GENERAL KINETICS INC
Form 10-K
August 29, 2003

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-K

ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF

THE SECURITIES EXCHANGE ACT OF 1934

For the fiscal year ended May 31, 2003

Commission File No. 0-1738

GENERAL KINETICS INCORPORATED

(Exact Name of Registrant as specified in its Charter)

Virginia	**54-0594435**
(State of Incorporation)	**(IRS Employer Identification No.)**
10688-D Crestwood Drive, Manassas, VA	**20109**
(Address of principal executive offices)	**(Zip Code)**

(703) 331-8033

Registrant s telephone number

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

None

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

Title of Each Class

Common Stock, $0. 25 par value per share

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 x 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 the 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 an accelerated filer (as defined in Exchange Act Rule 12b-2) YES ¨ NO x

The aggregate market value of the voting stock held by non-affiliates of the Registrant, based upon the closing sale price of Common Stock on November 30, 2002, the last business day of the registrant s most recently completed second fiscal quarter, as reported on the NASD OTC Bulletin Board, was approximately $104,419. Shares of Common Stock held by the executive officers, directors and under the Registrant s ESOP have been excluded in that such persons may be deemed affiliates. This determination of affiliate status is not necessarily a conclusive determination for other purposes.

The number of shares outstanding of Registrant s Common Stock, $0.25 par value, as of August 15, 2003, was 7,118,925

Documents Incorporated by Reference

Certain portions of the Registrant s Proxy Statement to be filed with the Securities and Exchange Commission not later than 120 days after the end of the Registrant s 2003 fiscal year are incorporated into Part III hereof.

CAUTIONARY STATEMENT REGARDING FORWARD LOOKING STATEMENTS

Certain statements contained in this Annual Report on Form 10-K constitute forward-looking statements . In some cases, forward-looking statements can be identified by the use of forward-looking terminology such as may, will, estimate, intend, continue, believe, expect o anticipate or the negatives thereof, variations thereon or similar terminology. The forward-looking statements contained in this Annual Report are generally located in the material set forth under the headings Business and Management s Discussion and Analysis of Financial Condition and Results of Operations, but may be found in other locations as well. These forward-looking statements generally relate to plans and objectives for future operations and are based upon management s reasonable estimates of future results or trends. Although the Company believes that the plans and objectives reflected in or suggested by such forward-looking statements are reasonable, such plans or objectives may not be achieved. Actual results may differ from projected results due, but not limited, to unforeseen developments, including developments relating to the following:

the risk that the Company may not be able to obtain and complete sufficient new orders to maintain positive cash flow;

the risk that the Company may not maintain its present financing facility or obtain additional financing, if necessary, including the risk that it will not be able to repay or refinance in full the approximately $8.8 million principal amount of its outstanding convertible debentures currently scheduled to mature in August 2004;

the risk that the Company may not be able to continue the necessary development of its operations, including maintaining or increasing sales and production levels, on a profitable basis;

the risk the Company may in the future have to comply with more stringent environmental laws or regulations or more vigorous enforcement policies of regulatory agencies, and that such compliance could require substantial expenditures by the Company;

the risk that U.S. defense spending may be substantially reduced; and

the risk that the Company s Common Stock will not continue to be quoted on the NASD Over The Counter Bulletin Board.

You should read this Annual Report completely and with the understanding that actual future results may be materially different from what the Company expects. All subsequent written and oral forward-looking statements attributable to the Company or to persons acting on the Company s behalf are expressly qualified in their entirety by the foregoing factors. These forward-looking statements speak only as of the date of the document in which they are made. The Company disclaims any obligation or undertaking to provide any updates or revisions to any forward-looking statement to reflect any change in the Company s expectations or any change in events, conditions or circumstances in which the forward-looking statement is based.

PART I

ITEM 1 BUSINESS

(a) General Development of Business

General Kinetics Incorporated (the Company or GKI) designs and manufactures high-quality precision enclosures for electronic systems, principally for sale to the U.S. Department of Defense and the U.S. Navy.

The Company was founded as a Virginia corporation in 1954 and its common stock became publicly traded in November 1961.

Beginning in December 1992, and ending in August 1994, the Company s operations were financed to a significant extent by debt and equity investments made by clients of Gutzwiller & Partner, A.G.(Gutzwiller), a corporation formed under the laws of Switzerland, now known as Rabo Investment Management Ltd. (the Manager). At May 31, 2003, convertible debentures initially issued to clients of Gutzwiller were outstanding in an aggregate principal amount of approximately $8.8 million. Such debentures mature in August 2004, are convertible into common stock at a conversion price of $0.50 per share, and bear interest at 1% per annum, which is payable annually. Shares issuable upon conversion are also subject to certain rights to registration under the Securities Act of 1933, as amended.

In a Schedule 13-D/A filed with the SEC dated November 9, 2001, the Manager indicated that it may be deemed to be the beneficial owner of debentures in an aggregate principal amount of $7,885,000, including debentures in an aggregate principal amount of $585,000 which were purchased by the manager to which the Manager is the economic beneficial owner of and holds sole voting and dispositive power, and $7,300,000 held in client accounts managed by the Manager on behalf of various clients who hold beneficial economic ownership thereof to which the Manager holds voting and dispositive power. Such Schedule 13D/A also indicated that the Manager may be deemed to be the beneficial owner of an aggregate of 1,715,000 outstanding shares of the Company s common stock, including 242,700 shares purchased by the Manager to which the Manager is the economic beneficial owner of and holds sole voting and dispositive power and 1,472,300 shares held in client accounts.

On March 12, 2003, Manassas Partners LLC, a Delaware limited liability company of which Larry Heimendinger, Chairman of the Board of Directors of the Company, is the managing member, purchased from third parties, at a significant discount, a portion of the Company s outstanding convertible debentures in an aggregate principal amount of $5,800,000.

(b) Financial Information About Industry Segments

The Company is currently operating in a single industry segment.

(c) Narrative Description of Business

The Business

General

The Company designs and manufactures high-quality precision enclosures for sophisticated electronic systems. The Company is a manufacturing and engineering services company which produces build-to-print as well as custom engineered products. The Company has manufactured electronics-ready enclosures and mounting systems for over 40 years. Products include both standard and made-to-order racks, cabinets and kits. These products are precision-manufactured to enclose and protect sensitive electronic communication and detection equipment from shock and vibration. The principal customer for these products is the U.S. Navy which, directly or indirectly through its prime contractors, accounted for 93%, 94%, and 91% of the Company s revenues in fiscal 2003, 2002 and 2001, respectively. The Company sells these products as a prime contractor and also as a subcontractor to major prime contractors such as Lockheed Martin, Raytheon, SAIC, Northrop Grumman, and DRS Laurel Technologies.

Strategy

The Company s long-term goals are to increase market penetration with the Department of Defense, and to expand into the non-government marketplace by targeting build-to-print or engineering design opportunities for enclosures and related products. The Company entered the commercial enclosure marketplace in fiscal 2000. The current strategy for these products is to concentrate on selling high-end precision enclosures through a small network of U.S. sales representatives. The Company does not expect the non-government marketplace to provide a significant portion of the Company s sales during fiscal 2004. Management intends to use its current sales force and build on its reputation for quality to expand sales to the U.S. Navy and other agencies within the government.

The Company plans to finance its strategy for fiscal 2004 through cash on hand as of May 31, 2003, careful management of operating expenses, factoring accounts receivable to alleviate short-term cash requirements, and cash flow generated through operations. The Company may also seek additional sources of debt or equity financing to allow it to meet cash commitments if sales and shipment levels fluctuate throughout the fiscal year.

