ENVIRONMENTAL TECTONICS CORP
Form 10-Q
January 07, 2013

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, DC 20549

FORM 10-Q

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

For the quarterly period ended November 23, 2012

Commission file no: 1-10655

ENVIRONMENTAL TECTONICS CORPORATION

Pennsylvania	23-1714256
(State of incorporation)	(I.R.S. Employer Identification No.)

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

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

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

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

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

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

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

As of December 27, 2012, there were 9,157,741 shares of the registrant’s Common Stock issued and outstanding.

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

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PART I – FINANCIAL INFORMATION

Item 1. Financial Statements (unaudited)

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

	Thirteen weeks ended		Thirty-nine weeks ended	
	November 23, 2012	November 25, 2011	November 23, 2012	November 25, 2011
Net sales	$15,148	$ 17,259	$47,720	$ 49,384
Cost of goods sold	8,657	11,606	28,684	31,314
Gross profit	6,491	5,653	19,036	18,070
Operating expenses:				
Selling and marketing	1,508	1,386	4,125	4,013
General and administrative	2,038	2,060	5,943	5,935
Research and development	258	171	905	552
	3,804	3,617	10,973	10,500
Operating income	2,687	2,036	8,063	7,570
Other expenses:				
Interest expense, net	319	195	764	552
Other expense, net	91	26	27	110
	410	221	791	662
Income before income taxes	2,277	1,815	7,272	6,908
Provision for income taxes	1,074	996	3,082	2,940
Net income	1,203	819	4,190	3,968
Income attributable to non-controlling interest	(25)	(10)	(19)	(28)
Net income attributable to Environmental Tectonics Corporation	$1,178	$ 809	$4,171	$ 3,940
Foreign currency translation adjustment and unrealized loss on cash flow hedge	(24)	(129)	31	(209)
Comprehensive income	$1,154	$ 680	$4,202	$ 3,731
Preferred Stock dividend	(286)	(552)	(1,390)	(1,656)
Income attributable to common and participating shareholders	$892	$ 257	$2,781	$ 2,284
Per share information:				

Basic earnings per common and participating share:				
Distributed earnings per share:				
Common	$-	$ -	$-	$ -
Preferred	$0.04	$ 0.05	$0.14	$ 0.15
Undistributed earnings per share:				
Common	$0.05	$ 0.01	$0.14	$ 0.11
Preferred	$0.05	$ 0.01	$0.14	$ 0.11
Diluted earnings per share	$0.05	$ 0.01	$0.14	$ 0.11
Basic weighted average common and participating shares:				
Common weighted average number of shares	9,152	9,118	9,143	9,111
Participating preferred shares	7,999	11,095	10,063	11,095
Total basic weighted average common and participating shares	17,151	20,213	19,206	20,206
Diluted weighted average shares:				
Basic weighted average common and participating shares	17,151	20,213	19,206	20,206
Dilutive effect of stock warrants and options	166	287	157	302
Total diluted weighted average shares	17,317	20,500	19,363	20,508

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

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

	November 23, 2012 (unaudited)	February 24, 2012
ASSETS		
Current assets:		
Cash and cash equivalents	$2,227	$3,425
Restricted cash	6,160	6,000
Accounts receivable, net	14,327	10,695
Costs and estimated earnings in excess of billings on uncompleted long-term contracts	17,884	18,766
Inventories, net	3,886	4,145
Deferred tax assets, current	3,804	4,170
Prepaid expenses and other current assets	1,805	830
Total current assets	50,093	48,031
Property, plant, and equipment, net	14,634	14,860
Capitalized software development costs, net	455	666
Deferred tax assets, non-current, net	1,726	4,190
Other assets	15	39
Total assets	$66,923	$67,786
LIABILITIES AND SHAREHOLDERS’ EQUITY		
Current liabilities:		
Current portion of long-term debt obligations	$3,000	$8
Accounts payable, trade	3,839	5,639
Billings in excess of costs and estimated earnings on uncompleted long-term contracts	4,024	6,519
Customer deposits	2,778	3,425
Accrued taxes	361	148
Accrued interest and dividends	935	941
Other accrued liabilities, current	3,568	3,565
Total current liabilities	18,505	20,245
Long-term debt obligations, less current portion:		
Credit facility payable to bank	12,985	16,716
Term loan	11,750	-
Total long-term debt obligations, less current portion	24,735	16,716
Other accrued liabilities, non-current	28	-
Total liabilities	43,268	36,961
Commitments and contingencies		
Shareholders’ equity:		
	-	386

