

ENVIRONMENTAL TECTONICS CORP

Form 10-K

May 24, 2007

**Table of Contents**

**UNITED STATES SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, DC 20549  
FORM 10-K**

**ANNUAL REPORT  
PURSUANT TO SECTIONS 13 OR 15(d) OF  
THE SECURITIES EXCHANGE ACT OF 1934**

**Annual report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934  
for the fiscal year ended February 23, 2007**

**or**

**Transition report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934  
For the transition period from \_\_\_\_\_ to \_\_\_\_\_.**

**Commission File Number 1-10655  
ENVIRONMENTAL TECTONICS CORPORATION**

Pennsylvania

23-1714256

(State or other jurisdiction of incorporation or  
organization)

(I.R.S. Employer Identification No.)

County Line Industrial Park  
Southampton, Pennsylvania 18966

(Address of principal executive offices, Zip Code)

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

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

Title of Each Class

Name of Each Exchange on Which Registered

Common Stock, par value \$.05 per share

American Stock Exchange

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

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

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

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

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

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

Large Accelerated Filer  Accelerated Filer  Non-accelerated Filer

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

As of August 25, 2006, the aggregate market value of the registrant's common stock held by non-affiliates of the registrant was approximately \$39,666,000 based upon the closing sale price of the registrant's common stock on the

American Stock Exchange of \$6.03 on such date. See footnote (1) below.

As of May 11, 2007, there were 9,028,469 shares of the registrant's common stock issued and outstanding.

**DOCUMENTS INCORPORATED BY REFERENCE.** Portions of registrant's 2007 Annual Report to Stockholders are incorporated by reference in Part II, Items 5, 6, 7, and 8.

Index to Exhibits appears after page 31 of this Report.

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

**ENVIRONMENTAL TECTONICS CORPORATION**  
**ANNUAL REPORT ON FORM 10-K**  
**FOR THE FISCAL YEAR ENDED**  
**FEBRUARY 23, 2007**  
**TABLE OF CONTENTS**

<u>PART I</u>	1
<u>Item 1. Business</u>	1
<u>Item 1A. Risk Factors</u>	8
<u>Item 2. Properties</u>	14
<u>Item 3. Legal Proceedings</u>	14
<u>Item 4. Submission of Matters to a Vote of Security Holders</u>	15
<u>PART II</u>	16
<u>Item 5. Market for the Registrant's Common Stock and Related Security Holder Matters</u>	16
<u>Item 6. Selected Consolidated Financial Data</u>	18
<u>Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	18
<u>Item 7A. Quantitative and Qualitative Disclosures About Market Risk</u>	18
<u>Item 8. Financial Statements and Supplementary Data</u>	18
<u>Item 9. Changes in and Disagreements with Accountants on Accounting and Financial Disclosure</u>	18
<u>Item 9A. Controls and Procedures</u>	18
<u>PART III</u>	19
<u>Item 10. Directors and Executive Officers of the Registrant</u>	19
<u>Item 11. Executive Compensation</u>	22
<u>Item 12. Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters</u>	28
<u>Item 13. Certain Relationships and Related Transactions</u>	29
<u>Item 14. Principal Accounting Fees and Services</u>	30
<u>PART IV</u>	32
<u>Item 15. Exhibits and Financial Statement Schedules.</u>	32
<u>SIGNATURES</u>	35
<u>EXHIBIT INDEX</u>	36
<u>EXHIBIT 13</u>	1
<u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	2
<u>Report of Independent Registered Public Accounting Firm</u>	19
<u>Consolidated Balance Sheets</u>	20
<u>Consolidated Statements of Operations</u>	21
<u>Consolidated Statements of Changes in Stockholders' Equity</u>	22
<u>Consolidated Statements of Cash Flows</u>	23
<u>Notes to the Consolidated Financial Statements</u>	24

When used in this Annual Report on Form 10-K, except where the context otherwise requires, the terms "we", "us", "our", "ETC" and the "Company" refer to Environmental Tectonics Corporation.

(i)

**Table of Contents**

**FORWARD-LOOKING STATEMENTS**

This Annual Report on Form 10-K includes forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. These forward-looking statements are based on ETC's current expectations and projections about future events. 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 ETC's vision, mission, strategies, goals, beliefs, plans, objectives, expectations, anticipations, estimates, intentions, financial condition, results of operations, future performance and business of ETC, including but not limited to, (i) projections of revenue, costs of raw materials, income or loss, earnings or loss per share, capital expenditures, growth prospects, dividends, capital structure, other financial items and the effects of currency fluctuations, (ii) statements of plans and objectives of ETC 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 ETC or its business, (v) statements made about the possible outcomes of litigation involving ETC, and (vi) statements preceded by, followed by or that include the words "may", "could", "should", "looking forward", "would", "believe", "expect", "anticipate", "estimate", "intend", "plan", or the n or similar expressions. These forward-looking statements involve risks and uncertainties which are subject to change based on various important factors. Some of these risks and uncertainties, in whole or in part, are beyond ETC's control. Factors that might cause or contribute to such a material difference include, but are not limited to, those discussed in this Annual Report on Form 10-K, in the section entitled "Risks Particular to Our Business". Shareholders are urged to review these risks carefully prior to making an investment in the ETC's common stock.