Products

The Company s principal products are enclosures, such as racks, cabinets, consoles, and mounting platforms for sophisticated electronic systems generally made in accordance with specific client requirements. The Company has developed a series of consoles and enclosures to offer as commercial-off-the-shelf products to be sold to prime contractors for contracts in the defense community that require this type of enclosure. These consoles and enclosures provide an environment that makes it possible to use commercial electronics while meeting the need for combat ready systems.

The Company s production processes cover a wide range of operations, including high volume production using tight tolerance, military-specified engineering requirements. Military specifications for metal fabrication and machinery require geometric dimensioning to and from fabricated areas to datums within ten thousandths (.0001) of an inch of their true fabricated position, and the machining of parts to a size of plus or minus one thousandth (.001) of an inch of their specified dimension. Furthermore, the Company has in-plant facilities to test for radio frequency interference (R.F. testing) as it is required to certify certain products. The Company fabricates metal cabinets and other products from sheet aluminum and steel and other metal components, all of which are readily available from numerous domestic suppliers. The manufactured products must satisfy the close-tolerance specifications of its customers and are subjected to in-house sound testing to ensure that the levels of noise emanating from the enclosures at various frequencies are within customer specifications. The Company s products have high visibility in such programs as AEGIS and other major U.S. Government programs.

Customers

During fiscal years 2003, 2002, and 2001, the Company sold 93%, 94%, and 91%, respectively, of its products to the U.S. Government, principally to the U.S. Navy, either as a prime contractor or a subcontractor to major prime contractors. Therefore, a material decline in spending by the Department of Defense, in particular spending by the U.S. Navy, could have a material adverse effect on the operations of the Company, unless offset by greater market penetration or new sales to other government and commercial customers. In addition, the Company s U.S. Government contracts and, in general, its subcontracts with the U.S. Government s prime contractors provide that such contracts may be terminated by the U.S. Government or prime contractor for convenience at any time. The Company considers its relationships with the U.S. Navy and its major prime contractor customers to be good.

Marketing and Sales

The Company currently markets its products through a direct sales force and through outside agencies. The Company also participates in industry trade shows as a means of contacting new and existing customers and introducing new products.

Backlog

The Company sells its products pursuant to both long and short-term contracts with scheduled backlog and delivery orders. Amounts are not carried in backlog until the related contracts receive government funding (in the case of government contracts) and, in any event, delivery orders are released to the Company. Once an order is received, production and delivery can be scheduled, but in some instances dates can be delayed by changing requirements of government or commercial customers.

The Company s contract backlog as of May 31, 2003 and May 31, 2002 was approximately $1.4 million and $1.9 million, respectively. All of the $1.4 million backlog at May 31, 2003 is expected to be shipped during fiscal 2004. The Company does not believe that seasonal fluctuations play a significant role in the backlog for its business.

Competition

The Company operates in a mature, highly fragmented market with intense competition. The principal elements of competition are price, the ability to deliver products in accordance with major U.S. Government and prime contractor production schedules, technical expertise, quality, service and support. The Company believes that the Company competes with approximately 25 other manufacturers of electronic enclosures, including, in some instances, major prime contractors, which are also customers of the Company. Certain of the Company s competitors have significantly greater financial, marketing and technological resources than the Company.

Research and Development

The Company expects research and development activities to total less than $50,000 during fiscal 2004. No material research and development expenses were incurred in fiscal 2003, 2002 or 2001.

The U.S. Government Procurement Process

The majority of the Company s fiscal 2003 revenue was generated from sales directly to departments and agencies of the U.S. Government, and to prime contractors reselling to the U.S. Government market, principally to the U.S. Navy. Revenue from these sales represented approximately 93% of the Company s total revenue in fiscal 2003. The Company sells to the U.S. Government through a wide variety of contract procurement mechanisms that include formal solicitations and requests for quotes. The Company s sales to U.S. Government prime contractors are typically made through contracts secured by formal competitive bidding.

The Company s U.S. Government contracts and, in general, its subcontracts with the U.S. Government s prime contractors, provide that such contracts may be terminated by the U.S. Government or prime contractor for convenience at any time. The Company estimates that substantially all of the Company s fiscal 2003 revenue was derived from contracts that are subject to termination for convenience. In the event of such a termination, the Company is normally entitled to receive the purchase price for delivered items, reimbursement for allowable costs for work in process, and an allowance for profit thereon or adjustment for loss if completion of performance would have resulted in a loss.

There were no terminations for convenience in fiscal 2003, 2002, or 2001. Upon termination of a U.S. Government contract for contractor default, the U.S. Government may seek to recover from the defaulting contractor the increased costs of procuring the specified goods and services from a different contractor. The U.S. Government to date has not terminated for default of any contract awarded to the Company.

In connection with its efforts to compete for U.S. Government business, the Company has enjoyed certain statutory advantages as a consequence of its size, location and the American-made character of its products. Such advantages may not be available to the Company in the future. Although the Company believes that it will continue to qualify under these statutory provisions for the foreseeable future, the Company does not believe that the loss of such status would be likely to have a material adverse effect upon the Company.

The Company s sales to the U.S. Government are subject to numerous other factors beyond the Company s control that generally apply to other U.S. Government contractors, including fluctuations and delays resulting from the appropriations process, the outcome of competition for contracts, and reductions in levels of military and other agencies spending.

Employees and Labor Agreements

As of May 31, 2003, the Company had 63 employees, all located in the United States. Of the 63 employees, 17 were salaried and 46 were paid by the hour. At that date, on a Company-wide basis, there were 2 employees in engineering, 1 employee in sales and marketing, 51 employees in manufacturing and assembly operations, and 9 employees in an executive capacity or in finance and administration. Thirty-seven of the Company s employees were represented by the International Brotherhood of Electrical Workers Union (the Union) in Johnstown, Pennsylvania. The Company and the Union are working under a five-year collective bargaining agreement that will expire on May 31, 2004. The Company considers its employee relations to be good.

Environmental Matters

The Company uses limited amounts of hazardous materials in its production process, primarily in the treatment of metal components. All such materials are disposed of by independent certified carriers. The Company believes it operates its facilities in compliance, in all material respects, with all existing federal, state and local environmental regulations.

Pursuant to the requirements of applicable federal, state, and local statutes and regulations, the Company believes it has received all of the environmental permits and approvals necessary for the operations of its facilities.

(d) Financial Information about Geographic Areas

The Company has not had significant foreign operations or export sales.

ITEM 2 PROPERTIES

The Company maintains its executive offices in a leased facility in Northern Virginia that is approximately 1,850 square feet.

The Company s manufacturing facilities are presently located in a 56,000 square foot industrial manufacturing plant in Johnstown, Pennsylvania that is owned by the Company. A small portion of the Johnstown facility is leased to unrelated third parties. The Johnstown facility is subject to a mortgage held by a local banking institution. The real estate mortgage agreement contains a subjective covenant that could allow the bank to accelerate the maturity of the debt if the bank determines that a material adverse change in the financial or business condition of the Company has occurred.

The Company believes that its present facilities are adequate to meet its current production requirements.

ITEM 3 LEGAL PROCEEDINGS

As of the date hereof, there are no material pending legal proceedings, to which the Company is a party or of which any of its property is the subject.

ITEM 4 SUBMISSION OF MATTERS TO A VOTE OF SHAREHOLDERS

None

PART II

ITEM 5 MARKET FOR THE COMPANY S COMMON EQUITY AND RELATED STOCKHOLDER MATTERS

The Company s Common Stock, $.25 par value per share, is quoted on the Over the Counter (OTC) Bulletin Board, under the symbol GKIN . The table below presents the high and low sales prices as reported for the fiscal quarters within the two most recent fiscal years:

Quarter Ended	High	Low
May 31, 2003	$0.09	$0.02
February 28, 2003	$0.06	$0.011
November 30, 2002	$0.035	$0.011
August 31, 2002	$0.045	$0.03
May 31, 2002	$0.055	$0.045
February 28, 2002	$0.06	$0.045
November 30, 2001	$0.07	$0.04
August 31, 2001	$0.08	$0.05

The number of holders of record of the Company s Common Stock, $.25 par value, as of August 15, 2003, was 1,004.