Cumulative convertible participating Preferred Stock, Series D, $0.05 par value, 11,000 shares authorized; 0 and 386 shares outstanding at November 23, 2012 and February 24, 2012, respectively		
Cumulative convertible participating Preferred Stock, Series E, $0.05 par value, 25,000 shares authorized; 12,127 and 21,741 shares outstanding at November 23, 2012 and February 24, 2012, respectively	12,127	21,741
Common Stock, $0.05 par value, 50,000,000 shares authorized; 9,155,343 and 9,134,403 shares issued and outstanding at November 23, 2012 and February 24, 2012, respectively	457	456
Additional paid-in capital	9,890	9,892
Retained earnings (Accumulated deficit)	1,595	(1,186)
Accumulated other comprehensive loss	(474)	(505)
Total shareholders' equity before non-controlling interest	23,595	30,784
Non-controlling interest	60	41
Total shareholders' equity	23,655	30,825
Total liabilities and shareholders' equity	$66,923	$67,786

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

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

	Thirty-nine weeks ended	
	November 23, 2012	November 25, 2011
Cash flows from operating activities:		
Net income	$4,190	$3,968
Adjustments to reconcile net income to net cash provided by (used in) operating activities:		
Depreciation and amortization	1,375	1,256
Deferred tax assets	2,830	1,779
Increase in valuation allowance for deferred tax assets	-	343
Increase in allowances for accounts receivable and inventories, net	35	41
Accretion of loan origination deferred charge and deferred financing costs	141	130
Stock compensation expense	68	76
Changes in operating assets and liabilities:		
Accounts receivable	(3,632)	(4,862)
Costs and estimated earnings in excess of billings on uncompleted long-term contracts	882	(8,480)
Inventories	224	(2,569)
Prepaid expenses and other assets	(1,056)	(131)
Accounts payable, trade	(1,800)	2,266
Billings in excess of costs and estimated earnings on uncompleted long-term contracts	(2,495)	(2,126)
Customer deposits	(647)	314
Accrued taxes	213	443
Accrued interest and dividends	(6)	157
Other accrued liabilities	3	(541)
Net cash provided by (used in) operating activities	325	(7,936)
Cash flows from investing activities:		
Acquisition of property, plant, and equipment	(913)	(1,357)
Capitalized software development costs	(25)	(163)
Net cash used in investing activities	(938)	(1,520)
Cash flows from financing activities:		
Proceeds from Term Loan	15,000	-
Repurchase of Preferred Stock	(10,000)	-
(Repayments) borrowings under line of credit	(3,731)	14,075
Payment of Preferred Stock dividends	(1,390)	(1,656)
Increase in restricted cash	(160)	(379)
Payments on the Term Loan and of other debt obligations	(258)	(250)
Payments of deferred financing and Preferred Stock repurchase costs	(136)	-
Issuance of Common Stock	31	37
Net cash (used in) provided by financing activities	(644)	11,827
Effect of exchange rate changes on cash	59	(209)

Net (decrease) increase in cash	(1,198)	2,162
Cash at beginning of period	3,425	1,423
Cash at end of period	$2,227	$3,585
Supplemental schedule of cash flow information:		
Interest paid	$886	$278
Income taxes paid	$181	$631
Supplemental information on non-cash operating and investing activities:		
Accrued dividends on Preferred Stock	$838	$552
Unrealized loss on cash flow hedge	$28	$-

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

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

Description of Business

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

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

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

1. Summary of Significant Accounting Policies

Basis of Presentation

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

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

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

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

References to 2013 third quarter are references to the thirteen week period ended November 23, 2012. References to 2012 third quarter are references to the thirteen week period ended November 25, 2011. References to 2013 first three quarters are references to the thirty-nine week period ended November 23, 2012. References to 2012 first three quarters are references to the thirty-nine week period ended November 25, 2011. References to fiscal 2013 or the 2013 fiscal year are references to the fifty-two week period ending February 22, 2013. References to fiscal 2012 or the 2012 fiscal year are references to the fifty-two week period ended February 24, 2012.

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

Significant Accounting Policies

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

Recent Accounting Pronouncements

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

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

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

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

2. Earnings per Share

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

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

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

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Environmental Tectonics Corporation
Notes to the Consolidated Financial Statements, continued
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At November 23, 2012, there was $12,127 of cumulative convertible participating Series E Preferred Stock convertible at an exercise price of $2.00 per share, equating to 6,063,321 shares of Common Stock, issued in July 2009.

