Stock were to be converted by the holder by the dividend record date. Therefore, the Preferred Stock is considered a participating security requiring the two-class method for the computation and presentation of net income per share – basic.

The two-class computation method for each period segregates basic earnings per common and participating share into two categories: distributed earnings per share (i.e., the Preferred Stock stated dividend) and undistributed earnings per share, which allocates earnings after subtracting the Preferred Stock dividend to the total of weighted average common shares outstanding plus equivalent converted common shares related to the Preferred Stock. Basic earnings per common and participating share excludes the effect of Common Stock equivalents, and is computed using the two-class computation method.

Diluted earnings per share reflects the potential dilution that could result if securities or other contracts to issue Common Stock were exercised or converted into Common Stock. Diluted earnings per share continues to be computed using the if-converted method. Diluted earnings per share assumes the exercise of stock options and warrants using the treasury stock method. If the effect of the conversion of any financial instruments would be anti-dilutive, it is excluded from the diluted earnings per share calculation.



**Environmental Tectonics Corporation**  
**Notes to the Consolidated Financial Statements, continued**  
**(Dollars in thousands, except per share information)**

At August 24, 2012 and February 24, 2012, there was \$22,127 of cumulative convertible participating Preferred Stock. These instruments were convertible at exercise prices of:

- Series D Preferred Stock of \$55 at \$0.94 per share, equating to 58,511 shares of Common Stock, issued in April 2009;
- Series D Preferred Stock of \$100 at \$1.11 per share, equating to 90,090 shares of Common Stock, issued in July 2009;
- Series D Preferred Stock of \$231 at \$3.02 per share, equating to 76,490 shares of Common Stock, issued in October 2010; and
- Series E Preferred Stock of \$21,741 at \$2.00 per share, equating to 10,870,321 shares of Common Stock, issued in July 2009.

On February 20, 2009, in connection with the issuance of a \$2,000 promissory note, the Company issued 200,000 warrants to purchase 143,885 shares of the Company's Common Stock at \$1.39 per share. Additionally, on July 2, 2009, in consideration of an increase of the guarantee on the line of credit with PNC Bank, National Association ("PNC Bank"), the Company issued 500,000 warrants to purchase 450,450 shares of the Company's Common Stock at \$1.11 per share. On January 4, 2011, the Company entered into amendments to these warrants to remove a provision in each of the warrants that provided anti-dilution protection in the event the Company issued securities at a price below the exercise price set forth in the warrants.

At August 24, 2012 and August 26, 2011, there were outstanding options to purchase the Company's Common Stock totaling 240,921 and 260,921 shares at an average price of \$4.26 and \$4.44 per share, respectively. Due to the conversion price of the Common Stock options, all 240,921 shares were excluded from the calculation of diluted earnings per share as of August 24, 2012 because the effect of their conversion would be antidilutive; likewise, all 260,921 shares were also excluded from the calculation of diluted earnings per share as of August 26, 2011.

### 3. Accounts Receivable

The components of accounts receivable are as follows:

	<b>August 24, 2012</b>	<b>February 24, 2012</b>
	<b>(unaudited)</b>	
U.S. Government	\$ 3,045	\$ 4,305
U.S. Commercial	1,123	2,994
International	2,659	3,797
	<u>6,827</u>	<u>11,095</u>
Less: allowance for doubtful accounts	(400)	(400)
	<u><u>\$ 6,427</u></u>	<u><u>\$ 10,695</u></u>

### 4. Inventories

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

	<b>August 24, 2012</b>	<b>February 24, 2012</b>
	<b>(unaudited)</b>	
Raw materials	\$ 39	\$ 42
Work in process	4,188	4,103
	<u><u>\$ 4,227</u></u>	<u><u>\$ 4,145</u></u>

Inventory is presented net of an allowance for obsolescence of \$1,159 (raw material \$80 and work in process \$1,079), and \$1,157 (raw material \$50 and work in process \$1,107) at August 24, 2012 and February 24, 2012, respectively.

In accordance with United States generally accepted accounting principles, the Company may capitalize into property, plant, and equipment certain costs of simulation equipment. This equipment may be used to provide training or as a demonstration device to market the technology, and may be sold as a product if appropriate. Upon receipt of a contract or contracts for products which are based on this technology, such costs will be transferred initially into inventory and subsequently charged to the cost of sales for that particular contract as manufacturing costs.

**Environmental Tectonics Corporation**  
**Notes to the Consolidated Financial Statements, continued**  
**(Dollars in thousands, except per share information)**

**5. Long-Term Obligations and Credit Arrangements**

**Lenfest Financing Transaction**

On April 24, 2009, the Company entered into a transaction (the “Lenfest Financing Transaction”) with H.F. Lenfest, a major shareholder and member of our Board of Directors (“Lenfest”), that provided for, among other things, the following: (i) the exchange of the Subordinated Note (as defined below) held by Lenfest, together with all accrued interest and warrants issuable under the Subordinated Note, and all Series B Preferred Stock and Series C Preferred Stock held by Lenfest, together with all accrued dividends thereon, for a new class of preferred stock, Series E Preferred Stock, the terms of which are described below; and (ii) the guarantee by Lenfest of all of ETC’s obligations to PNC Bank in connection with an increase of the existing \$15,000 revolving line of credit with PNC Bank (the “2007 PNC Credit Facility”) to \$20,000, and in connection with this guarantee, the pledge by Lenfest to PNC Bank of \$10,000 in marketable securities.

**Preferred Stock**

Presently, the Company has two classes of Cumulative Convertible Participating Preferred Stock: Series D (11,000 shares authorized) and Series E (25,000 shares authorized) (together, the “Preferred Stock”). The Preferred Stock was authorized by the Company’s Board of Directors in April 2009 as part of the Lenfest Financing Transaction. The Preferred Stock has a par value of \$0.05 per share and a stated value of \$1,000 per share. The Preferred Stock is entitled to receive cumulative dividends at the rate of 10% per year in preference to the holders of the Company’s Common Stock with respect to dividends. These dividends are payable only upon a liquidation event or when otherwise declared by the Board of Directors of the Company. The Company cannot declare or pay any dividends on its Common Stock until the dividends on the Preferred Stock have been paid. The Preferred Stock holders are entitled to receive any dividends paid with respect to the Common Stock on an “as-converted” basis. The Preferred Stock may be converted by the holder at any time and from time to time into the Company’s Common Stock by dividing the stated value of the Preferred Stock by the conversion price established at the time of issuance (see Series D Preferred Stock and Series E Preferred Stock, below). Upon a liquidation event, the holders of the Preferred Stock would be entitled to participate in any proceeds in preference to any common stock holders. The Preferred Stock would also participate in any liquidation event with the Common Stock holders on an “as-converted” basis. The Preferred Stock conversion price is subject to adjustment for certain transactions including stock splits and issuance of equity securities below the conversion prices.

The Company has reviewed the generally accepted accounting principles applicable to the Preferred Stock; specifically, the Company has reviewed both ASC 480 – Distinguishing Liabilities from Equity and ASC 815 – Derivatives and Hedging. Upon its review, the Company determined that the Preferred Stock is within the control of the Company and that the attributes of the Preferred Stock are more akin to equity than debt. The specific attributes considered by the Company include the designation of the instruments, the conversion of the instruments to the Company’s Common Stock, the participation feature, the non-mandatory conversion, the voting rights, and the ability to appoint directors. Secondly, the Company determined that the Preferred Stock qualifies as permanent equity because the Preferred Stock is not mandatorily redeemable, and there is no obligation to either repurchase the instruments or issue a variable amount of common shares. Lastly, the Company determined that the conversion feature qualifies for the scope exception of ASC 815 – Derivatives and Hedging as it is clearly and closely related to the Preferred Stock instrument.

Due to the Company’s accumulated deficit as of February 24, 2012, all dividends accruing through this date for the Series D and Series E Preferred Stock issuances have been recorded in the accompanying financial statements as a reduction in additional paid-in capital. As of August 24, 2012, the Company entered into a position of retained earnings; thus, all \$1,104 in dividends accrued for during the 2013 first half have been recorded as a reduction to retained earnings.

**Environmental Tectonics Corporation**  
**Notes to the Consolidated Financial Statements, continued**  
**(Dollars in thousands, except per share information)**

Issuances of the Preferred Stock are as follows:

**Series D Preferred Stock**

*Lenfest Credit Facility*

On April 24, 2009, the Company paid to Lenfest an origination fee of 1% of the committed amount of the Lenfest Credit Facility. The value of the origination fee was \$55. The origination fee was paid in 55 shares of Series D Preferred Stock, which have a conversion price of \$0.94 per share, equaling the closing price of the Company's Common Stock on that day and would convert into 58,511 shares of the Company's Common Stock.