The Company has not paid any dividends during the last five fiscal years and has no present plans to pay dividends in the foreseeable future.

ITEM 6 SELECTED FINANCIAL DATA

The following sets forth certain selected financial data for each of the years in the five-year period ended May 31, 2003. The statement of operations data for the fiscal years ended May 31, 2003, 2002, 2001 and the balance sheet data at May 31, 2003 and 2002 are derived from and are qualified by reference to the financial statements of the Company audited by BDO Seidman, LLP, the Company s independent certified public accountants, included elsewhere, herein. The statement of operations data for the fiscal years ended May 31, 2000 and 1999 and the balance sheet data at May 31, 2000, 1999 and 1998 are derived from financial statements of the Company also audited by BDO Seidman, LLP, but not included herein. The financial data should be read in conjunction with, and are qualified by reference to, the financial statements and related notes and other financial information and Management s Discussion and Analysis of Financial Condition and Results of Operations included elsewhere herein.

	Years ended May 31				
	1999	2000	2001	2002	2003
	(in thousands, except per share data)				
Statement of Operations Data:					
Net Sales	$ 7,490	$ 8,833	$ 8,259	$ 8,870	$ 6,377
Cost of sales	6,429	7,828	6,736	7,691	5,107
Gross profit	1,061	1,005	1,523	1,179	1,270
Selling, general, and administrative expenses	1,723	1,514	1,565	1,559	1,203
Product R&D, and improvement	0	0	43	0	3
Manufacturing Start-Up Costs	0	0	0	265	0
Provision for Note Receivable	13	0	0	0	0
Operating income (loss)	(675)	(509)	(85)	(645)	64
Gain on Note Settlement	0	279	0	0	0
Other Income	0	0	175	37	0
Interest expense, net	(241)	(299)	(220)	(227)	(195)
Loss before extraordinary item	(916)	(529)	(130)	(835)	(131)
Extraordinary gain from debt extinguishment	67	0	0	0	0
Loss before income taxes	(849)	(529)	(130)	(835)	(131)
Provision for income taxes	0	0	0	0	0
Net Loss	$ (849)	$ (529)	$ (130)	$ (835)	$ (131)
Basic and Diluted Earnings Per Share:					
Loss before extraordinary item per share	(.136)	(.079)	(.019)	(.124)	(.019)
Income from extraordinary item per share	.010	.000	.000	.000	.000
Basic loss per share	(.126)	(.079)	(.019)	(.124)	(.019)
Weighted average common shares outstanding	6,719	6,719	6,719	6,719	6,899
Cash dividends per common share	0	0	0	0	0

Balance Sheet and Other Data:

	May 31,				
	1999	2000	2001	2002	2003
			(in thousands)		
Working capital	$ 1,570	$ 1,381	$ 1,351	$ 606	$ 556
Cash	307	958	388	185	114
Total assets	4,685	4,130	4,009	2,918	2,156
Net property, plant & equipment	1,016	925	802	800	703
Capital expenditures	174	93	34	46	50
Long-term liabilities	9,580	9,570	9,551	9,597	9,334
Total Stockholders Deficit	$ (6,638)	$ (7,166)	$ (7,296)	$ (8,132)	$ (8,065)

ITEM 7 MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

Results of Operations

The following table sets forth items from the Company s statements of operations for fiscal years 2001, 2002 and 2003 (each ended May 31), as a percentage of revenue.

Percent of Revenue

	2001	2002	2003
Net sales	100.0 %	100.0 %	100.0 %
Gross profit	18.4 %	13.3 %	19.9 %
Operating expenses	(19.4)%	(20.6)%	(18.9)%
Operating income (loss)	(1.0)%	(7.3)%	1.0 %
Interest expense	(2.7)%	(2.5)%	(3.0)%
Other Income	2.1 %	0.4 %	0.0 %
Net loss	(1.6)%	(9.4)%	(2.0)%

Fiscal Year 2003 Compared to Fiscal Year 2002

Net sales for fiscal 2003 were approximately $6.4 million as compared with $8.9 million for fiscal 2002, representing a decrease of 28%. The decrease in sales was due primarily to a decrease in orders under a large blanket contract with a prime contractor to the U.S. Navy, in addition to an overall slowdown of orders from customers involved in projects related to the U.S. Navy.

The principal customer for the Company s products is the U.S. Government, principally the U.S. Navy, which, directly or through its prime contractors, accounted for 93% of the Company s revenues in fiscal year 2003. The Company s sales to the U.S, Government and its prime contractors represented approximately 94% and 91% of total net sales during the Company s fiscal years ended May 31, 2002 and May 31, 2001, respectively, and are expected to continue to account for a substantial portion of the Company s revenues for the foreseeable future. The Company s contracts with the United States Government are subject to the availability of funds through annual appropriations, may be terminated by the government for its convenience at any time and generally do not require the purchase of a fixed quantity of products. Reductions in U.S. Government defense spending could adversely affect the Company s operating results. While the Company is not aware of present or anticipated reductions in United States Government spending on specific programs or contracts pursuant to which the Company has sold material quantities of its products, there can be no assurance that such reductions will not occur or that decreases in United States Government defense spending in general will not have an adverse effect on sales of the Company s products in the future.

Gross profit for fiscal 2003 was approximately $1.3 million compared with approximately $1.2 million for fiscal 2002. Gross profit as a percentage of sales increased from 13.3% in fiscal 2002 to 19.9% in fiscal 2003. The primary reasons for the increase in the gross profit percentage were the mix of jobs for the current fiscal year as compared to the prior fiscal year, along with improved scheduling and planning procedures implemented during the prior fiscal year. The Company continues to address production issues through plant supervision and regular updating of scheduling and planning procedures. The Company is trying to stabilize the level of shipments at a profitable level through these changes and a focused sales effort.

Operating expenses for fiscal 2003 were approximately $1.2 million compared with $1.8 million for fiscal 2002. The decrease from fiscal 2002 was partially due to the Company recognizing, in 2002, $265,100 in start-up costs related to a large blanket contract with a U.S. Navy prime contractor. The Company incurred significant costs in planning, implementing, and training employees for the new production process related to this contract. In accordance with generally accepted accounting principles, the Company expensed these start-up costs. No such costs were incurred in fiscal 2003. In addition, the reduction was partially due to cost control measures during the third and fourth quarters of fiscal 2003, including salary reductions implemented by management in response to reduced backlog and shipping levels.

During fiscal 2002, the Company recorded $37,400 in other income related to stock issued to the Company in December 2001 by Prudential Financial upon its conversion from a mutual company to a stock company.

Interest Expense

Interest expense decreased to $195,200 in fiscal 2003 as compared to $227,800 in fiscal 2002. This decrease occurred principally because interest expense from factoring accounts receivable was $12,000 in fiscal 2003 as compared to $29,500 in fiscal 2002.

The overall net loss was $131,400 for fiscal 2003 as compared to a net loss of $835,400 in fiscal 2002. The decrease in the loss was primarily due to the increase in gross profits, the reduction in operating expenses, and the prior year manufacturing start-up costs discussed above.

Income Taxes

The Company had no income tax provision in fiscal 2003 or fiscal 2002 due to the net losses. Under Statement of Financial Accounting Standards No. 109, Accounting for Income Taxes (SFAS 109), deferred tax assets and liabilities are determined based on differences between financial reporting and tax basis of assets and liabilities and are measured using enacted tax rates and laws that will be in effect when the differences are expected to reverse. The Company has provided a full valuation allowance against its net deferred tax asset due to uncertainties of its ultimate realization. If the Company achieves profitable operations, it will be subject to alternative minimum taxes, which have a lower effective tax rate than the statutory rate of 34%.