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

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

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

At November 23, 2012 and November 25, 2011, there were outstanding options to purchase the Company's Common Stock totaling 240,921 and 270,921 shares at an average price of $4.26 and $4.35 per share, respectively. Due to the conversion price of the Common Stock options, all 240,921 shares were excluded from the calculation of diluted earnings per share as of November 23, 2012 because the effect of their conversion would be antidulutive; likewise, all 270,921 shares were also excluded from the calculation of diluted earnings per share as of November 25, 2011.

3. Accounts Receivable

The components of accounts receivable are as follows:

	November 23, 2012 (unaudited)	February 24, 2012
U.S. Government	$ 4,467	$ 4,305
U.S. Commercial	1,237	2,994
International	9,072	3,797
	14,777	11,095
Less: allowance for doubtful accounts	(450)	(400)
	$ 14,327	$ 10,695

4. Inventories

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

	November 23, 2012 (unaudited)	February 24, 2012
Raw materials	$ 122	$ 42
Work in process	3,764	4,103
	$ 3,886	$ 4,145

Inventory is presented net of an allowance for obsolescence of $1,142 (raw material $41 and work in process $1,101), and $1,157 (raw material $50 and work in process $1,107) at November 23, 2012 and February 24, 2012, respectively.

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

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

5. Long-Term Obligations and Credit Arrangements

2009 Lenfest Financing Transaction

On April 24, 2009, the Company entered into a transaction (the "2009 Lenfest Financing Transaction") with H.F. Lenfest, a major shareholder and member of our Board of Directors ("Lenfest"), that provided for, among other things, the following:

(i) a $7,500 credit facility provided by Lenfest to ETC (the "Lenfest Credit Facility"), which has expired;
(ii) the exchange of the senior subordinated convertible promissory note in the original principal amount of $10,000 issued by ETC to Lenfest on February 18, 2003, together with all accrued interest and warrants issuable under the note, and all Series B Preferred Stock and Series C Preferred Stock held by Lenfest, together with all accrued dividends thereon, for a new class of preferred stock, Series E Preferred Stock, the terms of which are described below; and
(iii) the guarantee by Lenfest of all of ETC's obligations to PNC Bank, National Association ("PNC Bank") in connection with an increase of the existing $15,000 revolving line of credit with PNC Bank (the "2007 PNC Credit Facility") to $20,000, and in connection with this guarantee, the pledge by Lenfest to PNC Bank of $10,000 in marketable securities to secure ETC's obligations to PNC Bank (the "Lenfest Pledge").

2012 Financial Restructuring

On September 28, 2012, the Company entered into transactions (the "2012 Financial Restructuring") that provided for, among other things, the following:

(i) the Company's credit facility with PNC Bank was reduced from $20,000 to $15,000 (the "Line of Credit"); however, the term of the Line of Credit was extended twenty-eight (28) months, from June 30, 2013 to October 31, 2015.
(ii) PNC Bank provided to the Company a new five-year term loan of $15,000 (the "Term Loan"). The Company used $10,000 of the proceeds from the Term Loan to repurchase and retire 10,000 shares of its Series D and Series E Preferred Stock owned by Lenfest at the stated price of $1,000 per share. The remaining $5,000 was used to repay indebtedness currently outstanding to PNC Bank and to pay Lenfest $417 of interest due under the Lenfest Pledge, in cash, in lieu of Series D Preferred Stock. The $10,000 in marketable securities associated with the Lenfest Pledge has been returned to Lenfest and the Lenfest Pledge has been terminated; therefore, as of November 23, 2012, no interest has been accrued for under the Lenfest Pledge.
(iii) the Line of Credit is no longer guaranteed by Lenfest. Instead, the Line of Credit and Term Loan are secured by substantially all of the Company's assets. In addition, the Term Loan is guaranteed by Lenfest for a period of thirty months, (i.e., until March 31, 2015), after which the guarantee will be removed.
(iv) following the close of the transactions on September 28, 2012, the dividend rate on the Series D and Series E Preferred Stock was reduced from ten percent (10%) to four percent (4%), subject to approval of the Company's Common Stock shareholders at the Company's next Annual Meeting of Stockholders.