The Company cautions that the foregoing list of important factors is not exclusive. ETC 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 ETC.

References to fiscal 2007 or the 2007 fiscal year are references to the year ended February 23, 2007. References to fiscal 2008 or the 2008 fiscal year are references to the year ending February 29, 2008.

**PART I**

**Item 1. Business**

We were incorporated in 1969 in Pennsylvania and are principally engaged in the design, manufacture and sale of software driven products and services used to recreate and monitor the physiological effects of motion on humans and equipment and to control, modify, simulate and measure environmental conditions. These products include aircrew training systems (aeromedical, tactical combat and general), disaster management training systems and services, entertainment products, sterilizers (steam and gas), environmental testing products and hyperbaric chambers and other products that involve similar manufacturing techniques and engineering technologies.

**Segments**

We operate in two primary business segments, the Training Services Group ( TSG ) (formerly Aircrew Training Systems (ATS)) and the Control Systems Group ( CSG ) (formerly the Industrial Group (IG)).

**Training Services Group.** This segment includes three primary product groups: aircrew training devices and services, disaster management training and systems, and entertainment products.

**Integrated Aircrew Training.** Aircrew training is performed in our National Aerospace Training and Research (NASTAR) Center. This center, set to open in fiscal 2008, is an integrated pilot training center offering a complete range of aviation training and research support for military jet pilots and civil aviation as well as space travel and tourism. The NASTAR Center houses state of the art pilot training equipment including the ATFS-400 Centrifuge, GYROLAB GL-2000 Advanced Spatial Disorientation Trainer, Hypobaric Altitude Chamber, an Ejection Seat Trainer, and Night Vision and Night Vision Goggle Training System.

**Aircrew Training Systems.** We design, develop and manufacture a full range of pilot training devices. Aircrew training devices are used for medical research, advanced tactical and physiological flight training, and for the

indoctrination and testing of military and commercial pilots. The major devices that we sell in this business segment are military and commercial flight simulators, night vision trainers, water survival training equipment, disorientation training equipment, human centrifuges, ejection seat trainers and vehicle simulators. We provide operational and maintenance services for installed equipment that we manufacture as well as for equipment produced by others. Disaster Management Training and Systems. Our Disaster Management Simulation line includes real-

## **Table of Contents**

time interactive training and systems that provide instruction on various disaster situations.

**Entertainment Products.** Our entertainment products consist of motion-based simulation rides and other products for the education and amusement industries.

The Training Services Group segment generated 53%, 60% and 60% of our consolidated revenues for the fiscal years ended February 23, 2007, February 24, 2006 and February 25, 2005, respectively.

**Control Systems Group.** This segment includes three primary product lines: sterilizers, environmental control systems and other products, and hyperbarics.

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

**Environmental Control Systems and Other Products.** Our environmental systems business consists of the design and fabrication of sampling and analysis systems, and test equipment and systems. The simulation systems generally consist of an enclosed chamber with instrumentation and equipment which enable the customer to control and modify environmental factors such as temperature, pressure, humidity, wind velocity and gas content to produce desired conditions. These products include controlled air systems for automotive companies and environmental chambers for HVAC and other applications.

**Hyperbarics.** Our hyperbaric product line includes monoplace (single person) and multiplace (multiple persons) chambers for high altitude training, decompression and wound care applications.

The Control Systems Group generated 47%, 40% and 40% of our consolidated revenues for the years ended February 23, 2007, February 24, 2006 and February 25, 2005, respectively.

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

For a more complete description of financial information regarding our business segments, see Note 11. Business Segment Information to our consolidated financial statements in the Annual Report to Stockholders attached hereto as Exhibit 13 and incorporated herein by reference.

## **Marketing**

We currently market our products and services primarily through our sales offices and employees. At February 23, 2007, approximately 29 employees were committed to sales and marketing functions. We use branch offices in England, Turkey, Egypt, Singapore, the United Arab Emirates, Malaysia and Japan as well as the services of approximately 100 independent sales organizations in seeking foreign orders for our products.

## **Product Development**

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

Within the Training Services Group segment, product development emphasizes additional functionality and fidelity, enhancing control systems and software graphics and exploring commercial possibilities. Our product development efforts are as follows:

### **Tactical Flight Combat and G-force / Disorientation Trainers.**

In response to the ongoing market budgetary constraints for pilot G-force training and spatial disorientation, in 2004 we began incorporating tactical combat flight capabilities into our centrifuge technology. Dubbed the Authentic Tactical Fighting System (ATFS), this product was the first fully flyable centrifuge-based tactical maneuvering ground based simulator. This technology allows a fighter pilot to practice tactical air combat maneuvers such as dodging enemy missiles, ground fire and aircraft obstacles while experiencing the real life environment of a high G-force fighter aircraft. These flight trainers provide a low cost and extremely less risky alternative to actual air flight. We continued development of this technology through fiscal 2007 including incorporating some of this functionality into our GYROLAB products as we received significant orders from the Japanese Defense Agency for a GL-4000 and from a Middle Eastern customer for a GL-1500.