Fiscal Year 2002 Compared to Fiscal Year 2001

Net sales for fiscal 2002 were approximately $8.9 million as compared with $8.3 million for fiscal 2001, representing an increase of 7.2%. The increase was due primarily to sales totaling $3.5 million under a large contract with a prime contractor to the U.S. Navy in fiscal 2002 as compared to sales of $1.3 million in fiscal 2001 for the same U.S. Navy program.

The principal customer for the Company s products is the U.S. Government, principally the U.S. Navy, which, directly or through its prime contractors, accounted for 94% of the Company s revenues in fiscal year 2002. The Company s sales to the United

States Government and its prime contractors represented approximately 94% and 91% of total net sales during the Company s fiscal years ended May 31, 2002 and May 31, 2001, respectively.

Gross profit for fiscal 2002 was approximately $1.2 million compared with approximately $1.5 million for fiscal 2001. Gross profit as a percentage of sales decreased from 18.4% in fiscal 2001 to 13.3% in fiscal 2002. The primary reasons for the decrease in gross profit margins were changes in the mix of jobs produced in the year ended May 31, 2002 as compared to the job mix in the year ended May 31, 2001. The mix of jobs produced in the year ended May 31, 2002 required more machine shop hours than the prior year, and a larger amount of the machine shop work was outsourced to subcontractors, at a higher cost per hour, during fiscal year 2002. In order to increase machine shop capacity and reduce the amount of outsourcing for machined parts, the Company entered into a lease purchase agreement for a new vertical machining center that was put into service in December 2001.

Operating expenses for fiscal 2002 were approximately $1.8 million compared with $1.6 million for fiscal 2001. The increase in fiscal 2002 was principally due to the Company S recognizing $265,100 in start-up costs related to a large blanket contract with a U.S. Navy prime contractor. The Company incurred significant costs in planning, implementing, and training employees for the new production process related to this contract. In accordance with generally accepted accounting principles, the Company has expensed these start-up costs. During the fiscal year ended May 31, 2001, the Company incurred $42,800 in product research, development & improvement costs related to the initial development work on a new enclosure product. No such costs were incurred in fiscal 2002.

During fiscal 2002, the Company recorded $37,400 in other income related to stock issued to the Company in December 2001 by Prudential Financial upon its conversion from a mutual company to a stock company. During the fiscal year ended May 31, 2001, the Company recorded $175,000 in other income related to the collection of notes receivable due from Link2It, LLC that had been fully reserved in the prior fiscal year (see Note 4 to the financial statements).

Interest Expense

Interest expense increased slightly to $227,800 in fiscal 2002 from $219,700 in fiscal 2001. This increase occurred principally because interest expense from factoring accounts receivable was

$29,500 in fiscal 2002 as compared to $9,300 in fiscal 2001.

The overall net loss in fiscal 2002 was $835,400 as compared to a net loss of $129,800 in fiscal 2001. The increased loss was primarily due to the decrease in gross profits and the manufacturing start-up costs discussed above.

Income Taxes

The Company had no income tax provision in fiscal 2002 or fiscal 2001 due to the net losses. Under SFAS 109, deferred tax assets and liabilities are determined based on differences between financial reporting and tax basis of assets and liabilities and are measured using enacted tax rates and laws that will be in effect when the differences are expected to reverse. The Company has provided a full valuation allowance against its net deferred tax asset due to uncertainties of its ultimate realization.

Liquidity and Capital Resources

The Company relies upon internally generated funds and accounts receivable factoring to finance its operations. During fiscal years 2003 and 2002, the Company incurred net losses of approximately $131,400 and $835,400, respectively. In order to generate the working capital required for operations, the Company must continue to generate orders, increase its gross margins, and effectively manage operating expenses during fiscal 2004.

The Company must continue to market electronic enclosure products to government and commercial markets, enter into contracts which the Company can complete with favorable profit margins, ship the orders in a timely manner, and control its operating costs in order to recover from its liquidity problems and seek to operate profitably for fiscal 2004.

The backlog at May 31, 2003 was $1.4 million, as compared to $1.9 million at May 31, 2002. The decrease in backlog is primarily due to a decrease in orders under a large blanket contract with a prime contractor to the U.S. Navy, in addition to an overall slowdown of orders from customers involved in projects related to the U.S. Navy. The Company must increase its level of sales under other contracts in order to make up for the reduction in orders under this contract, and to maintain a sales level that will provide positive cash flow for the remainder of the fiscal year. However, there is no assurance the Company will be successful in its efforts to obtain an adequate level of new contracts to maintain positive cash flow or profitable operations.

In recent months, the Company and its customers have experienced significant delays in the release of orders under awarded programs, and there can be no assurance that such delays will not continue or become more severe. In the absence of orders released against these rewards or other new business, the Company could experience a material decrease in its level of business, revenues and cash flows.

As of May 31, 2003, the Company had cash and marketable securities totaling $150,400. The Company has faced production issues that have contributed to losses from operations in the prior three fiscal years. The Company has taken and is continuing to take steps to address these production issues through changes and additions to plant supervision, regularly updating scheduling and planning procedures, and adding new production machinery. The Company is trying to stabilize the level of shipments at a profitable level through these changes. However, during the current fiscal year management implemented cost reductions, including salary reductions, in response to reduced sales and order backlog.

Management believes that unless there is an increase in the shippable order backlog, the Company may not be able to meet its cash requirements through the current fiscal year with cash on hand and borrowings from the factoring of accounts receivable. Meeting the Company s cash requirements through the next twelve months will also require an increase in the current order backlog, as well as profitable production and shipment of those orders. However, there is no assurance the Company will be successful in pursuing its plans or in obtaining additional financing to meet those cash requirements. The Company must increase its current level of sales, consistently make timely shipments and produce its products at adequate profit margins, or the Company will continue to face liquidity problems and may be left without sufficient cash to meet its ongoing requirements.

The accompanying financial statements have been prepared assuming that the Company will continue as a going concern. The Company has sustained operating losses in fiscal years 2003, 2002 and 2001, and in addition, the Company has significant short-term cash commitments, the funding of which is limited to cash flow from operations and the factoring of certain accounts receivable, if available. These issues, in addition to an overall slowdown of orders from customers involved in projects related to the U.S. Navy, raise significant doubt about the Company s ability to continue as a going concern. The financial statements do not contain any adjustment that might result from the outcome of these uncertainties.

The Company was formerly party to a factoring agreement with Reservoir Capital Corporation (Reservoir) that provided for advances (or loans) of up to 80% of specified accounts receivable. In August 2001, Link2It Corporation, a company formed by Larry Heimendinger and Richard McConnell, both of whom are directors of the Company, entered into a factoring agreement with the Company on terms substantially similar to those of the Reservoir facility, but more favorable to the Company in certain respects, including provision for advances at a rate of up to 85% of specified accounts receivable. A factoring agreement with Link2It Corporation, on similar terms, was entered into in April 2002. Subsequent to the fiscal year end, the Company entered into a new factoring agreement with Key Capital Factoring (Key) that also provides for advances of up to 85% of specified accounts receivable. The Company expects to draw on the Key facility during fiscal 2004 as necessary to help alleviate liquidity problems, although, as discussed above, the Company will also need to control expenses, maintain the sales backlog at appropriate levels, and keep shipment levels in line with booked orders in order to meet these requirements. At May 31, 2003, there were no outstanding advances due to Link2It Corporation.

The Company had significant amounts payable to trade creditors at May 31, 2003. Current maturities of long-term debt and capital lease obligations amount to $117,000 in fiscal 2004.