The material agreements providing for these transactions are described below:

Loan Agreement

Effective September 28, 2012, ETC and PNC Bank entered into a Loan Agreement, which included ETC executing a Term Loan Note and the Line of Credit Note (as defined below). As set forth in the Loan Agreement, the Company's Line of Credit was reduced from $20,000 to $15,000; however, the term of the Line of Credit was extended twenty-eight (28) months, from June 30, 2013 to October 31, 2015. PNC Bank also provided to the Company a Term Loan of $15,000. The Company used $10,000 of the proceeds from the Term Loan to repurchase and retire 10,000 shares of the Series D and Series E Preferred Stock owned by Lenfest, at the stated price of $1,000 per share (as described in more detail below under the heading "Preferred Stock Repurchase Agreement"). The remaining $5,000 was used to repay indebtedness currently outstanding to PNC Bank and to pay Lenfest $417 of interest due under the Lenfest Pledge, in cash, in lieu of Series D Preferred Stock.

The Line of Credit is no longer guaranteed by Lenfest. Instead both the Line of Credit and the Term Loan are secured by substantially all of the Company's assets, including a mortgage on the Company's headquarters in Southampton, Pennsylvania.

The Term Loan is guaranteed by Lenfest for a period of thirty months, (i.e., until March 31, 2015), after which the guarantee will be removed. The Company's obligation to repay the Term Loan is set forth in a Term Loan Note (the "Term Loan Note"). The interest rate on the Term Loan Note will be based on the PNC LIBOR rate (currently 2.9610%) plus a margin of 2.25% to 2.75% depending on the Operating Leverage Ratio (currently 2.75%).

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

Borrowings under the Line of Credit will be available for working capital and other general business purposes and for issuances of letters of credit. Amounts borrowed under the Line of Credit may be borrowed, repaid, and re-borrowed from time to time until October 31, 2015. The Company's obligation to repay the advances under the Line of Credit is set forth in the Amended and Restated Committed Line of Credit Note (the "Line of Credit Note"). At the Company's option, the interest rate on the Line of Credit Note will be based on either (i) the PNC Base Rate (currently 3.00%) plus a margin of -0.25% to 0.25% depending on the Company's Operating Leverage Ratio (currently 0.25%) or (ii) the PNC LIBOR rate (currently 2.9610%) plus a margin of 2.25% to 2.75% depending on the Operating Leverage Ratio (currently 2.75%). The Company will also be obligated to pay a fee of 0.25% for unused but available funds under the Line of Credit. As of November 23, 2012, the Company's availability under the Line of Credit was $1,237. This reflected cash borrowing under the Line of Credit of $12,985 and outstanding letters of credit of approximately $778.

As security for repayment of the Line of Credit Note and the Term Loan Note as noted above, the Company also concurrently entered into the Third Amended and Restated Reimbursement Agreement for Letters of Credit between ETC and PNC Bank dated September 28, 2012, a Security Agreement between ETC and PNC Bank dated September 28, 2012, a Pledge Agreement executed by ETC on September 28, 2012 in favor of PNC Bank ("Pledge Agreement"), an Amended and Restated Guaranty and Suretyship Agreement executed by Lenfest on September 28, 2012 in favor of PNC Bank, and an Open-End Mortgage and Security Agreement between ETC and PNC Bank dated September 28, 2012. Pursuant to the Pledge Agreement, the Company pledged to PNC as collateral the Company's ownership interest in certain subsidiaries of the Company.

The Loan Agreement contains affirmative and negative covenants that are customary for transactions of this type, including a minimum net worth, a maximum operating leverage ratio, and a minimum fixed charge coverage ratio, as well as limitations with respect to indebtedness, liens, investments, distributions, dispositions of assets, change of business, and transactions with affiliates. The financial covenants in the Loan Agreement, with which the Company is in compliance with as of November 23, 2012, are as follows:

- ETC must maintain a minimum Tangible Net Worth of $15,000.
- ETC must maintain an Operating Leverage Ratio (i.e., ratio of Senior Funded Debt to EDITDA, which is defined as earnings before interest, taxes, depreciation, and amortization) of less than 3.25 to 1. This ratio will reduce at the end of the first fiscal year to 3.00 to 1 and after the second fiscal year to 2.9 to 1, and will remain at that level at all times thereafter.
- ETC must maintain as of the end of each fiscal quarter, on a rolling four quarters basis, a Fixed Charge Coverage Ratio of at least 1.10 to 1.