**Table of Contents**

**Advanced Disaster Management Simulator (ADMS).**

During fiscal 2007, our simulation line continued to expand its influence in the disaster management arena through our completion of the largest disaster management simulation center at the Korean National Fire Service Academy (KNFSA). The KNFSA ADMS system is being used to provide advanced training for all Korean fire service officers in low and high-rise internal structural firefighting, industrial and hazardous material fires, major road traffic accidents, urban search and rescue, and mountain wildfires. This system was installed in Cheonan, South Korea. With 20 networked training stations this is the largest ADMS installation to date.

The high-fidelity virtual environment created for the KNFSA encompasses nearly 200 square miles and features the crowded urban city regions and mountainous rural areas uniquely representative of Korea. Given that the dense and heavily populated Korean cities make it especially difficult to realistically train for massive incidents or natural disasters, KNFSA turned to ETC for simulation-based training. The KNFSA environment also features suburban residential areas and a commercial/industrial area. The ADMS Scenario Generator allows KNFSA to develop an unlimited number of training scenarios, from small, simple incidents to major mass-casualty disasters.

Domestically, the division continued work on a contract with the Pennsylvania Southeast Region Counter-Terrorism Task Force (CTTF) to provide an ADMS-TEAM training system.

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

**Subsidiaries**

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

**Suppliers**

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

**Table of Contents****Patents and Trademarks**

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

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

We also hold a trademark on our logo, ETC<sup>®</sup>, as well as on the following products:

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

**ETC s Unregistered (Ô)<sup>SM</sup> Trademark / Service Marks are:**

<b>ADMS<sup>TM</sup></b>	Advanced Disaster Management Simulator
<b>ATFS<sup>TM</sup></b>	Authentic Tactical Fighting System
<b>Authentic Tactical Fighting System<sup>TM</sup></b>	Authentic Tactical Fighting System
<b>BARA-LAB<sup>TM</sup></b>	Hyperbaric Chamber (other than medical)
<b>BARA PRESS</b>	Hyperbaric Chamber Software
<b>BIG MAC<sup>TM</sup></b>	Entertainment ride based on a multi-armed Centrifuge Device
<b>CAS<sup>TM</sup></b>	Conditioned Air Supply
<b>DMI<sup>TM</sup></b>	Disaster Management Institute
<b>EAGLE-VISION<sup>TM</sup></b>	Visual Performance/Procedures Trainer
<b>EPC<sup>TM</sup></b>	Engine Pressure Controller/Environmental System

<b>ETC™</b>	ETC Biomedical Systems ( <i>Stylized ETC with caduceus.</i> )
<b>ETC™</b>	Entertainment Technology Corporation ( <i>Stylized ETC and name in color</i> )
<b>G-FET™</b>	Human Centrifuge (U.S. Navy type)
<b>G-FET-II™</b>	Human Centrifuge (Malaysian Air Force type)

**Table of Contents**

<b>G-MAS™</b>	Missile Avoidance System (Centrifuge feature)
<b>G-POINTING™</b>	Motion control algorithm feature; namely, a feature of Flight Simulators that duplicates G-force effects experienced during tactical flight in Class 9.
<b>GRAPH MASTER PROGRAMMER™</b>	Industrial Sterilizer Control
<b>GUARDIAN MONITORING PACKAGE™</b>	GMP features for Sterilizers
<b>GYRO-1™</b>	Multi-purpose basic Instrument Flight Trainer
<b>GYRO-SAT™</b>	Situational Awareness Trainer (feature of a Gyrolab)
<b>GYROSIM™</b>	Gyrolab as a Simulator
<b>LANE MASTER™</b>	Automobile Emissions Analyzer
<b>MAC™</b>	Entertainment Ride based on a Multi-Armed Centrifuge Device
<b>NASTAR<sup>SM</sup> CENTER</b>	The National Aerospace Training & Research Center (Standard Word Mark)
<b>OASIS™</b>	Software-driven tool to build Test and Training Systems and scoring them; curriculum development, capability assessment, etc.
<b>ProFlyer™</b>	Commercial Flight and Navigational Procedures Trainer meeting European regulations for civilian pilot training and certification
<b>PRO-GENESIS™</b>	Control Unit/column for Sterilizers
<b>ProTrainer™</b>	Commercial Instrument Procedures Trainer meeting FAA's PCATD requirements
<b>SENTRY 84™</b>	Automobile Emissions Analyzer
<b>SMOOTH RIDE™</b>	Computer Control Profile for Hyperbaric Chambers
<b>TACModule™</b>	Tactical Aircraft Configuration Module
<b>TNET™ and/or TRAINING NET™</b>	Computer Software for training emergency personnel in firefighting, disaster management, etc.
<b>TESS™</b>	Total Emissions Suppression System, EtO Sterilizer
<b>Thrills Without Ills™</b>	

Describing ETC's entertainment rides, particularly those utilizing ETC's Human Centrifuge Technology, which precludes motion sickness commonly associated with motion-based entertainment rides.