The Company has outstanding debentures originally issued to clients of Gutzwiller & Partner, now known as Rabo Investment Management Ltd. (the Manager), totaling approximately $8.8 million. The debentures mature in August 2004, are convertible into common stock at a conversion price of $0.50 per share, and bear interest at 1% per annum payable annually. In a filing with the SEC dated November 9, 2001, the Manager indicated that it might be deemed to be the beneficial owner of debentures having an aggregate principal amount of $7,885,000, including debentures in the principal amount of $585,000 which were purchased by the Manager as to which the Manager was the economic beneficial owner and held sole voting and dispositive power, and debentures in a principal amount of $7,300,000 held in client accounts managed by the Manager on behalf of various clients who held beneficial economic ownership thereof for which the Manager held voting and dispositive power. On March 12, 2003, Manassas Partners LLC, a Delaware limited liability company of which Larry Heimendinger, Chairman of the Board of Directors of the Company is the managing member, purchased from third parties, at a significant discount, a portion of the Company s outstanding convertible debentures in an aggregate principal amount of $5,800,000.

The Company does not expect that its cash flow, capital resources, and overall financial condition will be sufficient to repay or refinance in full the approximately $8.8 million principal amount of outstanding convertible debentures currently scheduled to mature in August 2004. At present, the Company has decided on no specific plans with respect to the repayment or refinancing of the debentures, but it expects to continue to review the situation and consider its potential alternatives during the coming fiscal year.

Analysis of Cash Flows

Operating activities provided $88,300 in cash in fiscal 2003. This reflects a net loss of $131,400 and $98,200 in cash to fund changes in working capital items, offset by $317,900 in net non-cash income and expenses. The cash used to fund changes in working capital items includes a decrease in inventories of $21,600 and a decrease in accounts receivable of $398,500, offset by a decrease in accounts payable of $399,600 and a decrease in accrued expenses and other payables of $174,100.

Investing activities used $49,900 in fiscal 2003. These activities consisted of acquiring property and equipment.

Financing activities used $109,500 in fiscal 2003. These activities consisted of the repayment of certain long-term debt and capital leases, and factoring of accounts receivable netting to $0.

Contractual Obligations and Commercial Commitments

The Company s commitments through May 31, 2008 are comprised of the following at May 31, 2003 (in thousands):

	Through May 31,					
	2004	2005	2006	2007	2008+	Total
Convertible debentures	$ 0	$ 8,795	$ 0	$ 0	$ 0	$ 8,795
Other notes payable	0	40	0	0	0	40
Real estate mortgage	96	102	107	55	0	360
Capital leases	26	26	26	15	0	93
Operating leases	29	25	3	3	1	61
Total	$ 151	$ 8,988	$ 136	$ 73	$ 1	$ 9,349

Inflation

The Company believes the effects of inflation currently do not have a material impact on its operations, financial position, or cash flows.

Critical Accounting Policies

The Company s significant accounting policies are more fully described in the notes to the financial statements. The preparation of financial statements in conformity with accounting principles generally accepted in the United States requires management to make estimates and assumptions in certain circumstances that affect amounts reported in the accompanying financial statements and related notes. In preparing these financial statements, management has made its best estimates and judgments of certain amounts included in the financial statements, giving due consideration to materiality. The Company does not believe there is a great likelihood that materially different amounts would be reported related to the accounting policies described below; however, application of these accounting policies involves the exercise of judgment and the use of assumptions as to future uncertainties and, as a result, actual results could differ from these estimates.

Work in process inventory represents actual production costs, including manufacturing overhead incurred to date, reduced by amounts identified with revenue recognized on units delivered as well as reserves for amounts in excess of estimated net realizable value. The costs attributable to units delivered are based on the estimated average costs of all units expected to be produced under multi-unit orders. Estimated costs to complete are based on historical experience and knowledge of building similar products. On an on-going basis, the Company evaluates the estimates of total costs to complete a multi-unit order. Work in process is reduced by charging any amounts in excess of estimated net realizable value to cost of sales as soon as they become known. Interim inventories are determined by application of estimated gross profit margins to sales.

The Company provides an allowance for uncollectible receivables based on experience with customers and individual review of any past due accounts. Although it is reasonably possible that that management s estimate could change in the near future, management is not aware of any events that would result in a change to its estimate which would be material to the Company s financial position or its results of operations. At May 31, 2003, the Company had an allowance for doubtful accounts of $22,900.

Recent Accounting Pronouncements

In November 2002, the Financial Accounting Standards Board (FASB) issued Financial Interpretation No. (FIN)45, Guarantor s Accounting and Disclosure Requirements for Guarantees, Including indirect Guarantees of Indebtedness of Others. FIN 45 standardizes practices related to the recognition of a liability for the fair value of a guarantor s obligation. The rule requires companies to record a liability for the fair value of its guarantee to provide or stand ready to provide services, cash or other assets. The rule applies to contracts that require a guarantor to make payments based on an underlying factor such as change in market value of an asset, collection of the scheduled contractual cash flows from individual financial assets held by a special purpose entity (SPE), non-performance of a third party, for indemnification agreements, or for guarantees of the indebtedness of others among other things. The provisions of FIN 45 are effective on a prospective basis for guarantees that are issued or modified after December 31, 2002. The disclosure requirements were effective for statements of annual or interim periods ending after December 15, 2002. The Company has no such guarantees, and therefore adoption of FIN 45 had no impact on the financial statements.

In January 2003, The FASB issued FIN 46, Consolidation of Variable Interest Entities. FIN 46 provides guidance on the identification of variable interest entities that are subject to consolidation requirements by a business enterprise. A variable interest entity subject to consolidation requirements is an entity that does not have sufficient equity at risk to finance its operations without additional support from third parties and the equity investors in the entity lack certain characteristics of a controlling financial interest as defined in the guidance. SPE s are one type of entity, which under certain circumstances may qualify as a variable interest entity. The Company does not use SPE s or any other form of variable interest entity, and therefore believes that adoption of the Statement will have no effect on its financial statements.

In April 2003 the FASB issued Statement No. 149, Amendment of Statement 133 On Derivative Instruments and Hedging Activities . The Statement amends Statement 133 for decisions made by the Derivatives Implementation Group, in particular the meaning of an initial net investment, the meaning of underlying and the characteristics of a derivative that contains financing components. Presently, the Company has no derivative financial instruments, and therefore believes that adoption of the Statement will have no effect on its financial statements.

In May 2003 the FASB issued Statement No. 150, Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity . The Statement requires that the issuer classify certain instruments as liabilities, rather than equity, or so-called mezzanine equity. Presently, the Company has no financial instruments that come under the scope of the Statement, and therefore believes that adoption of the new Statement will have no impact on its financial statements.

ITEM 7A Quantitative and Qualitative Disclosures About Market Risk

Market Risk The Company is exposed to market risk from adverse changes in interest rates.

Interest Rate Risks The Company is exposed to risk from changes in interest rates as a result of its borrowing activities. At May 31, 2003, the Company had total debt of $9.34 million, of which $0.36 million represents borrowing for its real estate mortgage, which is at a variable interest rate. Interest on the Company s debt is directly affected by changes in the prime interest rate, and therefore fluctuations may have an impact on the Company s financial results.

ITEM 8 FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

REPORT OF INDEPENDENT CERTIFIED PUBLIC ACCOUNTANTS

Board of Directors And Stockholders

General Kinetics Incorporated

Manassas, Virginia

We have audited the accompanying balance sheets of General Kinetics Incorporated as of May 31, 2003 and 2002, and the related statements of operations, stockholders deficit, and cash flows for each of the three years in the period ended May 31, 2003. These financial statements are the responsibility of the Company s management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall presentation of the financial statements. We believe our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of General Kinetics Incorporated as of May 31, 2003 and 2002, and the results of its operations and its cash flows for each of the three years in the period ended May 31, 2003 in conformity with accounting principles generally accepted in the United States of America.