*PNC Credit Facility*

In connection with the execution of the documents to increase the Company's existing \$15,000 revolving line of credit with PNC Bank to \$20,000, ETC paid to Lenfest an origination fee of 100 shares of Series D Preferred Stock, which is equal to one percent (1%) of the market value of the \$10,000 in marketable securities pledged by Lenfest to PNC Bank to secure ETC's obligations to PNC Bank. The 100 shares of Series D Preferred Stock have a stated value of \$1,000 per share, or \$100 in the aggregate. These shares of Series D Preferred Stock have a conversion price per share equal to \$1.11, equaling the average closing price of the Company's Common Stock during the 120 days preceding the issuance of such shares and would convert into 90,090 shares of the Company's Common Stock.

*Interest Payment*

On October 6, 2010, the Company issued to Lenfest 231 shares of Series D Preferred Stock with a stated value of \$1,000 per share in payment of \$231 of interest due under the Lenfest Pledge Agreement for the period July 2, 2009 through August 27, 2010. The 231 shares have a conversion price per share equal to \$3.02 equaling the average closing price of the Company's Common Stock during the 120 days preceding the issuance of such shares, and would convert into 76,490 shares of the Company's Common Stock. As of August 24, 2012, \$400 of interest has been accrued for the period August 28, 2010 through August 24, 2012.

*Preferred Stock Dividends*

As of August 24, 2012, the Series D Preferred Stock totaled \$386 and was convertible into 225,091 shares of the Company's Common Stock. All Series D Preferred Stock dividends accruing through August 24, 2012 will be paid in October 2012.

**Series E Preferred Stock**

On July 2, 2009, the Company issued 23,741 shares of Series E Preferred Stock to Lenfest in connection with the Lenfest Financing Transaction. The shares of Series E Preferred Stock are convertible to Common Stock at a conversion price per share equal to \$2.00 and would convert into 11,870,391 shares of the Company's Common Stock.

On March 10, 2010, August 12, 2010, and February 9, 2011, ETC entered into three separate agreements with Lenfest to repurchase and retire a total of 2,000 shares of Series E Preferred Stock owned by Lenfest. In the three agreements, the repurchases were made at the stated price of \$1,000 per share for a total of \$2,000.

As of August 24, 2012, the Series E Preferred Stock totaled \$21,741 and was convertible into 10,870,391 shares of the Company's Common Stock. All Series E Preferred Stock dividends accruing through August 24, 2012 will be paid in October 2012.

**Environmental Tectonics Corporation**  
**Notes to the Consolidated Financial Statements, continued**  
**(Dollars in thousands, except per share information)**

**Common Stock Warrants**

On February 28, 2009, in connection with a \$2,000 loan made by Lenfest to the Company, the Company issued to Lenfest warrants to purchase 143,885 shares of ETC Common Stock, which shares were equal in value to 10% of the \$2,000 note. The warrants are exercisable for seven years following issuance at an exercise price of \$1.39, which price equaled the average closing price of ETC Common Stock during the 120 days prior to the issuance of the warrant.

On July 2, 2009, in consideration of Lenfest's agreement to guarantee the \$5,000 increase to the Company's line of credit with PNC Bank, ETC issued to Lenfest warrants to purchase 450,450 shares of ETC Common Stock, which shares were equal in value to ten percent (10%) of the amount of the \$5,000 increase. The warrants are exercisable for seven years following issuance at an exercise price per share equal to \$1.11, equaling the average closing price of ETC Common Stock during the 120 days preceding the issuance of the warrant.

On January 4, 2011, the Company entered into amendments to each of the warrants issued to Lenfest pursuant to which Lenfest agreed to remove a provision in each of the warrants which provided anti-dilution protection in the event the Company issued securities at a price below the exercise price set forth in the warrants.

**Bank Credit and Facility**

The Company has a line of credit facility with PNC Bank ("PNC Credit Agreement") of \$20,000, which expires on June 30, 2013. The PNC Credit Agreement is subject to the condition that Lenfest continue to personally guarantee all of ETC's obligations to PNC Bank (the "Lenfest Guaranty") and that Lenfest pledge \$10,000 in marketable securities as collateral security for his guarantee (the "Lenfest Pledge").

In connection with the PNC Credit Agreement and the Lenfest Pledge, ETC paid to Lenfest an origination fee of 100 shares of Series D Convertible Preferred Stock of the Company (the "Series D Preferred Stock"), which is equal to one percent (1%) of the market value of the \$10,000 in marketable securities pledged by Lenfest to PNC Bank to secure ETC's obligations to PNC Bank. The 100 shares of Series D Preferred Stock have a stated value of \$1,000 per share, or \$100 in the aggregate. These shares of Series D Preferred Stock have a conversion price per share equal to \$1.11, equaling the average closing price of the Company's Common Stock during the 120 days preceding the issuance of such shares and would convert into 90,090 shares of the Company's Common Stock. Additionally, ETC will pay Lenfest annual interest equal to 2% of the amount of the Lenfest Pledge, payable in Series D Preferred Stock.

In consideration of Lenfest entering into the PNC Credit Agreement and Lenfest Pledge, ETC issued to Lenfest warrants to purchase shares of ETC Common Stock equal to 10% of the amount of a \$5,000 increase under the 2007 PNC Bank Credit Facility. The warrants are exercisable for seven years following issuance at an exercise price per share equal to \$1.11, which was equal to the average price of ETC Common Stock during the 120 days preceding the date of this warrant.

The Company recorded a loan origination deferred charge associated with these warrants of \$487 using the Black-Scholes options-pricing model with the following weighted average assumptions: expected volatility of 91.9%; risk-free interest rate of 0.49%; and an expected life of seven years. As of August 24, 2012, the unamortized balance of the deferred charge was \$85.

As of August 24, 2012, the Company's availability under the PNC Credit Agreement was \$5,005. This reflected cash borrowing under the PNC Credit Agreement of \$14,043 and outstanding letters of credit of approximately \$952. Amounts borrowed under the PNC Credit Agreement can be borrowed, repaid, and reborrowed from time-to-time until June 30, 2013, and bears interest at either the prime rate plus 0.50 percentage points or the London Interbank Offered Rate ("LIBOR") plus 2.50 percentage points. Additionally, ETC is obligated to pay a fee of 0.125% per year for unused but available funds under the line of credit.

The PNC Credit Agreement has the following financial covenants: (i) a Consolidated Tangible Net Worth covenant, for which the Company must maintain a minimum Consolidated Tangible Net Worth of at least \$10,000 and (ii) an EBITDA covenant for which the Company must maintain a minimum cumulative aggregate Earnings Before Interest, Taxes, Depreciation, and Amortization ("EBITDA") of \$4,000 for the fiscal quarter then ending and the three preceding fiscal quarters. The Company is in compliance with these financial covenants as of August 24, 2012.

**Financial Restructuring**

On September 28, 2012, the Company announced a financial restructuring agreement that will reduce its annual net cash payments for dividends and interest by approximately \$1,500, and reduce the number of participating preferred shares equivalent to 5,032,091 shares of Common Stock. As part of the financial restructuring, the Company's revolving line of credit with PNC Bank was reduced from \$20,000 to \$15,000, with the expiration date extended to October 31, 2015. PNC Bank also provided to the Company a five-year term loan of \$15,000, which will expire on September 28, 2017. For further details, see Note 9 to the Consolidated Financial Statements.

**Environmental Tectonics Corporation**  
**Notes to the Consolidated Financial Statements, continued**  
**(Dollars in thousands, except per share information)**

**Dedicated Line of Credit Agreement with PNC Bank**

The Company has a committed line of credit in the amount of \$5,422 with PNC Bank (the “Dedicated Line of Credit”). The Company uses the Dedicated Line of Credit to satisfy performance bond and repayment guarantee requirements for an international contract. Use of this Dedicated Line of Credit is restricted to funding contract performance and repayment guarantee requirements under this specific contract.

As security for the Dedicated Line of Credit, the Company has deposited \$5,422 in a certificate of deposit with PNC Bank. ETC is obligated to pay a fee of 3% per year for the Dedicated Line of Credit.

**ETC-PZL Line of Credit Agreement**

ETC-PZL has a line of credit in the amount of \$175 with a Warsaw bank to fund current activity. The line of credit will expire in July 2013. As of August 24, 2012, there were no outstanding borrowings under this line of credit.

**Summary of Long-Term Debt Obligations**

Long-term debt obligations at August 24, 2012 and February 24, 2012 consist of the following:

	<u>August 24, 2012</u>	<u>February 24, 2012</u>
	<u>(unaudited)</u>	
Note payable to bank	\$ 14,043	\$ 16,716
Equipment lease	-	8
Total long-term debt obligations	14,043	16,724
Less: current portion of long-term debt obligations	-	(8)
<b>Total long-term debt obligations, less current portion</b>	<b><u>\$ 14,043</u></b>	<b><u>\$ 16,716</u></b>

**6. Income Taxes**

Effective tax rates were 43.4% and 38.4% for the 2013 second quarter and the 2012 second quarter, respectively. Effective tax rates were 40.2% and 38.2% for the 2013 first half and the 2012 first half, respectively. Income tax provisions of \$994 and \$952 were recorded in the 2013 second quarter and the 2012 second quarter, respectively. Income tax provisions of \$2,008 and \$1,944 were recorded in the 2013 first half and the 2012 first half, respectively. At the end of each interim period, we make our best estimate of the effective tax rate expected to be applicable for the full fiscal year and the impact of discrete items, if any, and adjust the quarterly rate as necessary.