The Loan Agreement provides for customary events of default, including the failure to pay any principal or interest when due, failure to comply with covenants, material misrepresentations, certain bankruptcy, insolvency or receivership events, imposition of certain judgments, and the liquidation of ETC. Upon an event of default under the Loan Agreement, including the non-payment of principal or interest, the obligations of the Company under the Loan Agreement may be accelerated and the assets securing the obligations secured.

Interest Rate Swap

On September 28, 2012, the Company entered into an interest rate swap agreement to protect against certain interest rate fluctuations of the LIBOR rate initially on $5,000 of our $15,000 variable rate Term Loan. The effective date of the interest rate swap was September 28, 2012, and it is scheduled to expire on September 28, 2017. The notional

amount of $5,000 will decrease ratably over the duration of the interest rate swap agreement. The interest rate swap effectively fixes our LIBOR interest rate on the notional amount at a rate of 0.74% in excess of the margin. We have recognized the fair value of our interest rate swap as a long-term liability of approximately $28 as of November 23, 2012. We have designated our current interest rate swap as a cash flow hedge instrument. As of November 23, 2012, we have determined the hedge to be effective.

Preferred Stock Repurchase Agreement

Effective September 28, 2012, ETC and Lenfest entered into a Preferred Stock Repurchase and Financial Restructuring Agreement.

Immediately following the closing of the Loan Agreement with PNC Bank, the Company purchased from Lenfest, at the stated price of $1,000 per share, (i) 386 shares of Series D Preferred Stock, representing all of the Company's issued and outstanding shares of Series D Preferred Stock, and (ii) 9,614 shares of Series E Preferred Stock, representing a significant portion of the Company's issued and outstanding Series E Preferred Stock. Lenfest is the only holder of the outstanding Series E Preferred Stock, and 12,127 shares of Series E Preferred Stock remain outstanding as of November 23, 2012.

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Following the execution of the Preferred Stock Repurchase and Financial Restructuring Agreement, the dividend rate on the Series D and Series E Preferred Stock was reduced from ten percent (10%) to four percent (4%). The reduction of the Preferred Stock dividend will require the approval of the Company's shareholders at the Company's next Annual Meeting of Stockholders, and until that time Lenfest has agreed that all dividends on the outstanding Series E Preferred Stock will be paid at the rate of 4% per year.

Termination of Certain Lenfest Agreements

On September 28, 2012, upon the execution of the Preferred Stock Repurchase and Financial Restructuring Agreement described above, the following prior agreements between ETC and Lenfest were terminated: (i) Secured Credit Facility and Warrant Purchase Agreement between the Company and Lenfest, dated as of April 24, 2009; (ii) the Security Agreement, dated February 18, 2009, by the Company in favor of Lenfest; (iii) the Security Agreement, dated April 24, 2009, among the Company, Entertainment Technology Corporation, a Pennsylvania corporation and a wholly-owned subsidiary of the Company ("ETC Entertainment"), and Lenfest; (iv) the Guaranty, dated April 24, 2009, by ETC Entertainment in favor of Lenfest; and (v) the Amended and Restated Open-End Mortgage and Security Agreement, dated April 24, 2009, by the Company in favor of Lenfest. These Agreements were entered into as part of, or directly related to, the "2009 Lenfest Financing Transaction". As part of the 2012 Financial Restructuring, the $10,000 in marketable securities associated with the Lenfest Pledge has been returned to Lenfest and the Lenfest Pledge has been terminated.

The warrants ETC issued to Lenfest as part of the "2009 Lenfest Financing Transaction" were not terminated. See Common Stock Warrants, below.

Preferred Stock

Presently, the Company has two classes of Cumulative Convertible Participating Preferred Stock authorized: Series D (11,000 shares authorized) and Series E (25,000 shares authorized) (together, the "Preferred Stock"). The Preferred Stock was authorized by the Company's Board of Directors in April 2009 as part of the 2009 Lenfest Financing Transaction. The Preferred Stock has a par value of $0.05 per share and a stated value of $1,000 per share. The Preferred Stock is currently entitled to receive cumulative dividends at the rate of 4% per year in preference to the holders of the Company's Common Stock with respect to dividends. These dividends are payable only upon a liquidation event or when otherwise declared by the Board of Directors of the Company. The Company cannot declare or pay any dividends on its Common Stock until the dividends on the Preferred Stock have been paid. The Preferred Stock holders are entitled to receive any dividends paid with respect to the Common Stock on an "as-converted" basis. The Preferred Stock may be converted by the holder at any time and from time to time into the Company's Common Stock by dividing the stated value of the Preferred Stock by the conversion price established at the time of issuance (see Series D Preferred Stock and Series E Preferred Stock, below). Upon a liquidation event, the holders of the Preferred Stock would be entitled to participate in any proceeds in preference to any common stock holders. The Preferred Stock would also participate in any liquidation event with the Common Stock holders on an "as-converted" basis. The Preferred Stock conversion price is subject to adjustment for certain transactions including stock splits and issuance of equity securities below the conversion prices.