The accompanying financial statements have been prepared assuming the Company will continue as a going concern. The Company has sustained recurring operating losses in fiscal 2003, 2002, and 2001. In addition, the Company has significant short-term cash commitments and funding is limited to cash flow from operations and loans collateralized by certain accounts receivable. These factors raise substantial doubt about the Company s ability to continue as a going concern. Management s plans in regards to these matters are described in Note 1. The financial statements do not contain any adjustments that might result from the outcome of these uncertainties.

/s/ BDO Seidman, LLP

BDO Seidman, LLP

Bethesda, Maryland

July 30, 2003

General Kinetics Incorporated

Balance Sheets

At May 31, 2003 and 2002

	May 31, 2003	May 31, 2002
Assets		
Current Assets:		
Cash and cash equivalents	$ 114,000	$ 185,100
Marketable securities - trading	36,400	37,400
Accounts receivable, net of allowance of $22,900 and $70,900	521,600	872,100
Inventories, net	728,900	906,300
Prepaid expenses and other	41,200	56,800
Total Current Assets	1,442,100	2,057,700
Property, Plant and Equipment	2,960,400	2,925,100
Less: Accumulated Depreciation and Amortization	(2,257,700)	(2,124,700)
	702,700	800,400
Other Assets	11,100	59,400
Total Assets	$ 2,155,900	$ 2,917,500
Liablilities and Stockholders Deficit		
Current Liabilities:		
Current maturities of long-term debt	$ 96,300	$ 90,000
Current maturities of capital lease	20,600	18,500
Accounts payable, trade	366,300	765,900
Accrued expenses and other payables	403,400	577,500
Total Current Liabilities	886,600	1,451,900
Long-Term Liabilities:		
Long-term debt - less current maturities	9,023,600	9,256,700
Capital lease - less current maturities	60,800	82,000
Other long-term liabilities	249,900	258,400
Total Long-Term Liabilities	9,334,300	9,597,100
Total Liabilities	10,220,900	11,049,000
Commitments and Contingencies		
Stockholders Deficit:		
Common Stock, $0.25 par value, 50,000,000 shares authorized, 7,645,557 and 7,245,557 shares issued, 7,118,925 and 6,718,925 shares outstanding	1,911,500	1,811,500
Additional Contributed Capital	7,337,300	7,239,400
Accumulated Deficit	(16,863,600)	(16,732,200)
	(7,614,800)	(7,681,300)

Less:		
Treasury Stock, at cost (526,632 shares)	(450,200)	(450,200)
Total Stockholders Deficit	(8,065,000)	(8,131,500)
Total Liabilities and Stockholders Deficit	$ 2,155,900	$ 2,917,500

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

General Kinetics Incorporated

Statements of Operations

For the Years Ended May 31, 2003, 2002, and 2001

	2003	2002	2001
Net Sales	$ 6,377,100	$ 8,870,000	$ 8,258,500
Cost of Sales	5,106,900	7,691,100	6,735,800
Gross Profit	1,270,200	1,178,900	1,522,700
Selling, General & Administrative	1,202,900	1,558,800	1,565,000
Product Research, Development & Improvement	3,500		42,800
Manufacturing Start-Up Costs		265,100	
Total Operating Expenses	1,206,400	1,823,900	1,607,800
Operating Income/ (Loss)	63,800	(645,000)	(85,100)
Other Income		37,400	175,000
Interest Expense	(195,200)	(227,800)	(219,700)
Net Loss	$ (131,400)	$ (835,400)	$ (129,800)
Basic and diluted loss per share	$ (0.019)	$ (0.124)	$ (0.019)
Weighted Average Number of Common Shares Outstanding	6,898,651	6,718,925	6,718,925

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

General Kinetics Incorporated

Statements of Stockholders Deficit

For the Years Ended May 31, 2003, 2002, and 2001

	Common Stock		Additional Contributed Capital	Accumulated Deficit	Treasury Stock	Total Stockholders Equity
	Shares	Amount				
Balance 5/31/00	7,245,557	1,811,500	7,239,400	(15,767,000)	(450,200)	(7,166,300)
Net Loss				(129,800)		(129,800)
Balance 5/31/01	7,245,557	1,811,500	7,239,400	(15,896,800)	(450,200)	(7,296,100)
Net Loss				(835,400)		(835,400)
Balance 5/31/02	7,245,557	1,811,500	7,239,400	(16,732,200)	(450,200)	(8,131,500)
Converted Debentures	400,000	100,000	97,900			197,900
Net Loss				(131,400)		(131,400)
Balance 5/31/03	7,645,557	$ 1,911,500	$ 7,337,300	$ (16,863,600)	$ (450,200)	$ (8,065,000)

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

General Kinetics Incorporated

Statements of Cash Flows

For the years ended May 31, 2003, 2002, and 2001

	2003	2002	2001
Cash Flows From Operating Activities:			
Net Loss	$ (131,400)	$ (835,400)	$ (129,800)
Adjustments to reconcile net loss to net cash provided by (used in) operating activities:			
Unrealized loss on marketable equity securities	1,000		
Depreciation and amortization	147,600	155,000	157,400
Amortization of bond discount	61,500	61,900	61,900
Write-off of patent		38,000	
Gain from distribution of stock		(37,400)	
Bad debt recovery			(175,000)
Provision for doubtful accounts	(48,000)	(1,800)	(2,300)
Provision for inventory obsolescence	155,800	101,200	85,000
Write-off of inventory		(117,500)	(125,000)
(Increase) Decrease in Assets:			
Accounts receivable	398,500	381,300	(118,700)
Inventories	21,600	562,300	(429,500)
Prepaid expenses	15,600	(2,900)	23,100
Other assets	48,300	(35,800)	(4,700)
Increase (Decrease) in Liabilities:			
Accounts payable - trade	(399,600)	(338,200)	230,400
Accrued expenses and other payables	(174,100)	2,500	(164,300)
Other long term liabilities	(8,500)	(4,600)	(6,000)
Net cash provided by (used in) Operating Activites	88,300	(71,400)	(597,500)
Cash Flows from Investing Activities:			
Acquisition of property, plant and equipment	(49,900)	(45,600)	(34,200)
Collection of notes recievable			175,000
Net cash provided by (used in) Investing Activities	(49,900)	(45,600)	140,800
Cash Flows from Financing Activities:			
Advances from Factor/Borrowings on Demand Notes Payable	553,000	1,305,700	132,700
Repayments of Advances from Factor/Demand Notes Payable	(553,000)	(1,305,700)	(176,800)
Principal payments under capital lease	(19,100)	(7,600)	
Repayments on Long Term Debt	(90,400)	(78,600)	(69,000)
Net cash used in Financing Activities	(109,500)	(86,200)	(113,100)
Net decrease in cash and cash equivalents	(71,100)	(203,200)	(569,800)
Cash and Cash Equivalents: Beginning of Period	185,100	388,300	958,100
Cash and Cash Equivalents: End of Period	$ 114,000	$ 185,100	$ 388,300
Supplemental Disclosures of Cash Flow Information:			
Cash paid during the year for:			
Interest	$ 195,200	$ 162,600	$ 151,300
Income Taxes	$ 800	$ 800	$ 800

Non-cash investing and financing activities:			
Assets acquired under capital lease	$	$ 108,100	$
Conversion of long-term debt (net of unamortized discount)	$ 197,900	$	$

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

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GENERAL KINETICS INCORPORATED

NOTES TO FINANCIAL STATEMENTS

1. FUTURE PROSPECTS AND RECENT OPERATIONS:

General Kinetics Incorporated (the Company or GKI) relies upon internally generated funds and accounts receivable financing to finance its operations. During fiscal years 2003 and 2002, the Company showed a net loss of approximately $131,400 and $835,400, respectively. In order to generate the working capital required for operations, the Company must continue to generate orders, increase its gross margins, and effectively manage operating expenses during fiscal 2004.