Generally, accounting standards require companies to provide for income taxes each quarter based on their estimate of the effective tax rate for the full year. The authoritative guidance for accounting for income taxes allows use of the discrete method when, in certain situations, the actual interim period effective tax rate may be used if it provides a better estimate of income tax expense.

As of August 24, 2012, the Company had approximately \$18.4 million of federal net loss carryforwards available to offset future income tax liabilities, which begin to expire in 2025. In addition, the Company has the ability to offset deferred tax assets against deferred tax liabilities created for such items as depreciation and amortization.

**7. Commitments and Contingencies**

Certain claims, suits, and complaints arising in the ordinary course of business have been filed or are pending against us. We believe, after consultation with legal counsel handling these specific matters, all such matters are reserved for or adequately covered by insurance or, if not so covered, are without merit or are of such kind, or involve such amounts, as would not be expected to have a significant effect on our financial position or results of operations if determined adversely against us.

**Environmental Tectonics Corporation**  
**Notes to the Consolidated Financial Statements, continued**  
**(Dollars in thousands, except per share information)**

**8. Segment Information (unaudited)**

As indicated, we operate in two business segments – Aerospace and CIS.

Aerospace encompasses the design, manufacture, and sale of; (1) software driven products and services used to create and monitor the physiological effects of flight, including high performance jet tactical flight simulation, upset recovery and spatial disorientation, and both suborbital and orbital commercial human spaceflight, (2) altitude (hypobaric) chambers; (3) hyperbaric (100% oxygen) chambers for multiple persons (multiplace chambers); and (4) ADMS, as well as integrated logistics support for customers who purchase these products. These products and services provide customers with an offering of comprehensive solutions for improved readiness and reduced operational costs.

CIS encompasses the design, manufacture, and sale of; (1) steam and gas (ethylene oxide) sterilizers; (2) environmental testing and simulation devices for the automotive industry; and (3) hyperbaric (100% oxygen) chambers for one person (monoplace chambers), as well as parts and service support.

The following unaudited segment information reflects the accrual basis of accounting.

<b><u>Thirteen weeks ended August 24, 2012:</u></b>	<b><u>Aerospace</u></b>	<b><u>CIS</u></b>	<b><u>Corporate</u></b>	<b><u>Company Total</u></b>
Net sales	\$ 11,140	\$ 5,362	\$ -	\$ 16,502
Interest expense, net	156	75	-	231
Depreciation and amortization	282	164	15	461
Operating income (loss)	1,688	1,452	(679)	2,461
Provision for income taxes	-	-	994	994
Identifiable assets	38,912	7,967	17,670	64,549
Expenditures for segment assets	239	24	25	288

**Thirteen weeks ended August 26, 2011:**

Net sales	\$ 12,469	\$ 3,382	\$ -	\$ 15,851
Interest expense, net	163	44	-	207
Depreciation and amortization	322	84	12	418
Operating income (loss)	2,479	810	(630)	2,659
Provision for income taxes	-	-	952	952
Identifiable assets	34,511	9,696	19,975	64,182
Expenditures for segment assets	519	89	91	699

**Reconciliation to consolidated net income attributable to**

<b><u>Environmental Tectonics Corporation:</u></b>	<b><u>Thirteen weeks ended</u></b>	
	<b><u>August 24, 2012</u></b>	<b><u>August 26, 2011</u></b>
Operating income	\$ 2,461	\$ 2,659
Interest expense, net	(231)	(207)
Other income (expense), net	61	24
Provision for income taxes	(994)	(952)
Loss (gain) attributable to non-controlling interest	1	(2)
<b>Net income attributable to Environmental Tectonics Corporation</b>	<b>\$ 1,298</b>	<b>\$ 1,522</b>

**Environmental Tectonics Corporation**  
**Notes to the Consolidated Financial Statements, continued**  
**(Dollars in thousands, except per share information)**

**8. Segment Information (unaudited) (continued)**

<u>Twenty-six weeks ended August 24, 2012:</u>	<u>Aerospace</u>	<u>CIS</u>	<u>Corporate</u>	<u>Company Total</u>
Net sales	\$ 21,617	\$ 10,955	\$ -	\$ 32,572
Interest expense, net	295	150	-	445
Depreciation and amortization	580	306	28	914
Operating income (loss)	4,012	2,667	(1,303)	5,376
Provision for income taxes	-	-	2,008	2,008
Identifiable assets	38,912	7,967	17,670	64,549
Expenditures for segment assets	649	50	92	791

**Twenty-six weeks ended August 26, 2011:**

Net sales	\$ 24,561	\$ 7,564	\$ -	\$ 32,125
Interest expense, net	274	83	-	357
Depreciation and amortization	585	173	12	770
Operating income (loss)	4,952	2,048	(1,466)	5,534
Provision for income taxes	-	-	1,944	1,944
Identifiable assets	34,511	9,696	19,975	64,182
Expenditures for segment assets	818	181	91	1,090

**Reconciliation to consolidated net income attributable to**

**Environmental Tectonics Corporation:**

	<u>Twenty-six weeks ended</u>	
	<u>August 24, 2012</u>	<u>August 26, 2011</u>
Operating income	\$ 5,376	\$ 5,534
Interest expense, net	(445)	(357)
Other income (expense), net	64	(84)
Provision for income taxes	(2,008)	(1,944)
Loss (gain) attributable to non-controlling interest	6	(18)
<b>Net income attributable to Environmental Tectonics Corporation</b>	<b>\$ 2,993</b>	<b>\$ 3,131</b>

Approximately 62.2% of net sales in the 2013 second quarter, totaling \$10,259, were made to the U.S. Government under three contracts, to one Domestic commercial customer, and to one International customer. Approximately 68.1% of net sales in the 2012 second quarter, totaling \$10,796, were made to the U.S. Government under three contracts, one Domestic commercial customer, and to one International customer.

The segment information for the 2013 second quarter includes export sales of \$4,772, including sales to the Korean government of \$2,632. The segment information for the 2012 second quarter includes export sales of \$4,611, including sales to the Korean government of \$1,846.

Approximately 62.4% of net sales in the 2013 first half, totaling \$20,312, were made to the U.S. Government under three contracts, to one Domestic commercial customer, and to one International customer. Approximately 68.5% of net sales in the 2012 first half, totaling \$22,016, were made to the U.S. Government under three contracts, one Domestic commercial customer, and to one International customer.

The segment information for the 2013 first half includes export sales of \$8,973, including sales to the Korean government of \$4,564. The segment information for the 2012 first half includes export sales of \$8,978, including sales to the Korean government of \$3,904.

As of both August 24, 2012 and August 26, 2011, substantially all of the Company's long-lived assets were located in the United States.

**Environmental Tectonics Corporation**  
**Notes to the Consolidated Financial Statements, continued**  
**(Dollars in thousands, except per share information)**

**9. Subsequent Events**

On September 28, 2012, the Company announced a financial restructuring agreement that will reduce its annual net cash payments for dividends and interest by approximately \$1,500, and reduce the number of participating preferred shares equivalent to 5,032,091 shares of Common Stock. As part of the financial restructuring, the Company's revolving line of credit with PNC Bank was reduced from \$20,000 to \$15,000, with the expiration date extended to October 31, 2015. The interest rate on the PNC line of credit will remain unchanged. PNC Bank also provided to the Company a five-year term loan of \$15,000, which will expire on September 28, 2017. The Company utilized \$10,000 of the proceeds from the term loan to repurchase and retire 10,000 shares of 10% Preferred Stock, equivalent to 5,032,091 shares of Common Stock. The revolving line of credit will no longer be guaranteed by H.F. Lenfest, a major shareholder and member of our Board of Directors, and will instead be secured by substantially all of the Company's assets. Mr. Lenfest will provide a guarantee on the new \$15,000 term loan for a period of thirty months, after which his guarantee will be removed. In addition, dividends on the remaining Series E Preferred Stock will be reduced from ten percent (10%) to four percent (4%), subject to shareholder approval.

Other than the disclosures above, we did not identify any other events or transactions that should be recognized or disclosed in the accompanying financial statements.



## Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

### FORWARD-LOOKING STATEMENTS

Discussions of some of the matters contained in this Quarterly Report on Form 10-Q for ETC may constitute forward-looking statements within the meaning of the Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities and Exchange Act of 1934, as amended (**the "Exchange Act"**), and, as such, may involve risks and uncertainties. We have based these forward-looking statements on our current expectations and projections about future events or future financial performance, which include implementing our business strategy, developing and introducing new technologies, obtaining, maintaining and expanding market acceptance of the technologies we offer, and competition in our markets. These forward-looking statements are subject to known and unknown risks, uncertainties and assumptions about ETC 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 revenues, costs of 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, (vi) statements regarding the Company's ability to obtain financing to support its operations and other expenses, and (vii) statements preceded by, followed by or that include terminology such as "may," "will," "should," "expect," "plan," "anticipate," "believe," "estimate," "future," "predict," "potential," "intend," or "continue," and 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 our Annual Report on Form 10-K for the 2012 fiscal year, in the sections entitled "Risk Factors" and "Management's Discussion and Analysis of Financial Condition and Results of Operations." 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 factors that could affect forward-looking statements by ETC is not exclusive. Except as required by federal securities law, 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.

References to 2013 second quarter are references to the thirteen week period ended August 24, 2012. References to 2012 second quarter are references to the thirteen week period ended August 26, 2011. References to 2013 first half are references to the twenty-six week period ended August 24, 2012. References to 2012 first half are references to the twenty-six week period ended August 26, 2011. References to fiscal 2013 or the 2013 fiscal year are references to the fifty-two week period ending February 22, 2013. References to fiscal 2012 or the 2012 fiscal year are references to the fifty-two week period ended February 24, 2012.

### **Overview**

ETC was incorporated in 1969 in Pennsylvania. For over forty-three years, we have provided our customers with products, service, and support. Innovation, continuous technological improvement and enhancement, and product quality are core values that are critical to our success. We are a significant supplier and innovator in the following product areas: (1) software driven products and services used to create and monitor the physiological effects of flight, including high performance jet tactical flight simulation, upset recovery and spatial disorientation, and both suborbital and orbital commercial human spaceflight; (2) altitude (hypobaric) chambers; (3) the Advanced Disaster Management Simulator ("ADMS"); (4) steam and gas sterilizers; (5) environmental testing and simulation devices; and (6) hyperbaric (100% oxygen) chambers.

We operate in two business segments – Aerospace and CIS.

Aerospace encompasses the design, manufacture, and sale of; (1) software driven products and services used to create and monitor the physiological effects of flight, including high performance jet tactical flight simulation, upset recovery and spatial disorientation, and both suborbital and orbital commercial human spaceflight; collectively, Aircrew Training Systems ("ATS"), (2) altitude (hypobaric) chambers, (3) hyperbaric (100% oxygen) chambers for multiple persons (multiplace chambers); and (4) ADMS, as well as integrated logistics support for customers who purchase these products. These products and services provide customers with an offering of comprehensive solutions for improved readiness and reduced operational costs.

CIS encompasses the design, manufacture, and sale of; (1) steam and gas (ethylene oxide) sterilizers; (2) environmental testing and simulation devices; and (3) hyperbaric (100% oxygen) chambers for one person (monoplace chambers), as well as parts and service support.

Net sales, operating income, identifiable assets, and other financial information regarding our segments may be found in Note 8 – Segment Information (unaudited) of the Notes to the Consolidated Financial Statements.

We sell integrated training services and products. Some of our products are customized, using our proprietary software based on specifications provided by our customers. Some of our products take more than one year to manufacture and deliver to the customer.

In the Aerospace segment, we offer integrated aircrew training services to commercial, governmental, and military defense agencies, and training devices to governmental and military defense agencies both in the United States and internationally. We sell our multiplace hyperbaric chambers to the military. We sell our disaster management simulation training and products to fire and emergency training schools, and to state and local governments.

In the CIS segment, we sell our sterilizers to pharmaceutical and medical device manufacturers. We sell our environmental testing systems primarily to commercial automobile manufacturers and heating, ventilation and air conditioning (HVAC) manufacturers. We sell our monoplace hyperbaric chambers to hospitals and clinics. We also provide upgrade, maintenance, and repair services for our products and for products manufactured by other parties.

We presently have two operating subsidiaries. ETC-PZL, our 95%-owned subsidiary in Warsaw, Poland, manufactures simulators and provides software to support our domestic products. ETC-Europe, our 99%-owned subsidiary, functions as a sales office in the United Kingdom.

We utilize both employees and independent representatives to market our products and services. We have branch offices in England, Egypt, Turkey, United Arab Emirates, India, China, Thailand, Malaysia, and Japan. Internationally, we have relationships with numerous independent sales representatives and distributors.

In December 2011, we learned of potential non-compliant accounting practices at one of these foreign subsidiaries, relating to the manner in which internal personnel costs were allocated to certain contracts. The Audit Committee of our Board of Directors initiated an independent internal investigation to determine the extent and materiality of the potential non-compliance with respect to the Company's financial reporting for fiscal 2012, and the investigation has now been completed.

Based on the information obtained during the course of the investigation, including a forensic audit of selected electronically stored information, and interviews with certain employees and management of the foreign subsidiary, the Audit Committee's independent counsel did not find a sufficient basis from which to conclude that the reallocation of personnel costs was due to an illegitimate purpose or motive. However, it was noted that reallocations of time entries among contracts had occurred and that the subsidiary did not have a uniform centralized system for recording personnel time and retaining source data, thereby creating a situation where there was insufficient maintenance of records that reflect the transactions in reasonable detail so as to permit the timely preparation of financial statements in accordance with generally accepted accounting principles. In addition, the corporate governance structure of the foreign subsidiary, which vested significant control of the subsidiary in the subsidiary's management board, did not allow for prompt and effective intervention by the Company or its Board and significantly complicated the investigation. Taken together, our Chief Executive Officer and Chief Financial Officer have concluded that these circumstances constitute a material weakness in our internal control over financial reporting ( *see* Item 4. Controls and Procedures, below).

The following factors had an impact on our financial performance, cash flow, and financial position for the 2013 first half:

- Production under U.S. Government contracts

The Base Realignment and Closure (BRAC) Act passed by Congress in 2005 mandated base closures and consolidations through all the U.S. defense services. As a result of this Act, we were awarded three major contracts for pilot training simulators. Our fiscal 2013 opening backlog of firm orders included approximately \$39.0 million for three significant contracts including one from the U.S. Navy for a research disorientation device and two from the U.S. Air Force to provide a high performance human centrifuge and a suite of research altitude chambers. As a result of engineering and production activity on these three contracts beginning to wind down, sales to the U.S. Government decreased by \$3.0 million or 18.5% during the 2013 first half compared to the 2012 first half. Although at the current time we still have a significant sales backlog with the U.S. Government for equipment being procured under the BRAC Act, given the current domestic economic conditions and political environment, it should not be assumed that any additional contracts will be awarded to us.

- Provisions for income taxes

During fiscal 2012, an income tax provision of \$2.6 million was recorded in our Consolidated Statement of Income and Comprehensive Income. This provision primarily reflected the realization of the Company's federal net loss carryforwards. During the 2013 first half, an income tax provision of \$2.0 million was recorded in our Consolidated Statement of Income and Comprehensive Income. As of August 24, 2012, the Company had approximately \$18.4 million of federal net loss carryforwards available to offset future income tax liabilities.

- The independent internal investigation by the Audit Committee of our Board of Directors

We have incurred substantial costs and diverted management resources in connection with the aforementioned independent internal investigation. In addition, the enhancements to be implemented to remediate the material weakness ( *see* Item 4. Controls and Procedures, below) will require us to incur additional costs and to divert management resources in the upcoming fiscal quarters.

## **Critical Accounting Policies**

The discussion and analysis of the Company's financial condition and results of operation are based upon the Company's consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States of America. The preparation of these consolidated financial statements requires the Company to make estimates and judgments that affect the reported amount of assets and liabilities, revenues and expenses, and related disclosure of contingent assets and liabilities at the date of the Company's condensed 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. For a detailed discussion on the application of these and other accounting policies, see Note 2 to the Consolidated Financial Statements, entitled Summary of Significant Accounting Policies, in the Company's Annual Report on Form 10-K for the 2012 fiscal year.