**VPT-1000™**

Visual Procedures Trainer

5

---

## **Table of Contents**

### **Customers**

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

In fiscal 2007 one customer represented individually 10% or more of total sales, Jupitor (Japan), which generated \$3,365,000 or 19.3% of total sales. International sales totaling at least \$500,000 per country were made to customers in Japan, Australia and Pakistan. Open orders for one international and one domestic customer represented 43.9% of our backlog at February 23, 2007. We do not have any relationship with these customers other than as customers. We expect to continue to conduct business with these customers in fiscal 2008, albeit at a much reduced level.

### **Foreign and Domestic Operations and Export Sales**

During the fiscal years ended February 23, 2007, February 24, 2006 and February 25, 2005, approximately \$586,000 (3%), \$2,586,000 (10%) and \$2,904,000 (10%), respectively, of our net revenues were attributable to contracts with agencies of the U.S. Government or with other customers who had prime contracts with agencies of the U.S. Government.

During the fiscal years ended February 23, 2007, February 24, 2006 and February 25, 2005, \$10,821,000 (62%), \$13,343,000 (53%) and \$12,912,000 (47%), respectively, of our net revenues were attributable to export sales, including those in our foreign subsidiaries. Our customers' obligations to us with regards to export sales are normally secured by irrevocable letters of credit based on the creditworthiness of the customer and the geographic area of the world in which they are located.

During the fiscal years ended February 23, 2007, February 24, 2006 and February 25, 2005, \$6,012,000 (35%), \$9,140,000 (37%) and \$11,998,000 (43%), respectively, of our net revenues were attributable to domestic sales to customers other than the U.S. government.

See Note 11. Business Segment Information to our consolidated financial statements in the Annual Report to Stockholders attached hereto as Exhibit 13 and incorporated herein by reference.

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

We derive a large portion of our sales from long-term contracts requiring more than one year to complete. We account for sales under long-term contracts on the percentage of completion basis. See the section Critical Accounting Policies in the Management's Discussion and Analysis of Financial Condition and Results of Operations and Note 3. Summary of Significant Accounting Policies to our consolidated financial statements in the Annual Report to Stockholders attached hereto as Exhibit 13 and incorporated herein by reference.

Our U.S. Government contracts contain standard terms permitting termination for the convenience of the U.S. Government. In the event of termination of a government contract, we are entitled to receive reimbursement on the basis of work completed (cost incurred plus a reasonable profit). We customarily record the amounts that we anticipate to be recovered from termination claims in income as soon as those amounts can be reasonably determined rather than at the time of final settlement. All costs applicable to a termination claim are charged as an offsetting expense concurrently with the recognition of income from the claim.

### **Manufacturing Facilities**

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

### **Backlog**

Our sales backlog at February 23, 2007 and February 24, 2006, for work to be performed and revenue to be recognized under written agreements after such dates, was \$13,564,000 and \$8,132,000, respectively. In addition, our training, maintenance and upgrade contracts backlog at February 23, 2007 and February 24, 2006, for work to be performed and revenue to be recognized after such dates under written agreements, was \$1,276,000 and \$1,774,000, respectively. Of the February 23, 2007 backlog, approximately 68% was concentrated between environmental and

aircrew training systems and maintenance support, including \$4,945,000 for a domestic automotive customer and \$1,568,000 for Indonesia.

We expect to complete approximately 88% of the February 23, 2007 backlog prior to February 29, 2008, the end of our 2008 fiscal year. Of the February 24, 2006 backlog, we completed approximately 75% by February 23, 2007.

**Table of Contents**

**Competition**

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

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

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

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

**Compliance with Environmental Laws**

We have not incurred during fiscal 2007, nor do we anticipate incurring during fiscal 2008, any material capital expenditures to maintain compliance with federal, state and local statutes, rules and regulations concerning the discharge of materials into the environment, nor do we anticipate that compliance with these provisions will have a material adverse effect on our earnings or competitive position.

**Compliance with Export Controls**

Depending on the product, customer, location and the application or use, many of our aeromedical products require an export license from the U.S. Commerce or State Department. We have implemented an Export License Compliance Program which covers all key aspects of the International Traffic in Arms (ITAR), as issued by the U.S. Department of Defense Trade Controls, an arm of the U.S. Department of State. Although most export licenses are readily obtainable in a reasonable timeframe, most of our international contracts for aeromedical equipment include the issuance of an export license as a *force majeure* exception for any contract penalties or liquidated damages.

**Employees**

On February 23, 2007, we had 257 full-time employees, of which four were employed in executive positions, 64 were engineers, engineering designers, or draftspeople, 71 were administrative (sales, sales support, accounting, etc.) and clerical personnel, and 118 were engaged principally in production, operations and field support.