The Company has reviewed the generally accepted accounting principles applicable to the Preferred Stock; specifically, the Company has reviewed both ASC 480 – Distinguishing Liabilities from Equity and ASC 815 – Derivatives and Hedging. Upon its review, the Company determined that the Preferred Stock is within the control of

the Company and that the attributes of the Preferred Stock are more akin to equity than debt. The specific attributes considered by the Company include the designation of the instruments, the conversion of the instruments to the Company's Common Stock, the participation feature, the non-mandatory conversion, the voting rights, and the ability to appoint directors. Secondly, the Company determined that the Preferred Stock qualifies as permanent equity because the Preferred Stock is not mandatorily redeemable, and there is no obligation to either repurchase the instruments or issue a variable amount of common shares. Lastly, the Company determined that the conversion feature qualifies for the scope exception of ASC 815 – Derivatives and Hedging as it is clearly and closely related to the Preferred Stock instrument.

Due to the Company's accumulated deficit as of February 24, 2012, all dividends accruing through this date for the Series D and Series E Preferred Stock issuances were recorded in the accompanying financial statements as a reduction in additional paid-in capital. During the current fiscal year, the Company entered into a position of retained earnings; thus, all $1,390 of dividends recorded during the 2013 first three quarters have been recorded as a reduction to retained earnings.

Issuances of the Preferred Stock are as follows:

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Series D Preferred Stock

Lenfest Credit Facility

On April 24, 2009, the Company paid to Lenfest an origination fee of 1% of the committed amount of the Lenfest Credit Facility. The value of the origination fee was $55. The origination fee was paid in 55 shares of Series D Preferred Stock, which have a conversion price of $0.94 per share, equaling the closing price of the Company's Common Stock on that day and would convert into 58,511 shares of the Company's Common Stock. As part of the 2012 Financial Restructuring, and immediately following the September 28, 2012 closing of the Loan Agreement with PNC Bank, the Company purchased from Lenfest, at the stated price of $1,000 per share, all of these 55 shares of Series D Preferred Stock.

2007 PNC Credit Facility

On April 24, 2009, in connection with the execution of the documents to increase the Company's existing $15,000 revolving line of credit with PNC Bank to $20,000, ETC paid to Lenfest an origination fee of 100 shares of Series D Preferred Stock, which is equal to one percent (1%) of the market value of the $10,000 in marketable securities associated with the Lenfest Pledge. The 100 shares of Series D Preferred Stock have a stated value of $1,000 per share, or $100 in the aggregate. These shares of Series D Preferred Stock have a conversion price per share equal to $1.11, equaling the average closing price of the Company's Common Stock during the 120 days preceding the issuance of such shares and would convert into 90,090 shares of the Company's Common Stock. As part of the 2012 Financial Restructuring, and immediately following the September 28, 2012 closing of the Loan Agreement with PNC Bank, the Company purchased from Lenfest, at the stated price of $1,000 per share, all of these 100 shares of Series D Preferred Stock.

Interest Payment

On October 6, 2010, the Company issued to Lenfest 231 shares of Series D Preferred Stock with a stated value of $1,000 per share in payment of $231 of interest due under the Lenfest Pledge for the period July 2, 2009 through August 27, 2010. The 231 shares have a conversion price per share equal to $3.02, equaling the average closing price of the Company's Common Stock during the 120 days preceding the issuance of such shares, and would convert into 76,490 shares of the Company's Common Stock. As part of the 2012 Financial Restructuring, and immediately following the September 28, 2012 closing of the Loan Agreement with PNC Bank, the Company purchased from Lenfest, at the stated price of $1,000 per share, all of these 231 shares of Series D Preferred Stock. In addition, the Company paid to Lenfest $417 of interest due under the Lenfest Pledge for the period August 28, 2010 through September 28, 2012, in cash, in lieu of Series D Preferred Stock. Also as part of the 2012 Financial Restructuring, the $10,000 in marketable securities associated with the Lenfest Pledge were returned to Lenfest and the Lenfest Pledge has been terminated; therefore, as of November 23, 2012, no interest has been accrued under the Lenfest Pledge.