**Results of Operations****Thirteen weeks ended August 24, 2012 compared to thirteen weeks ended August 26, 2011**

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

	<b>Summary Table of Results</b>			
	<b>(amounts in thousands)</b>			
	<b>(unaudited)</b>			
	<b>Thirteen weeks ended</b>		<b>Variance</b>	<b>Variance</b>
	<b>August 24, 2012</b>	<b>August 26, 2011</b>	<b>\$</b>	<b>%</b>
Net sales:				
Domestic	\$ 4,988	\$ 2,756	\$ 2,232	81.0
U.S. Government	6,742	8,484	(1,742)	(20.5)
International	4,772	4,611	161	3.5
Total net sales	16,502	15,851	651	4.1
Gross profit	6,097	5,919	178	3.0
Selling and marketing expenses	1,277	1,336	(59)	(4.4)
General and administrative expenses	2,022	1,788	234	13.1
Research and development expenses	337	136	201	147.8
Operating income	2,461	2,659	(198)	(7.4)
Interest expense, net	231	207	24	11.6
Other (income) expense, net	(61)	(24)	(37)	(154.2)
Income before income taxes	2,291	2,476	(185)	(7.5)
Provision for income taxes	994	952	42	4.4
Loss (gain) attributable to non-controlling interest	1	(2)	3	150.0
<b>Net income attributable to ETC</b>	<b>\$ 1,298</b>	<b>\$ 1,522</b>	<b>\$ (224)</b>	<b>(14.7)</b>
Per share information:				
Basic earnings per common and participating share:				
Distributed earnings per share:				
Common	\$ -	\$ -	\$ -	
Preferred	\$ 0.05	\$ 0.05	\$ -	
Undistributed earnings per share:				
Common	\$ 0.04	\$ 0.05	\$ (0.01)	
Preferred	\$ 0.04	\$ 0.05	\$ (0.01)	
<b>Diluted earnings per share</b>	<b>\$ 0.04</b>	<b>\$ 0.05</b>	<b>\$ (0.01)</b>	

**Net Income Attributable To ETC**

Net income attributable to ETC was \$1.3 million, or \$0.04 diluted earnings per share, in the 2013 second quarter, compared to \$1.5 million or \$0.05 diluted earnings per share, during the 2012 second quarter, representing a decrease of \$224 thousand, or 14.7%. This decrease reflects a decrease in income before income taxes of \$185 thousand, a result of a \$178 thousand increase in gross profit, which was more than offset by a \$376 thousand increase in operating expenses.

**Net Sales**

The following schedule presents the Company's unaudited net sales by segment, business unit, and geographic area (amounts in thousands):

	Thirteen weeks ended August 24, 2012				Thirteen weeks ended August 26, 2011			
	Domestic	U.S.		Total	Domestic	U.S.		Total
		Gov't	International			Gov't	International	
<b>Aerospace Solutions</b>								
ATS	\$ 199	\$ 2,471	\$ 3,221	\$ 5,891	\$ 110	\$ 6,114	\$ 2,454	\$ 8,678
Chambers	-	4,271	328	4,599	-	2,370	210	2,580
Simulation	200	-	56	256	460	-	106	566
ETC-PZL and other	85	-	309	394	15	-	630	645
Subtotal	484	6,742	3,914	11,140	585	8,484	3,400	12,469
<b>Commercial/Industrial Systems</b>								
Environmental	1,031	-	479	1,510	95	-	86	181
Sterilizers	2,382	-	41	2,423	1,502	-	-	1,502
Hyperbaric	458	-	274	732	4	-	1,081	1,085
Service and spares	633	-	64	697	570	-	44	614
Subtotal	4,504	-	858	5,362	2,171	-	1,211	3,382
<b>Total net sales</b>	<b>\$ 4,988</b>	<b>\$ 6,742</b>	<b>\$ 4,772</b>	<b>\$ 16,502</b>	<b>\$ 2,756</b>	<b>\$ 8,484</b>	<b>\$ 4,611</b>	<b>\$ 15,851</b>

Net sales for the 2013 second quarter were \$16.5 million, an increase of \$0.6 million, or 4.1%, compared to 2012 second quarter net sales of \$15.9 million. The increase reflects increased sales to Domestic customers, offset in part, by decreased sales to the U.S. Government.

**Domestic Sales**

Domestic sales in the 2013 second quarter were \$5.0 million, an increase of \$2.2 million, or 81.0%, over 2012 second quarter sales of \$2.8 million. The increase in Domestic sales is due primarily to an increase in Environmental, Sterilizer, and Hyperbaric sales within the CIS segment. Domestic sales represented 30.2% of the Company's total net sales in the 2013 second quarter compared to 17.4% of the Company's total net sales in the 2012 second quarter.

**U.S. Government Sales**

U.S. Government sales in the 2013 second quarter were \$6.7 million, a decrease of \$1.8 million, or 20.5%, compared to 2012 second quarter sales of \$8.5 million, and represented 40.9% of total net sales in the 2013 second quarter compared to 53.5% for the 2012 second quarter. This decrease is the result of lower ATS sales, offset in part, by an increase in sales related to a suite of research altitude chambers. Given the existing progress made on U.S. Government sales contracts in the Company's backlog, the Company anticipates the concentration of sales to the U.S. Government will continue to lessen in fiscal 2013.

**International Sales**

International sales for the 2013 second quarter, including those of the Company's foreign subsidiaries, were \$4.8 million compared to \$4.6 million in the 2012 second quarter, an increase of \$0.2 million, or 3.5%, and represented 28.9% of total net sales in the 2013 second quarter compared to 29.1% in the 2012 second quarter. The increase in International sales reflects an increase in ATS sales, offset in part, by a decrease in Hyperbaric sales. International sales in the 2013 second quarter included \$2.6 million in sales to the Korean government. International sales in the 2012 second quarter included \$1.8 million in sales to the Korean government.

**Gross Profit**

Gross profit for the 2013 second quarter was \$6.1 million as compared to \$5.9 million in the 2012 second quarter, an increase of \$0.2 million, or 3.0%. The increase in gross profit was a result of an increase in net sales; however, gross profit margin as a percentage of net sales decreased slightly to 36.9% in the 2013 second quarter from 37.3% in the 2012 second quarter.

## **Selling and Marketing Expenses**

Selling and marketing expenses for the 2013 second quarter of \$1.3 million remained unchanged compared to the 2012 second quarter. As a percentage of net sales, selling and marketing expenses decreased to 7.7% in the 2013 second quarter from 8.4% in the 2012 second quarter. Although the dollar amount of selling and marketing expenses did not change, there was a decrease in commission generating revenue in the 2013 second quarter compared to the 2012 second quarter; thus, commission expense as a percentage of net sales was lower in the 2013 second quarter compared to the 2012 second quarter.

## **General and Administrative Expenses**

General and administrative expenses for the 2013 second quarter were \$2.0 million, an increase of \$0.2 million, or 13.1%, compared to \$1.8 million for the 2012 second quarter. As a percentage of net sales, general and administrative expenses increased to 12.3% in the 2013 second quarter from 11.3% in the 2012 second quarter. The increase is primarily the result of an increase in domestic salary expenses and expenses related to ETC-PZL, offset in part, by a decrease in consulting expenses.

## **Research and Development Expenses**

Research and development expenses include spending for potential new products and technologies, and internationally, work performed under government grant programs. This spending, net of grant payments from the Polish and Turkish governments, totaled \$0.3 million for the 2013 second quarter compared to \$0.1 million for the 2012 second quarter, an increase of \$0.2 million. The increase was a result of less research and development employees being assigned to specific contracts; thus, expenses related to these employees were included in research and development expenses in the 2013 second quarter. 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. As a percentage of sales, research and development expenses were 2.0% in the 2013 second quarter compared to 0.9% in the 2012 second quarter.

## **Operating Income**

Operating income decreased by \$0.2 million, or 7.4%, to \$2.5 million for the 2013 second quarter compared to \$2.7 million in the 2012 second quarter. Operating income as a percentage of net sales decreased to 14.9% from 16.8% in the 2012 second quarter. On a segment basis, Aerospace had operating income of \$1.7 million for the 2013 second quarter, a \$0.8 million decrease from operating income of \$2.5 million in the 2012 second quarter. CIS had operating income of \$1.5 million in the 2013 second quarter, a \$0.7 million increase from operating income of \$0.8 million in the 2012 second quarter. These segment operating results were offset, in part, by unallocated corporate expenses of \$0.7 million and \$0.6 million in the 2013 second quarter and the 2012 second quarter, respectively.

## **Interest Expense, Net**

Interest expense, net, for the 2013 second quarter was \$231 thousand compared to \$207 thousand in the 2012 second quarter, representing a higher level of bank borrowing as a result of cash used in operations through the better part of the 2013 second quarter, primarily for costs and estimated earnings in excess of billings on uncompleted long-term contracts.

## **Other (Income) Expense, Net**

Other income, net for the 2013 second quarter was \$61 thousand compared to other income, net of \$24 thousand in the 2012 second quarter, an increase of \$37 thousand. Other (income) expense, net consists primarily of bank and letter of credit fees, as well as foreign currency exchange gains and losses.

## **Income Taxes**

As of August 24, 2012, the Company reviewed the components of its deferred tax assets and determined, based upon all available information, that its current and expected future operating income will more likely than not result in the realization of its deferred tax assets relating to its federal net operating loss carryforwards. The Company has a net deferred tax asset related primarily to its federal net operating loss carryforwards of \$6.5 million. Income tax provisions of \$1.0 million were recorded in both the 2013 second quarter and the 2012 second quarter.