The Company must continue to market electronic enclosure products to government and commercial markets, enter into contracts which the Company can complete with favorable profit margins, ship the orders in a timely manner, and control its operating costs in order to recover from its liquidity problems and seek to operate profitably for fiscal 2004.

The decrease in sales is primarily due to a decrease in orders under a large blanket contract with a prime contractor to the U.S. Navy, in addition to an overall slowdown of orders from customers involved in projects related to the U.S. Navy. The Company must increase its level of sales under other contracts in order to make up for the reduction in future orders under this contract, and to maintain a sales level that will provide positive cash flow for the 2004 fiscal year. However, there is no assurance the Company will be successful in its efforts to obtain an adequate level of new contracts to maintain positive cash flow or profitable operations.

In recent months, the Company and its customers have experienced significant delays in the release of orders under awarded programs, and there can be no assurance that such delays will not continue or become more severe. In the absence of orders released against these awards or other new business, the Company could experience a material decrease in its level of business, revenues and cash flows.

Management believes that, unless there is an increase in future sales, the Company may not be able to meet its cash requirements through the current fiscal year with cash on hand and borrowings from the factoring of accounts receivable. Meeting the Company s cash requirements through the next twelve months will also require an increase in the current order backlog, as well as profitable production and shipment of those orders. However, there is no assurance the Company will be successful in pursuing its plans or in obtaining additional financing to meet those cash requirements. The Company must increase its current level of sales, consistently make timely shipments and produce its products at adequate profit margins, or the Company will continue to face liquidity problems and may be left without sufficient cash to meet its ongoing requirements.

The accompanying financial statements have been prepared assuming that the Company will continue as a going concern. The Company has sustained operating losses in fiscal years 2003, 2002 and 2001, and in addition, the Company has significant short-term cash commitments, the funding of which is limited to cash flow from operations and the factoring of certain accounts receivable, if available. These issues, in addition to an overall slowdown of orders from customers involved in projects related to the U.S. Navy, raise significant doubt about the Company s ability to continue as a going concern. The financial statements do not contain any adjustment that might result from the outcome of these uncertainties.

The Company was formerly party to a factoring agreement with Reservoir Capital Corporation (Reservoir) that provided for advances (or loans) of up to 80% of specified accounts receivable. In August 2001, Link2It Corporation, a company formed by Larry Heimendinger and Richard McConnell, both of whom are directors of the Company, entered into a factoring agreement with the Company on terms substantially similar to those of the Reservoir facility, but more favorable to the Company in certain respects, including provision for advances at a rate of up to 85% of specified accounts receivable. A new factoring agreement with Link2It Corporation, on similar terms, was entered into in April 2002. Subsequent to the fiscal year end, the Company entered into a new factoring agreement with Key Capital Factoring (Key) that also provides for advances of up to 85% of specified accounts receivable. The Company expects to draw on the Key facility during fiscal 2004 as necessary to help alleviate liquidity problems, although, as discussed above, the Company will also need to control expenses, maintain the sales backlog at appropriate levels, and keep shipment levels in line with booked orders in order to meet these requirements. At May 31, 2003, there were no outstanding advances due to Link2It Corporation.

The Company has outstanding debentures originally issued to clients of Gutzwiller & Partner, now known as Rabo Investment

Management Ltd. (the Manager), totaling approximately $8.8 million. The debentures mature in August 2004, are convertible into common stock at a conversion price of $0.50 per share, and bear interest at 1% per annum payable annually. On March 12, 2003, Manassas Partners LLC, a Delaware limited liability company of which Larry Heimendinger, the Company s Chairman of the Board, is the managing member, purchased from third parties, at a significant discount, a portion of the Company s outstanding convertible debentures in a principal amount of $5,800,000.

The Company does not expect that its cash flow, capital resources, and overall financial condition will be sufficient to repay or refinance in full the approximately $8.8 million principal amount of outstanding convertible debentures currently scheduled to mature in August 2004. At present, the Company has decided on no specific plans with respect to the repayment or refinancing of the debentures, but it expects to continue to review the situation and consider its potential alternatives during the coming fiscal year.

2. SIGNIFICANT ACCOUNTING POLICIES:

The Company s significant accounting policies are described below.

NATURE OF BUSINESS:

The Company designs, manufactures and sells specialty metal products such as precision enclosures and rack mounting systems for the installation of electronics.

Cash and Cash Equivalents

The Company classifies all temporary investments purchased with a maturity of less than three months as cash equivalents.

Revenue Recognition and Profit Determination

Revenues, sales, and cost of sales on fixed-price contracts are generally recorded when units are delivered based on the profit rate anticipated on the contracts at completion. The Company s contracts are primarily fixed price. Sales and cost of sales from cost reimbursable and time-and-materials contracts are recognized as costs are incurred. Profits expected to be realized on contracts are based on total sales value and estimated costs at completion. These estimates are reviewed and revised periodically throughout the lives of the contracts and adjustments to profits resulting from such revisions are made cumulative to the date of change. Amounts in excess of the agreed-upon contract price for customer caused delays, errors, and change orders are recognized in contract value if it is probable that the claim will result in additional revenue and the amount can be reasonably estimated. Losses on contracts are recorded in full as soon as they become known.

Marketable Securities

Investments in equity securities with readily determinable fair values are reported at fair value, with gains and losses reported in the statement of operations.

Accounts Receivable

Accounts receivable are customer obligations due under normal trade terms. They consist primarily of amounts due from the sale of products. Senior management reviews accounts receivable on a monthly basis to determine if any receivables will be potentially uncollectible. Any accounts receivable balances that are determined to be uncollectible, along with general reserve, are included in the overall allowance for doubtful accounts. After all attempts to collect a receivable have failed, the receivable is written off against the allowance. Management believes the allowance for doubtful accounts as of May 31, 2003 and 2002 is adequate. However, write-offs might exceed the recorded allowance.

Inventories

Inventories are valued at the lower of cost (first-in, first-out method) or market (net realizable value).

Property, Plant, and Equipment

Property, plant and equipment are recorded at cost. The Company provides for depreciation and amortization on an accelerated basis for machinery and equipment and furniture and fixtures and on a straight-line basis for all other assets over the following estimated useful lives:

Buildings and improvements	18 to 45 years
Machinery and equipment	3 to 7 years
Furniture and fixtures	5 to 7 years
Transportation equipment and other	3 years

Leasehold improvements are amortized on a straight-line basis over the shorter of the useful life of the improvement or the remaining term of the lease. Expenditures for maintenance and repairs are charged against income as incurred; betterments which increase the value or materially extend the life of the asset are capitalized. When assets are sold or retired, the cost and accumulated depreciation are removed from the accounts, and any gain or loss is included in income.

In accordance with SFAS 144, the Company periodically evaluates the carrying value of long-lived assets when events and circumstances warrant such a review. The carrying value of a long-lived asset is considered impaired when the anticipated undiscounted cash flow from such asset is separately identifiable and is less than the carrying value. In that event, a loss is recognized based on the amount by which the carrying value exceeds the fair market value of the long-lived asset. Fair market value is determined primarily using the anticipated cash flows discounted at a rate commensurate with the risk involved.

Product Research, Development and Improvements

Costs associated with product research, development and improvements are expensed as incurred.