Preferred Stock Dividends

On September 28, 2012, as part of the 2012 Financial Restructuring and immediately following the closing of the Loan Agreement with PNC Bank, the Company purchased from Lenfest, at the stated price of $1,000 per share, 386 shares of Series D Preferred Stock (i.e., the 55, 100, and 231 shares noted above), representing all of the Company's issued and outstanding shares of Series D Preferred Stock. Since there were no outstanding shares of Series D

Preferred Stock for the period September 28, 2012 through November 23, 2012, there were no dividends accrued during this period. All Series D Preferred Stock dividends accrued as of November 23, 2012, which totaled $13 and represented dividends accrued during the period May 26, 2012 through September 28, 2012, were scheduled to be paid in cash subsequent to November 23, 2012; $10 was paid in December 2012 and $3 is to be paid in January 2013.

Series E Preferred Stock

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

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

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Notes to the Consolidated Financial Statements, continued
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On September 28, 2012, as part of the 2012 Financial Restructuring and immediately following the closing of the Loan Agreement with PNC Bank, the Company purchased from Lenfest, at the stated price of $1,000 per share, 9,614 shares of Series E Preferred Stock, representing a significant portion of the Company's issued and outstanding Series E Preferred Stock. Lenfest is the only holder of the outstanding Series E Preferred Stock, and 12,127 shares of Series E Preferred Stock remain outstanding as of November 23, 2012.

As of November 23, 2012, the Series E Preferred Stock totaled $12,127 and was convertible into 6,063,321 shares of the Company's Common Stock. All Series E Preferred Stock dividends accruing through November 23, 2012, which totaled $825, were scheduled to be paid in cash subsequent to November 23, 2012; $542 was paid in December 2012 and $283 is to be paid in January 2013.

Common Stock Warrants

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

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

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

Dedicated Line of Credit Agreement with PNC Bank

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

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

ETC-PZL Line of Credit Agreement

As of August 24, 2012, ETC-PZL had a line of credit in the amount of $175 with a Warsaw bank to fund current activity. The line of credit would have expired in July 2013. On November 20, 2012, this line of credit was increased to $1,125 and extended to November 2013. As of November 23, 2012, there were no outstanding borrowings under this line of credit.

Summary of Long-Term Debt Obligations

Long-term debt obligations at November 23, 2012 and February 24, 2012 consist of the following:

	November 23, 2012 (unaudited)	February 24, 2012
Credit facility payable to bank	$ 12,985	$ 16,716
Term loan	14,750	-
Equipment lease	-	8
Total long-term debt obligations	27,735	16,724
Less: current portion of long-term debt obligations	(3,000)	(8)
Total long-term debt obligations, less current portion	$ 24,735	$ 16,716

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6. Income Taxes

Effective tax rates were 47.2% and 54.9% for the 2013 third quarter and the 2012 third quarter, respectively. Effective tax rates were 42.4% and 42.6% for the 2013 first three quarters and the 2012 first three quarters, respectively. Income tax provisions of $1,074 and $996 were recorded in the 2013 third quarter and the 2012 third quarter, respectively. Income tax provisions of $3,082 and $2,940 were recorded in the 2013 first three quarters and the 2012 first three quarters, respectively. At the end of each interim period, we make our best estimate of the effective tax rate expected to be applicable for the full fiscal year and the impact of discrete items, if any, and adjust the quarterly rate as necessary.

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

As of November 23, 2012, the Company had approximately $15,700 of federal net loss carryforwards available to offset future income tax liabilities, which begin to expire in 2025. In addition, the Company has the ability to offset deferred tax assets against deferred tax liabilities created for such items as depreciation and amortization.