As of August 24, 2012, the Company had approximately \$18.4 million of federal net loss carryforwards available to offset future income tax liabilities, which begin to expire in 2025. In addition, the Company has the ability to offset deferred tax assets against deferred tax liabilities created for such items as depreciation and amortization.

**Twenty-six weeks ended August 24, 2012 compared to twenty-six weeks ended August 26, 2011**

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

	<b>Summary Table of Results</b>			
	<b>(amounts in thousands)</b>			
	<b>(unaudited)</b>		<b>Variance</b>	<b>Variance</b>
	<b>Twenty-six weeks ended</b>		<b>\$</b>	<b>%</b>
	<b>August 24, 2012</b>	<b>August 26, 2011</b>		
<b>Net sales:</b>				
Domestic	\$ 10,469	\$ 7,030	\$ 3,439	48.9
U.S. Government	13,130	16,117	(2,987)	(18.5)
International	8,973	8,978	(5)	(0.1)
Total net sales	32,572	32,125	447	1.4
Gross profit	12,545	12,417	128	1.0
Selling and marketing expenses	2,617	2,627	(10)	(0.4)
General and administrative expenses	3,905	3,875	30	0.8
Research and development expenses	647	381	266	69.8
Operating income	5,376	5,534	(158)	(2.9)
Interest expense, net	445	357	88	24.6
Other (income) expense, net	(64)	84	(148)	(176.2)
Income before income taxes	4,995	5,093	(98)	(1.9)
Provision for income taxes	2,008	1,944	64	3.3
Loss (gain) attributable to non-controlling interest	6	(18)	24	(133.3)
<b>Net income attributable to ETC</b>	<b>\$ 2,993</b>	<b>\$ 3,131</b>	<b>\$ (138)</b>	<b>(4.4)</b>
<b>Per share information:</b>				
<b>Basic earnings per common and participating share:</b>				
<b>Distributed earnings per share:</b>				
Common	\$ -	\$ -	\$ -	
Preferred	\$ 0.10	\$ 0.10	\$ -	
<b>Undistributed earnings per share:</b>				
Common	\$ 0.09	\$ 0.10	\$ (0.01)	
Preferred	\$ 0.09	\$ 0.10	\$ (0.01)	
<b>Diluted earnings per share</b>	<b>\$ 0.09</b>	<b>\$ 0.10</b>	<b>\$ (0.01)</b>	

**Net Income Attributable To ETC**

Net income attributable to ETC was \$3.0 million, or \$0.09 diluted earnings per share, in the 2013 first half, compared to \$3.1 million or \$0.10 diluted earnings per share, during the 2012 first half, representing a decrease of \$138 thousand, or 4.4%. This decrease reflects a decrease in operating income of \$158 thousand, a result of a \$128 thousand increase in gross profit, which was more than offset by a \$286 thousand increase in operating expenses.

**Net Sales**

The following schedule presents the Company's unaudited net sales by segment, business unit, and geographic area (amounts in thousands):

	Twenty-six weeks ended August 24, 2012				Twenty-six weeks ended August 26, 2011			
	Domestic	U.S.		Total	Domestic	U.S.		Total
		Gov't	International			Gov't	International	
<b>Aerospace Solutions</b>								
ATS	\$ 248	\$ 5,550	\$ 6,414	\$ 12,212	\$ 501	\$ 12,521	\$ 5,098	\$ 18,120
Chambers	-	7,580	573	8,153	-	3,596	904	4,500
Simulation	211	-	137	348	765	-	233	998
ETC-PZL and other	191	-	713	904	46	-	896	942
Subtotal	650	13,130	7,837	21,617	1,312	16,117	7,131	24,560
<b>Commercial/Industrial Systems</b>								
Environmental	1,573	-	482	2,055	231	-	86	317
Sterilizers	6,181	-	41	6,222	3,651	-	57	3,708
Hyperbaric	951	-	549	1,500	672	-	1,611	2,283
Service and spares	1,114	-	64	1,178	1,164	-	93	1,257
Subtotal	9,819	-	1,136	10,955	5,718	-	1,847	7,565
<b>Total net sales</b>	<b>\$ 10,469</b>	<b>\$ 13,130</b>	<b>\$ 8,973</b>	<b>\$ 32,572</b>	<b>\$ 7,030</b>	<b>\$ 16,117</b>	<b>\$ 8,978</b>	<b>\$ 32,125</b>

Net sales for the 2013 first half were \$32.6 million, an increase of \$0.5 million, or 1.4%, compared to 2012 first half net sales of \$32.1 million. The increase reflects increased sales to Domestic customers, offset in part, by decreased sales to the U.S. Government.

**Domestic Sales**

Domestic sales in the 2013 first half were \$10.5 million, an increase of \$3.5 million, or 48.9%, over 2012 first half sales of \$7.0 million. The increase in Domestic sales is due primarily to an increase in Environmental and Sterilizer sales within the CIS segment, offset in part, by a decrease in Simulation sales. Domestic sales represented 32.1% of the Company's total net sales in the 2013 first half compared to 21.9% of the Company's total net sales in the 2012 first half.

**U.S. Government Sales**

U.S. Government sales in the 2013 first half were \$13.1 million, a decrease of \$3.0 million, or 18.5%, compared to 2012 first half sales of \$16.1 million, and represented 40.3% of total net sales in the 2013 first half compared to 50.2% for the 2012 first half. This decrease is the result of lower ATS sales, offset in part, by an increase in sales related to a suite of research altitude chambers. Given the existing progress made on U.S. Government sales contracts in the Company's backlog, the Company anticipates the concentration of sales to the U.S. Government will continue to lessen in fiscal 2013.

**International Sales**

International sales for the 2013 first half, including those of the Company's foreign subsidiaries, of \$9.0 million remained unchanged compared to the 2012 first half, and represented 27.5% of total net sales in the 2013 first half compared to 27.9% in the 2012 first half. Although the dollar amount of International sales did not change, there was an increase in ATS and Environmental sales, offset in part, by a decrease in Hyperbaric sales. International sales in the 2013 first half included \$4.6 million in sales to the Korean government. International sales in the 2012 first half included \$3.9 million in sales to the Korean government.

**Gross Profit**

Gross profit for the 2013 first half was \$12.5 million compared to \$12.4 million in the 2012 first half, an increase of \$0.1 million, or 1.0%. The increase in gross profit was a result of an increase in net sales; however, gross profit margin as a percentage of net sales decreased slightly to 38.5% in the 2013 first half from 38.7% in the 2012 first half.



## **Selling and Marketing Expenses**

Selling and marketing expenses for the 2013 first half of \$2.6 million remained unchanged compared to the 2012 first half. As a percentage of net sales, selling and marketing expenses decreased to 8.0% in the 2013 first half from 8.2% in the 2012 first half. Although the dollar amount of selling and marketing expenses did not change, there was a decrease in commission generating revenue in the 2013 first half compared to the 2012 first half; thus, commission expense as a percentage of net sales was lower in the 2013 first half compared to the 2012 first half.

## **General and Administrative Expenses**

General and administrative expenses for the 2013 first half of \$3.9 million remained unchanged compared to the 2012 first half. As a percentage of net sales, general and administrative expenses decreased to 12.0% in the 2013 first half from 12.1% in the 2012 first half. Although the dollar amount of general and administrative expenses did not change, there was an increase in domestic salary expenses and expenses related to ETC-PZL and ETC-Europe, offset by a decrease in consulting expenses and the absence of a one-time charge to vacation expense in the 2012 first half.

## **Research and Development Expenses**

Research and development expenses include spending for potential new products and technologies, and internationally, work performed under government grant programs. This spending, net of grant payments from the Polish and Turkish governments, totaled \$0.6 million for the 2013 first half compared to \$0.4 million for the 2012 first half, an increase of \$0.2 million, or 69.8%. The increase was a result of less research and development employees being assigned to specific contracts; thus, expenses related to these employees were included in research and development expenses in the 2013 first half. 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. As a percentage of sales, research and development expenses were 2.0% in the 2013 first half compared to 1.2% in the 2012 first half.

## **Operating Income**

Operating income decreased by \$0.1 million, or 2.9%, to \$5.4 million for the 2013 first half compared to \$5.5 million in the 2012 first half. Operating income as a percentage of net sales decreased to 16.5% from 17.2% in the 2012 first half. On a segment basis, Aerospace had operating income of \$4.0 million for the 2013 first half, a \$1.0 million decrease from operating income of \$5.0 million in the 2012 first half. CIS had operating income of \$2.7 million in the 2013 first half, a \$0.7 million increase from operating income of \$2.0 million in the 2012 first half. These segment operating results were offset, in part, by unallocated corporate expenses of \$1.3 million and \$1.5 million in the 2013 first half and the 2012 first half, respectively.

## **Interest Expense, Net**

Interest expense, net, for the 2013 first half was \$445 thousand as compared to \$357 thousand in the 2012 first half, representing a higher level of bank borrowing as a result of cash used in operations through the better part of the 2013 first half, primarily for costs and estimated earnings in excess of billings on uncompleted long-term contracts.