**Table of Contents**

**Item 1A. Risk Factors**

**RISKS PARTICULAR TO OUR BUSINESS**

**Our business is subject to numerous risks and uncertainties which could cause our actual operating results and developments to be materially different from those expressed or implied in any of our public announcements or filings including this Annual Report on Form 10-K for the year ended February 23, 2007. These risks and uncertainties include the following items. This list is not inclusive of all the risks and uncertainties associated with our business.**

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

We are currently preparing our claim with the U.S. Government to go to trial in July of this year. Additionally, we anticipate that our litigation with Disney will be resolved this fiscal year. Legal and claims costs in fiscal 2007 were \$1.4 million or 15% of total general and administrative spending and 8% of sales. It is expected that this spending level will increase in fiscal 2008 as litigation nears the trial stage. See Item 3 (Legal Proceedings) for further information on our litigation.

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

In one of our cases of commercial litigation currently in progress, we have been counter-sued for an amount in excess of \$65 million. While we believe we have valid defenses to each of the counterclaims and intend to vigorously defend ourselves against these counterclaims, an unfavorable outcome could result in a material adverse effect on our financial position. With respect to our claim against the U.S. government, recoveries from prior claims of this nature have usually exceeded the carrying value of claims. However, this claim was filed in the Court of Federal Appeals whereas prior government claims were filed with the Armed Services Board of Contract Appeals (ASBCA), which has complicated the litigation process. This case is currently scheduled for trial in July 2007. Our claims require significant management time and effort. Also, there is no assurance that we will always have positive experience with regard to recoveries for our contract claims, whether at the carrying values of the claims or amounts in excess of the carrying values of the claims, and an unfavorable result could have a material adverse effect on our financial situation.

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

In any given fiscal year, a substantial portion of our revenues is typically derived from a small number of customers. For example, in fiscal 2007 one customer Jupitor (Japan) represented approximately 19% of total sales. In fiscal 2006 we generated approximately 30% of our revenues from sales to two customers, L-3 Communications and the Pakistan Air Force. In fiscal 2005, we generated approximately 36% of our revenues from sales to four customers, the Royal Malaysian Air Force, the United Kingdom Ministry of Defense, the Army Corp of Engineers, and a domestic customer. Two customers accounted for 44% of our sales backlog at February 23, 2007. We cannot be certain that our most significant customers at any point in time will continue to order our products and services at the same level at which they have ordered them in the past. Due to the expensive nature and highly specialized market for our products and services, if any of these customers stops purchasing our products and services and we are unable to identify new customers in a timely manner, our business will be adversely affected.

**If our funding source does not provide us with sufficient funds to operate our business, our results of operations and financial condition would be materially adversely affected.**

Since 2003, H. F. Lenfest, a member of the Board of Directors of ETC, has provided significant funds which we have used to operate our business. Mr. Lenfest has also personally guaranteed our obligations to our commercial lender. In connection with our filing of this Annual Report on Form 10-K, Mr. Lenfest has entered into an agreement with ETC pursuant to which he has agreed, subject to the terms of the agreement, to continue to fund our operations through June 30, 2008, provided that ETC shall not request more than an additional \$10 million in the aggregate from May 9, 2007, through June 30, 2008, including all requests made under our existing unsecured promissory note and equity credit line. We are also in discussions with a commercial lender to obtain debt financing for our operations, which Mr. Lenfest has agreed to personally guarantee if we enter into a financing arrangement with the lender. We

can provide no assurance regarding our ability to secure commercial financing for our operations. If Mr. Lenfest is unable or unwilling to fund our operations and we were unable to identify a suitable funding source to replace the financing provided by Mr. Lenfest, our results of operations and financial condition would be materially adversely affected.

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

We have a significant amount of indebtedness. Our subordinated debt, \$10,000,000 face value, carries an interest rate of 10%, although this rate has been temporarily reduced to 8% for the period from December 1, 2004 through November 30, 2007. Our outstanding preferred stock (issued in 2006 to Mr. Lenfest) carries a coupon of 6% per annum. On November 16, 2006, the Company executed an Unsecured Promissory Note (the Lenfest Note ) in favor of Mr. Lenfest in the aggregate principal amount of \$3,000,000. Pursuant to the terms of the Lenfest Note, ETC can borrow up to \$3,000,000, in increments of \$1,000,000, prior to the maturity date of

**Table of Contents**

October 6, 2007. Any borrowings under the Lenfest Note will carry an interest rate of 6% per annum. To conserve cash outlay, Mr. Lenfest has agreed to defer the actual payment of all dividends on outstanding preferred stock until April 6, 2012 or upon 30 days written notice of demand, but not before June 30, 2008. Additionally, starting with the interest payment on our subordinated debt which was due on December 1, 2006, Mr. Lenfest has agreed to defer payment of interest until February 18, 2009 or until such time as we receive written demand notice of payment, but not before June 30, 2008. (Mr. Lenfest has also agreed to waive paying interest on deferred interest payments.) Since our bank agreement with PNC expires in June 2007 and both the Lenfest Equity Line and the Lenfest Note expire in October 2007, we will need to restructure or replace our financing arrangements. We may also incur additional indebtedness in the future. We may not generate sufficient cash flow from operations, or have future borrowings available to us, sufficient to pay our debt. During fiscal 2007 and 2006 we experienced negative cash flows from operations of \$6,997,000 and \$7,849,000, respectively. At May 11, 2007, our short-term debt was \$2,000,000, total long-term debt was \$10,000,000 and we had \$6,000,000 of outstanding preferred stock. Our total stockholders' equity was \$14,791,000. As of the date of this filing on Form 10-K, we had \$9 million available under the Lenfest Equity Line and \$1 million available under the Lenfest Note.