Income Taxes

The Company accounts for income taxes under the asset and liability method, which requires that deferred tax assets and liabilities be recognized for the estimated future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases. The recognition of net deferred tax assets is reduced, if necessary, by a valuation allowance for the amount of any tax benefits that, based on available evidence, are not expected to be realized. Deferred tax assets and liabilities are measured using enacted tax rates in effect for the year in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income tax expense in the period that includes the enactment date.

Basic and Diluted Earnings Per Share

Earnings per share is based on the weighted average number of shares of common stock and dilutive common stock equivalents outstanding. Basic earnings per share includes no dilution and is computed by dividing net income (loss) by the weighted average number of common shares outstanding for the period. Diluted earnings per share reflects the potential dilution of securities that could share in the earnings of an entity. Common stock equivalents consist of convertible debentures (see Note 8) and stock options (see Note 12). Basic and diluted earnings per share were the same in fiscal 2003, as they were in both fiscal 2002 and fiscal 2001, because the impact of dilutive securities is anti-dilutive.

Stock Options

The Company has adopted the disclosure-only provisions of SFAS No. 123, Accounting for Stock Based Compensation and SFAS No. 148, Accounting for Stock-Based Compensation Transition and Disclosure , but applies Accounting Principles Board Opinion No. 25 and related interpretations in accounting for its stock plans.

If the Company had elected to recognize compensation expense based on the fair value at the grant dates consistent with the method prescribed by SFAS 123, net loss and loss per share would have been changed to the pro forma amounts indicated below:

	2003	2002	2001
Net Loss:			
As reported	$ (131,400)	$ (835,400)	$ (129,800)
Stock based compensation expense determined under fair value based method	(1,000)	(3,500)	(4,700)
Pro forma net loss	(132,400)	(838,900)	(134,500)
Basic and Diluted Loss per share:			
As reported	(.02)	$ (0.12)	$ (0.02)
Pro forma	(.02)	$ (0.12)	$ (0.02)

Estimates and Assumptions

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. Certain estimates used by management are particularly susceptible to significant changes in the economic environment. These include estimates of inventory obsolescence, valuation allowances for trade receivables and deferred tax assets. Each of these estimates, as well as the related amounts reported in the financial statements, are sensitive to near term changes in the factors used to determine them. A significant change in any one of those factors could result in the determination of amounts different than those reported in the financial statements. Management believes that, as of May 31, 2003, the estimates used in the financial statements are adequate based on the information currently available.

Recent Accounting Pronouncements

In November 2002, the Financial Accounting Standards Board (FASB) issued Financial Interpretation No. (FIN)45, Guarantor s Accounting and Disclosure Requirements for Guarantees, Including indirect Guarantees of Indebtedness of Others. FIN 45 standardizes practices related to the recognition of a liability for the fair value of a guarantor s obligation. The rule requires companies to record a liability for the fair value of its guarantee to provide or stand ready to provide services, cash or other assets. The rule applies to contracts that require a guarantor to make payments based on an underlying factor such as change in market value of an asset, collection of the scheduled contractual cash flows from individual financial assets held by a special purpose entity (SPE), non-performance of a third party, for indemnification agreements, or for guarantees of the indebtedness of others among other things. The provisions of FIN 45 are effective on a prospective basis for guarantees that are issued or modified after December 31, 2002. The disclosure requirements were effective for statements of annual or interim periods ending after December 15, 2002. The Company has no such guarantees, and therefore adoption of FIN 45 had no impact on the financial statements.

In January 2003, The FASB issued FIN 46, Consolidation of Variable Interest Entities. FIN 46 provides guidance on the identification of variable interest entities that are subject to consolidation requirements by a business enterprise. A variable interest entity subject to consolidation requirements is an entity that does not have sufficient equity at risk to finance its operations without additional support from third parties and the equity investors in the entity lack certain characteristics of a controlling financial interest as defined in the guidance. SPE s are one type of entity, which under certain circumstances may qualify as a variable interest entity. The Company does not use SPE s or any other form of variable interest entity, and therefore believes that adoption of the Statement will have no effect on its financial statements.

In April 2003 the FASB issued Statement No. 149, Amendment of Statement 133 On Derivative Instruments and Hedging Activities . The Statement amends Statement 133 for decisions made by the Derivatives Implementation Group, in particular the meaning of an initial net investment, the meaning of underlying and the characteristics of a derivative that contains financing components. Presently, the Company has no derivative financial instruments, and therefore believes that adoption of the Statement will have no effect on its financial statements.

In May 2003 the FASB issued Statement No. 150, Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity . The Statement requires that the issuer classify certain instruments as liabilities, rather than equity, or so-called mezzanine equity. Presently, the Company has no financial instruments that come under the scope of the Statement, and therefore believes that adoption of the new Statement will have no impact on its financial statements.

3. RELATED PARTY TRANSACTIONS

At May 31, 2000, the Company had a membership interest in Link2It, LLC, a company formed by Larry Heimendinger and Richard McConnell, both of whom are members of the Board of Directors of the Company. The financial statements at May 31, 2000 included a note receivable of $175,000 from Link2It. This note receivable was fully reserved due to the uncertainty of its ultimate collection.

During January 2001, Link2It LLC merged into Link2It Corporation and completed a sale of equity securities in a private transaction. The $175,000 principal amount of the notes was repaid in full and recognized in fiscal 2001 as other income on the accompanying statement of operations. The Company also retained approximately 5.7% of Link2It Corporation s then current outstanding common stock, which it accounts for using the cost method. The Company has assigned no value to this investment due to its speculative nature. The entire value was assigned to the note receivable.

In August 2001, Link2It entered into a factoring agreement with the Company, intended to replace the Company s prior factoring agreement. The agreement, which was approved by a unanimous vote of the Company s Board of Directors, including the unanimous vote of the disinterested directors, was on terms substantially similar to those of the prior facility, but was more favorable to the Company in certain respects. A new factoring agreement with Link2It Corporation, on similar terms, was entered into in April 2002. Interest expense related to the Link2It factoring agreement was $10,500 in fiscal 2003 and no borrowings were outstanding at May 31, 2003. Subsequent to the fiscal year end, the Company replaced the Link2It factoring agreement with a new factoring agreement with Key Capital Factoring, an unrelated third party. The Key Capital Factoring agreement allows the Company to factor 85% of the face value of eligible accounts receivable, with the aggregate outstanding for all factored accounts receivable not to be greater than $750,000.

4. CREDIT RISK

For the years ended May 31, 2003, 2002, and 2001, the Company s net sales to the U.S. government and/or subcontractors accounted for 93%, 94%, and 91%, respectively, of net sales. Accounts receivable from those customers amounted to $.52 million and $.84 million as of May 31, 2003 and 2002, respectively. A substantial portion of the Company s sales are to the U.S. government and/or subcontractors, and consequently a material decline in Department of Defense spending could have a material adverse effect on the operations of the Company. Competition in the Company s electronic enclosure business is intense as it primarily operates in a mature industry. The Company s uncollectible receivables have historically not been material.

The Company has a cash balance with a bank in excess of the federally insured limit. The Company minimizes the risk by placing these funds with high-quality financial institutions.

5. INVENTORIES

Inventories consist of the following:

	May 31,	
	2003	2002
Work in process	$ 561,800	$ 692,900
Finished Goods	15,400	27,700
Raw materials	450,300	328,500
Valuation reserve	(298,600)	(142,800)
Total	$ 728,900	$ 906,300

Work in process inventory represents actual production costs, including manufacturing overhead incurred to date, reduced by amounts identified with revenue recognized on units delivered. The costs attributable to units delivered are based on the estimated average costs of all units expected to be produced under multi-unit orders. Estimated costs to complete are based on historical experience and knowledge of building similar products. On an on-going basis, the Company evaluates the estimates of total costs to complete a multi-unit order. Work in process is reduced by charging any amo