## **Other (Income) Expense, Net**

Other income, net for the 2013 first half was \$64 thousand compared to other expense, net of \$84 thousand in the 2012 first half, a difference of \$148 thousand. Other (income) expense, net consists primarily of bank and letter of credit fees, as well as foreign currency exchange gains and losses.

## **Income Taxes**

As of August 24, 2012, the Company reviewed the components of its deferred tax assets and determined, based upon all available information, that its current and expected future operating income will more likely than not result in the realization of its deferred tax assets relating to its federal net operating loss carryforwards. The Company has a net deferred tax asset related primarily to its federal net operating loss carryforwards of \$6.5 million. Income tax provisions of \$2.0 million and \$1.9 million were recorded in the 2013 first half and the 2012 first half, respectively.

As of August 24, 2012, the Company had approximately \$18.4 million of federal net loss carryforwards available to offset future income tax liabilities, which begin to expire in 2025. In addition, the Company has the ability to offset deferred tax assets against deferred tax liabilities created for such items as depreciation and amortization.

## Liquidity and Capital Resources

As a result of collections pertaining to several of our long-term contracts as they begin to wind down, the Company reduced the amount outstanding on its line of credit during the 2013 first half. The Company's availability under its line of credit with PNC Bank at August 24, 2012 was \$5.0 million. The Company expects the availability to continue increasing as several of our long-term contracts with back loaded cash receipts continue to wind down. Working capital, or current assets less current liabilities, was \$28.9 million at August 24, 2012 compared with \$27.8 million at February 24, 2012. The increase in working capital was primarily the result of an increase in costs and estimated earnings in excess of billings on uncompleted long-term contracts, which will reduce upon the achievement of certain milestones, as well as a decrease in billings in excess of costs and estimated earnings on uncompleted long-term contracts. The Company's current ratio, current assets divided by current liabilities, improved to 2.6:1 at August 24, 2012 from 2.4:1 at February 24, 2012.

With unused availability under the PNC Bank line of credit, the Company's ability to generate cash from operations, and the Company's expectation of extending the expiration date of the PNC Bank line of credit, the Company anticipates these sources of liquidity will be sufficient to fund its operating activities, anticipated capital expenditures, and debt repayment obligations for the twelve months subsequent to August 24, 2012.

The schedule below presents the Company's available borrowings under its existing credit facilities (amounts in thousands):

Credit facility*	As of August 24, 2012			As of February 24, 2012		
	Total Facility	Amount Borrowed	Amount Available**	Total Facility	Amount Borrowed	Amount Available**
PNC Bank line of credit	\$ 20,000	\$ 14,043	\$ 5,005	\$ 20,000	\$ 16,716	\$ 2,502
Dedicated line of credit	5,422	5,422	-	5,422	5,422	-
ETC-PZL line of credit	175	-	175	-	-	-
<b>Total</b>	<b>\$ 25,597</b>	<b>\$ 19,465</b>	<b>\$ 5,180</b>	<b>\$ 25,422</b>	<b>\$ 22,138</b>	<b>\$ 2,502</b>

\*See Note 5 to the Consolidated Financial Statements, entitled Long-Term Obligations and Credit Arrangements, in this quarterly report on Form 10-Q.

\*\* Amount available takes into account letters of credit outstanding against the PNC Bank line of credit of \$952 thousand and \$782 thousand as of August 24, 2012 and February 24, 2012, respectively.

The Company expects to meet its long-term obligations through cash flow from operations and from increasing borrowing capacity resulting from the Company's anticipated strengthening equity position and modest leverage.

### Cash flows from operating activities

Cash flow from operating activities is driven by income from sales of our products offset by the timing of receipts and payments in the ordinary course of business.

During the 2013 first half, as a result of collections pertaining to several of our long-term contracts as they begin to wind down, the Company generated \$4.3 million of cash from operating activities compared to cash used in operating activities of \$3.8 million in the 2012 first half. The aforementioned generation of cash was offset, in part, by cash utilized for the increase in costs and estimated earnings in excess of billings and the decrease in billings in excess of costs and estimated earnings on uncompleted long-term percentage of completion ("POC") contracts. Under POC revenue recognition, these accounts represent the timing differences of spending on production activities versus collecting on long-term contracts.

### Cash flows from investing activities

Cash used for investing activities primarily relates to funds used for capital expenditures in equipment and software development. The Company's investing activities used \$0.8 million in the 2013 first half, and consisted primarily of costs for the acquisition of computer equipment and the manufacturing of demonstration simulators for our NASTAR Center, coupled with software enhancements for our Advanced Tactical Fighter Systems technology and Hyperbaric products. This is comparable to cash used in investing activities of \$1.1 million in the 2012 first half.

### Cash flows from financing activities

The Company's financing activities used \$3.9 million of cash in the 2013 first half. This primarily reflected repayments under the Company's PNC Bank line of credit and dividends paid on Preferred Stock. In the 2012 first half, net cash provided by financing activities totaled \$8.2 million, primarily for borrowings under the line of credit, offset in part, by dividends paid on Preferred Stock.

**Outlook**

On September 28, 2012, the Company announced a financial restructuring agreement that will reduce its annual net cash payments for dividends and interest by approximately \$1.5 million, and reduce the number of participating preferred shares in the amount equating to 5,032,091 shares of Common Stock; as a result, positively impacting the Company's earnings. As part of the financial restructuring, the Company's revolving line of credit with PNC Bank was reduced from \$20 million to \$15 million, with the expiration date extended to October 31, 2015. The interest rate on the PNC line of credit will remain unchanged. PNC Bank also provided to the Company a five-year term loan of \$15 million, which will expire on September 28, 2017. The Company utilized \$10 million of the proceeds from the term loan to repurchase and retire 10,000 shares of 10% Preferred Stock, equivalent to 5,032,091 shares of Common Stock. The revolving line of credit will no longer be guaranteed by H.F. Lenfest, a major shareholder and member of our Board of Directors, and will instead be secured by substantially all of the Company's assets. Mr. Lenfest will provide a guarantee on the new \$15 million term loan for a period of thirty months, after which his guarantee will be removed. In addition, dividends on the remaining Series E Preferred Stock will be reduced from ten percent (10%) to four percent (4%), subject to shareholder approval.

We expect to use our cash, cash equivalents, and credit facilities for working capital and general corporate purposes, products, product rights, technologies, property, plant and equipment, the payment of contractual and other legal obligations, including scheduled interest payments on our credit facilities and dividends on our Preferred Stock, the potential acquisition of businesses, and/or the purchase, redemption or retirement of our credit facilities and Preferred Stock. We expect that net sales of our currently marketed products, combined with availability under our lines of credit, should continue to provide us sufficient funds for fiscal 2013. At this time, however, we cannot accurately predict the effect of certain developments on our anticipated rate of sales growth in fiscal 2014 and beyond, because of factors such as the degree of market acceptance, the impact of competition, the effectiveness of our sales and marketing efforts, and the outcome of our efforts to develop our products.

At the end of each fiscal quarter in fiscal 2013, and through the term of the new PNC Bank credit facility, we expect to maintain, per bank covenant requirement, a minimum Consolidated Tangible Net Worth of \$15.0 million, a maximum Operating Leverage Ratio (defined as Senior Funded Debt divided by EBITDA) of 3.25:1 (which will reduce to 3.00:1 at the end of the first fiscal year and 2.90:1 at the end of the second fiscal year and will remain at this level at all times thereafter), and a minimum Fixed Charge Coverage Ratio (defined as EBITDA divided by the sum of Current Maturities plus interest expense, cash taxes paid, dividends, and Unfunded Capital Expenditures) of 1.10:1.

**Backlog**

Below is a breakdown of the Company's August 24, 2012 and February 24, 2012 sales backlog (unaudited – amounts in thousands except percentages):

**August 24, 2012:**

Geographic area	Business segment		Total	%
	Aerospace	CIS		
Domestic	\$ 852	\$ 7,964	\$ 8,816	14.0%
U.S. Government	26,141	-	26,141	41.6
International	25,455	2,424	27,879	44.4
<b>Total</b>	<b>\$ 52,448</b>	<b>\$ 10,388</b>	<b>\$ 62,836</b>	<b>100.0%</b>
<b>% of Total</b>	<b>83.5%</b>	<b>16.5%</b>	<b>100.0%</b>	

**February 24, 2012:**

Geographic area	Business segment		Total	%
	Aerospace	CIS		
Domestic	\$ 389	\$ 12,102	\$ 12,491	16.8%
U.S. Government	39,501	-	39,501	53.0
International	21,354	1,167	22,521	30.2
<b>Total</b>	<b>\$ 61,244</b>	<b>\$ 13,269</b>	<b>\$ 74,513</b>	<b>100.0%</b>
<b>% of Total</b>	<b>82.2%</b>	<b>17.8%</b>	<b>100.0%</b>	

Our sales backlog at August 24, 2012 and February 24, 2012 for work to be performed and revenue to be recognized under written agreements after such dates was \$62.8 million and \$74.5 million, respectively. Of the August 24, 2012 sales backlog, approximately \$12.4 million represents two International contracts for multiple aircrew training simulators. Approximately 99.3% of the U.S. Government backlog relates to three contracts.