Our ability to make debt payments depends on future performance, which, to a certain extent, is subject to general economic, financial, competitive and other factors, some of which are beyond our control. We are currently in negotiations with a bank to establish a line of credit which will either replace or supplant our existing equity line and unsecured note with Mr. Lenfest. Based upon our current level of operations and anticipated growth, we believe that cash on hand and borrowings under either our existing arrangements or new arrangements with Mr. Lenfest and/or others will be adequate to meet our financial needs. There can be no assurance, however, that our business will generate sufficient cash flow from operations to enable us to pay our debts or to make necessary capital expenditures, that we will be successful in negotiating new financial arrangements, or that any refinancing of debt would be available on commercially reasonable terms.

Our substantial indebtedness could have important consequences including:

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

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

**We do not currently have a bank facility which can be used to borrow funds for operating purposes.**

On November 16, 2006, we entered into a Letter Agreement with PNC Bank. This Letter Agreement amended, restated and replaced the existing PNC Credit Agreement. Pursuant to such agreement, PNC Bank (i) terminated our Credit Agreement dated as of February 18, 2003 (ii) re-approved our \$5 million Line of Credit for Letters of Credit, and (iii) re-affirmed the Tangible Net Worth covenant (as defined in the Agreement) to a be a minimum of

\$9,000,000. The \$5 million Line of Credit for Letters of Credit continued to be guaranteed by Mr. Lenfest. As of February 23, 2007, we had used approximately \$2,607,000 of the availability under the PNC Agreement for international letters of credit.

We may need to obtain additional sources of capital in order to continue growing and operating our business. This capital may be difficult to obtain and the cost of this additional capital is likely to be relatively high.

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

- declare or pay dividends or any other distributions to our securities holders;
- redeem or repurchase capital stock;
- incur certain additional debt;
- place liens on our assets;
- make certain payments and investments;
- sell or otherwise dispose of assets; and

## **Table of Contents**

acquire or be acquired by other entities.

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

We are currently in negotiations with a bank to establish a line of credit which will either replace or supplant our existing equity line and unsecured note with Mr. Lenfest. Because we have established businesses in many markets, significant fixed assets including a building, and other business assets which can be used for security, we believe that we will be able to locate such additional sources of capital, although there is no assuredness that we will be successful in this endeavor.

Effective May 9, 2007, the Company entered into a letter agreement with Mr. Lenfest ( the Lenfest Letter Agreement ) whereas Mr. Lenfest agreed to provide financial support to the Company in the form of a guarantee and/or provide access to funding until June 30, 2008. The Company is currently in negotiations with an institutional lender in connection with a proposed facility which would require the personal guarantee of Mr. Lenfest. If successful, the proposed facility would replace the Company's current equity credit line and unsecured promissory note with Mr. Lenfest. Alternately, Mr. Lenfest has agreed to maintain his existing financial arrangements with the Company and in addition provide additional funding, provided that the Company shall not request more than an additional \$10 million in the aggregate from the date of the Lenfest Letter Agreement through June 30, 2008, including all requests made under the existing \$3 million unsecured promissory note and the \$15 million equity credit line.

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

### **We are attempting to introduce a new business model in two of our divisions.**

In a major re-engineering of our aeromedical business, we are shifting our business model from reliance on building aeromedical products to providing both tactical combat flight training and G-force instruction. In fiscal 2006, we began construction of the National Aerospace Training and Research Center. This center, set to open in fiscal 2008, is an integrated pilot training center offering a complete range of aviation training and research support for military jet pilots and civil aviation as well as space travel and tourism.

In our ADMS division, we have contracted marketing studies to evaluate the best way to sell simulation training. The result was a decision to migrate to a services-based approach. We cannot be certain that we will be successful in this new approach of marketing training services.

### **We need to attain validation from the U.S. defense agencies of our Authentic Tactical Fighting Systems technology.**

A second and equally challenging issue for our ATFS technology has been marketing this technology to the world's defense agencies. This is a new technology that goes contrary to conventional training belief that tactical flight and combat skills can only be learned in a flying aircraft. In January 2007 we achieved a major milestone in that the U.S. Air Force Research Lab prepared a business plan which incorporated the funds to build a joint strike fighter cockpit for the ATFS-400 simulator. This is the first step towards testing and validation of this technology by the U.S. military. At this point we cannot be certain that we will be able to overcome the conventional thinking on training nor achieve an acceptable level of validation with respect to the applicability and efficacy of ATFS training.

### **We have invested a significant amount of capital and resources in creating the NASTAR Center.**

We cannot be certain that we will generate enough training revenues to recoup the major investment we have made to develop, produce and construct the equipment and building modifications for the NASTAR Center.

### **Our operations involve rapidly evolving products and technological change.**

The rapid change of technology is a key feature of most of the industries in which our businesses operate. To succeed in the future, we will need to continue to design, develop, manufacture, assemble, test, market and support new products and enhancements on a timely and cost-effective basis. Historically, our technology has been developed through both customer-funded and internally funded research and development, and we expect this practice will continue to be required in the future. We cannot guarantee that we will continue to maintain comparable levels of research and development nor that this development will be customer-funded in the same ratio going forward.

Reinvestment of operating funds and profits in an amount greater than currently earned may be required. Even so, we cannot be assured you that we will successfully identify new opportunities and continue to have the financial resources required to develop new products profitably. At the same time, products and technologies developed by others may render our products and systems obsolete or non-competitive.

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

In accordance with generally accepted accounting principles for long-term contracts, under the percentage of completion ( POC ) accounting method, we record an asset for our costs and estimated earnings that exceed the amount we are able to bill our customers on uncompleted contracts. At February 23, 2007, this asset totaled \$2.8 million. Although a significant portion of these costs have been billed and collected since fiscal year-end, we cannot bill additional amounts unless and until we meet certain contractual milestones related to the production, delivery and integration of our products. Normally there will be a lag ranging from 6 to 24 months between performance and associated costs for these types of projects and billing and collection of payments. Our failure to meet these milestones by delivering and integrating our products in a timely manner may impact our ability to recover our costs and estimated earnings that exceeded our billings on uncompleted contracts, which could severely impact our cash flow.

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

The variety and complexity of our high technology product lines require us to deal with suppliers and subcontractors supplying highly specialized parts, operating highly sophisticated equipment and performing highly technical calculations. The processes of planning and managing production, inventory levels and delivery schedules are also highly complex and specialized. Many of our products must be custom designed and manufactured, which is not only complicated and expensive, but can also require long periods of time to accomplish. Slight errors in design, planning and managing production, inventory levels, delivery schedules, or manufacturing can result in unsatisfactory products that may not be correctable. If we are unable to meet our delivery schedules, we may be subject to penalties, including liquidated damages that are included in some of our customer contracts. Except for the RTAF contract (See Note 4 Accounts Receivable in the Notes to Consolidated Financial Statements section of the Annual Report to Stockholders attached as Exhibit 13 to this Annual Report on Form 10-K), our actual losses have been minimal, but we may incur substantial liquidated damages in the future in connection with product delays.

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

Historically, we have provided our products and services primarily through fixed-price contracts. Fixed-price contracts provided approximately 92% of our sales for the fiscal year ended February 23, 2007. Under a fixed-price contract, we agree to perform the scope of work required by the contract for a predetermined contract price. Although a fixed-price contract generally permits us to retain profits if the total actual contract costs are less than the estimated contract costs, we bear the risk that increased or unexpected costs may reduce our profit or cause us to sustain losses on the contract. Therefore, unless there are customer-requested changes in scope or other changes in specifications which are reimbursable, we fully absorb cost overruns on fixed-price contracts and this reduces our profit margin on the contract. These cost overruns may result in us recognizing a loss on the contract. A further risk associated with fixed-price contracts is the difficulty of estimating sales and costs that are related to performance in accordance with contract specifications. Our failure to anticipate technical problems, estimate costs accurately or control costs during performance of a fixed-price contract may reduce our profitability or cause a loss.

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

We record sales and profits on a significant portion of our contracts using the POC method of accounting. On long-term contracts over \$250,000 in value and over six months in length the POC revenue recognition method is utilized. Under this method a percentage is calculated based on costs incurred from inception to date on a contract as compared to the estimated total costs required to fulfill the contract. This percentage is then multiplied by the contract value to determine the amount of revenue to be recognized in any given accounting period. As a result, contract price and cost estimates on fixed-price contracts are reviewed periodically as the work progresses, and adjustments are reflected in income in the period when the estimates are revised. To the extent that these adjustments result in a loss, reduction or elimination of previously reported profits, we would recognize a charge against current earnings, which could be material and have a negative effect on our business, financial condition or results of operations. Although we believe that adequate provisions for losses for our fixed-prices contracts are recorded in our financial statements as required under accounting principles generally accepted in the United States of America, we cannot assure you that

our contract loss provisions, which are based on estimates, will be adequate to cover all actual future losses.