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

### **Item 3. Quantitative and Qualitative Disclosures about Market Risk**

Not applicable.

### **Item 4. Controls and Procedures**

#### *Disclosure Controls and Procedures*

As of the end of the period covered by this report, our management, including our Chief Executive Officer and Chief Financial Officer, evaluated our disclosure controls and procedures (as defined in Rule 13a-15(e) under the Exchange Act). Disclosure controls and procedures are designed to provide reasonable assurance that the information required to be disclosed in the reports we file under the Exchange Act is (i) recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms and (ii) is accumulated and communicated to management, including our Chief Executive Officer and Chief Financial Officer, as appropriate to allow timely decisions regarding required disclosures. A control system cannot provide absolute assurances, however, that the objectives of the control system are met, and no evaluation of controls can provide absolute assurance that all control issues and instances of fraud, if any, within a company have been detected. Based on that evaluation, our Chief Executive Officer and Chief Financial Officer have concluded that our disclosure controls and procedures were not effective at August 24, 2012 because of the material weakness in internal control over financial reporting related to (i) a foreign subsidiary not having a uniform centralized system for recording personnel time and retaining source data for certain contracts, and (ii) this subsidiary's corporate governance structure, as more fully described in our Annual Report on Form 10-K for the 2012 fiscal year. We performed additional analysis and other post-closing procedures with regard to this foreign subsidiary to provide reasonable assurance that our Consolidated Financial Statements are prepared in accordance with generally accepted accounting principles.

#### *Changes in Internal Control Over Financial Reporting*

There was no change in our internal control over financial reporting (as such term is defined in Rule 13a-15(f) under the Exchange Act) during our fiscal quarter ended August 24, 2012 that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

During the fiscal quarter ended August 24, 2012, the Company reorganized the management composition of the foreign subsidiary so as to assist in the acculturation of the subsidiary into the Company's organizational culture.

During the last two quarters of fiscal 2013, the Company expects to implement the following additional enhancements to its internal control over financial reporting that are designed to address the material weakness described in the Annual Report on Form 10-K for the 2012 fiscal year:

- A uniform centralized system for recording personnel time will be implemented at the foreign subsidiary, and employees will be trained with respect to the system's functionality.
- The Company will issue a series of policies and procedures applicable to the foreign subsidiary, including but not limited to record retention, so as to improve the governance over the subsidiary.
- On a quarterly basis, Company management will perform a detailed review of the recording of employee time, and the allocation of these personnel costs to the foreign subsidiary's contracts.

## **PART II – OTHER INFORMATION**

### **Item 1. Legal Proceedings**

Certain claims, suits, and complaints arising in the ordinary course of business have been filed or are pending against us. We believe, after consultation with legal counsel handling these specific matters, all such matters are reserved for or adequately covered by insurance or, if not so covered, are without merit or are of such kind, or involve such amounts, as would not be expected to have a significant effect on our financial position or results of operations if determined adversely against us.

### **Item 1A. Risk Factors**

The following risk factor is an update to, and should be read in conjunction with, the risk factors in Item 1A - Risk Factors in our Annual Report on Form 10-K for the Fiscal Year ended February 24, 2012:

***We derive a significant portion of our revenues from U.S. Government contracts, which are dependent on continued political support and funding.***

Approximately 40.3% of our revenues for the 2013 first half were derived from U.S. Government contracts, and approximately 41.6% of our firm backlog as of August 24, 2012 is derived from U.S. Government contracts. The Budget Control Act of 2011 commits the U.S. Government to reduce the federal deficit over ten years through caps on discretionary spending. The Budget Control Act of 2011 also established a Congressional Joint Select Committee on Deficit Reduction (the “Super Committee”) responsible for identifying an additional \$1.2 to \$1.5 trillion in deficit reductions by November 23, 2011. With the failure of the Super Committee to produce a deficit reduction proposal by this deadline, “sequestration” was triggered, which calls for automatic spending cuts split between defense and non-defense programs beginning in 2013 and continuing over a ten-year period. While Congress is discussing various options to prevent or defer sequestration, we cannot predict whether any such efforts will succeed. While the impact of sequestration on our U.S. Government contracts, if any, is unknown, a funding delay or cancellation could have a material adverse impact on our business, financial condition and results of operations.

### **Item 2. Unregistered Sales of Equity Securities and Use of Proceeds**

None

### **Item 3. Defaults upon Senior Securities**

None.

### **Item 4. Mine Safety Disclosures**

None.

### **Item 5. Other Information**

None.

**Item 6. Exhibits**

<u>Number</u>	<u>Item</u>
10.1	Loan Agreement, dated September 28, 2012, between Registrant and PNC Bank, with the Term Note and the Line of Credit Note (each as defined in such Loan Agreement) attached thereto as exhibits, which was filed on October 2, 2012 as Exhibit 10.1 to Form 8-K and is incorporated herein by reference.
10.2	Security Agreement by the Registrant in favor of PNC Bank, dated as of September 28, 2012, which was filed on October 2, 2012 as Exhibit 10.2 to Form 8-K and is incorporated herein by reference.
10.3	Pledge Agreement between the Registrant and PNC Bank, dated as of September 28, 2012, which was filed on October 2, 2012 as Exhibit 10.3 to Form 8-K and is incorporated herein by reference.
10.4	Open-End Mortgage and Security Agreement by the Registrant in favor of PNC Bank, dated as of September 28, 2012, which was filed on October 2, 2012 as Exhibit 10.4 to Form 8-K and is incorporated herein by reference.
10.5	Third Amended and Restated Reimbursement Agreement for Letters of Credit between the Registrant and PNC Bank, dated as of September 28, 2012, which was filed on October 2, 2012 as Exhibit 10.5 to Form 8-K and is incorporated herein by reference.
10.6	Preferred Stock Repurchase and Financial Restructuring Agreement between the Registrant and H.F. Lenfest, dated September 28, 2012, which was filed on October 2, 2012 as Exhibit 10.6 to Form 8-K and is incorporated herein by reference.
10.7	Amended and Restated Guaranty Agreement, dated September 28, 2012, by H.F. Lenfest in favor of PNC Bank, which was filed on October 2, 2012 as Exhibit 10.7 to Form 8-K and is incorporated herein by reference.
<a href="#">31.1</a>	Certification pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 made by William F. Mitchell, Chief Executive Officer.
<a href="#">31.2</a>	Certification pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 made by Robert L. Laurent, Jr., Chief Financial Officer.
<a href="#">32</a>	Certification pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 made by William F. Mitchell, Chief Executive Officer, and Robert L. Laurent, Jr., Chief Financial Officer.
101.INS*	XBRL Instance
101.SCH*	XBRL Taxonomy Extension Schema
101.CAL*	XBRL Taxonomy Extension Calculation
101.LAB*	XBRL Taxonomy Extension Labels
101.PRE*	XBRL Taxonomy Extension Presentation
101.DEF*	XBRL Taxonomy Extension Definition

\* XBRL (Extensible Business Reporting Language) information is furnished and not filed or a part of a registration statement or prospectus for purposes of Sections 11 or 12 of the Securities Act of 1933, is deemed not filed for purposes of Section 18 of the Securities Exchange Act of 1934, and otherwise is not subject to liability under these sections.

**Signatures**

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

**ENVIRONMENTAL TECTONICS CORPORATION**

(Registrant)

Date: October 9,  
2012

By: /s/ William F. Mitchell

William F. Mitchell  
President and Chief  
Executive Officer  
(Principal Executive Officer)

Date: October 9,  
2012

By: /s/ Robert L. Laurent, Jr.

Robert L. Laurent, Jr.  
Chief Financial Officer  
(Principal Financial and Accounting Officer)

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 Quarterly Report on Form 10-Q 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 officer 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)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f) 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) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
  - c) 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
  - d) 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 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: October 9, 2012

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

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

I, Robert L. Laurent, Jr., certify that:

1. I have reviewed this Quarterly Report on Form 10-Q 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 officer 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)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f) 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) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
  - c) 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
  - d) 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 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: October 9, 2012

By: /s/ Robert L. Laurent, Jr.  
Robert L. Laurent, Jr.  
Chief Financial Officer

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**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 Quarterly Report on Form 10-Q of Environmental Tectonics Corporation (the "Company") for the fiscal quarter ended August 24, 2012 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, Robert L. Laurent, Jr., 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/ Robert L. Laurent, Jr.  
Robert L. Laurent, Jr.  
Chief Financial Officer

October 9, 2012

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.

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