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

Government contracts require compliance with various contract provisions and procurement regulations. The adoption of new or modified procurement regulations could have a material adverse effect on our business, financial condition or results of operations or increase the costs of competing for or performing government contracts. If we violate any of these regulations, then we may be subject to termination of these contracts, imposition of fines or exclusion from government contracting and government-approved subcontracting for some specific time period. In addition, our contract costs and revenues are subject to adjustment as a result of audits by government auditors. We reflect any adjustments required by government auditors in our financial statements. Although we have



## **Table of Contents**

thus far not been required to make any material audit adjustments, adjustments may be required in the future. In connection with our government contracts, we have been required to obtain bonds, letters of credit or similar credit enhancements. We cannot assure you that we will be successful in obtaining these types of credit enhancements or that the credit enhancements available will be affordable in the future.

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

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

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

Although significant portions of our revenues are generated from the sale of our services and products in commercial markets, we cannot assure you that we will continue to compete successfully in these markets. Most of our commercial contracts contain fixed pricing which subjects us to substantial risks relating to unexpected cost increases and other factors outside of our control. We may fail to anticipate technical problems, estimate costs accurately, or control costs during performance of a fixed-price contract. Any of these failures may reduce our profit or cause a loss under our commercial contracts.

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

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

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

Our international business activities expose us to a variety of risks. Our international business including that from our foreign subsidiaries, accounted for approximately 62% of our sales in fiscal 2007 and 53% of our sales in fiscal 2006. We expect that international sales will continue to be a significant portion of our overall business in the foreseeable future. Our international business experiences many of the same risks our domestic business encounters as well as additional risks such as:

- the effects of terrorism;
- exchange rate fluctuations;
- a longer and more complicated collections cycle;
- a high degree of corruption in some countries;

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

The majority of our contracts which originate from ETC-Southampton are denominated in U.S. dollars. Except for intercompany work, and contracts with U.S. based companies, most of our contracts which originate from ETC-PZL are in Polish Zlotys.

## Table of Contents

Since most of our production and administrative costs are based in U.S. dollars, a weakening of the U.S. dollar currency versus other international currencies may make our pricing un-competitive when compared to foreign local in-country competitors.

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

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

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

In order to comply with the Sarbanes-Oxley Act of 2002, as well as changes to the American Stock Exchange listing standards and rules adopted by the Securities and Exchange Commission ( SEC ), we have been required to strengthen our internal controls, hire additional personnel and retain additional outside legal, accounting and advisory services, all of which have caused and will continue to cause our general and administrative costs to increase. These and other costs of operating as a public company totaled approximately \$600,000 in fiscal 2007. We anticipate that public company costs will continue to constitute a significant portion of our general and administrative spending going forward. Although we have not experienced any director and officer liability claims, these premiums are a significant part of our business insurance premiums and may increase as a result of the (i) high claims rates insurers have incurred with other companies over the past years (ii) the high stock ownership position of some of our non-affiliated shareholders, and (iii) our reduced operating performance. Changes in the accounting rules and auditing standards, including legislative and other proposals to account for employee stock options as a compensation expense, among others, could materially increase the expenses that we incur and report under generally accepted accounting principles and adversely affect our operating results.

**Although up from the prior year, our fiscal 2008 opening backlog is still relatively lower than the balance at the beginning of most comparable prior fiscal periods. Additionally, our sales backlog is not necessarily indicative of revenues that we will actually realize in fiscal year 2008 or at all.**

Our opening backlog for fiscal 2008 is approximately \$14.8 million. The opening backlog for fiscal years 2002 through 2005 was in excess of approximately \$20 million for each year. Although our open proposal quote log remains strong and we have recently experienced renewed customer interest in some significant international aeromedical proposals, there is no assurance that we will be able to bring a significant amount of these contracts to award status. Additionally, we may not actually generate revenues in fiscal 2008 for all items included in our backlog at the end of our 2007 fiscal year. While we estimate that approximately 88% of this \$14.8 million backlog will be completed prior to the end of our 2008 fiscal year, we cannot be certain that these projects will be completed so that we can record these revenues by such date, or at all. During fiscal 2007, we recorded revenue on approximately 75% of our opening backlog. Our backlog includes the total value of all contracts less any revenue recorded on those contracts through the measurement date. Many of our government contracts are multi-year contracts and contracts with option years, and portions of these contracts are carried forward from one year to the next as part of our backlog. We cannot assure that cancellations or adjustments in the terms of these contracts might not occur.

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

International sales accounted for 62% and 53% of our revenues for fiscal years 2007 and 2006, respectively. In the event terrorist attacks, war, disease or other activities or occurrences make air travel difficult or reduce the demand or willingness of our customers to purchase our commercial simulation products, our revenue may decline.

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

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

Our common stock is listed on the American Stock Exchange. Our average daily trading volume on the American Stock Exchange during fiscal 2007 was 3,690 shares; on the consolidated markets (which includes shares traded on the American Stock Exchange), the average daily volume was 5,645 shares. This limited trading activity may make it difficult for investors to sell larger blocks of our common stock at prevailing prices as there are generally a small number of participants in the market for our common stock and such sales may lower the market price of our common stock.

**Table of Contents**

**The market price of our common stock may be volatile.**

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

- actual or anticipated operating results;
- changes in estimates by analysts;
- market conditions in the industry;
- announcements by competitors;