7. Commitments and Contingencies

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

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Environmental Tectonics Corporation
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8. Segment Information (unaudited)

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

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

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

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

Thirteen weeks ended November 23, 2012:	Aerospace	CIS	Corporate	Company Total
Net sales	$10,569	$4,579	$-	$15,148
Interest expense, net	220	99	-	319
Depreciation and amortization	341	109	11	461
Operating income (loss)	2,887	718	(918)	2,687
Provision for income taxes	-	-	1,074	1,074
Identifiable assets	43,044	7,762	16,117	66,923
Expenditures for segment assets	139	5	3	147
Thirteen weeks ended November 25, 2011:				
Net sales	$12,860	$4,399	$-	$17,259
Interest expense, net	145	50	-	195
Depreciation and amortization	339	110	37	486
Operating income (loss)	1,848	884	(696)	2,036
Provision for income taxes	-	-	996	996
Identifiable assets	38,507	10,725	18,113	67,345
Expenditures for segment assets	324	61	45	430

Reconciliation to consolidated net income attributable to Environmental Tectonics Corporation:	Thirteen weeks ended November 23, 2012	Thirteen weeks ended November 25, 2011
Operating income	$ 2,687	$ 2,036
Interest expense, net	(319)	(195)

Other expense, net		(91)		(26)
Provision for income taxes		(1,074)		(996)
Income attributable to non-controlling interest		(25)		(10)
Net income attributable to Environmental Tectonics Corporation	$	1,178	$	809

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8. Segment Information (unaudited) (continued)

Thirty-nine weeks ended November 23, 2012:	Aerospace	CIS	Corporate	Company Total
Net sales	$32,186	$15,534	$-	$47,720
Interest expense, net	515	249	-	764
Depreciation and amortization	921	415	39	1,375
Operating income (loss)	6,899	3,385	(2,221)	8,063
Provision for income taxes	-	-	3,082	3,082
Identifiable assets	43,044	7,762	16,117	66,923
Expenditures for segment assets	788	55	95	938
Thirty-nine weeks ended November 25, 2011:				
Net sales	$37,421	$11,963	$-	$49,384
Interest expense, net	419	133	-	552
Depreciation and amortization	924	283	49	1,256
Operating income (loss)	6,800	2,932	(2,162)	7,570
Provision for income taxes	-	-	2,940	2,940
Identifiable assets	38,507	10,725	18,113	67,345
Expenditures for segment assets	1,142	242	136	1,520

Reconciliation to consolidated net income attributable to Environmental Tectonics Corporation:	Thirty-nine weeks ended November 23, 2012	November 25, 2011
Operating income	$ 8,063	$ 7,570
Interest expense, net	(764)	(552)
Other expense, net	(27)	(110)
Provision for income taxes	(3,082)	(2,940)
Income attributable to non-controlling interest	(19)	(28)
Net income attributable to Environmental Tectonics Corporation	$ 4,171	$ 3,940

Approximately 47.2% of net sales in the 2013 third quarter, totaling $7,146, were made to the U.S. Government under three contracts, to one Domestic commercial customer, and to one International customer. Approximately 61.0% of net sales in the 2012 third quarter, totaling $10,528, were made to the U.S. Government under three contracts, one Domestic commercial customer, and to one International customer.

The segment information for the 2013 third quarter includes export sales of $5,453, including sales to the Korean government of $1,346. The segment information for the 2012 third quarter includes export sales of $6,417, including sales to the Korean government of $3,668.

Approximately 57.5% of net sales in the 2013 first three quarters, totaling $27,441, were made to the U.S. Government under three contracts, to one Domestic commercial customer, and to one International customer. Approximately 65.1% of net sales in the 2012 first three quarters, totaling $32,145, were made to the U.S. Government under three contracts, one Domestic commercial customer, and to one International customer.

The segment information for the 2013 first three quarters includes export sales of $14,426, including sales to the Korean government of $5,910. The segment information for the 2012 first three quarters includes export sales of $15,394, including sales to the Korean government of $7,572.

As of both November 23, 2012 and November 25, 2011, substantially all of the Company's long-lived assets were located in the United States.

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9. Fair Value Measurements and Interest Rate Swap

Our assets and liabilities that are measured at fair value on a recurring basis include the unrealized gains or losses on interest rate swap contracts. We use significant other observable market data or assumptions (Level 2 inputs as defined in the accounting guidance) that we believe market participants would use in pricing similar assets or liabilities, including assumptions about counterparty risk. Our fair value estimates reflect an income approach based on the terms of the interest rate contracts and inputs corroborated by observable market data including interest rate curves.

As of November 23, 2012, we had one interest rate swap contract in place to reduce our exposure to fluctuations in interest rates on our Term Loan. The swap converts the variable interest rate to a fixed interest rate initially on $5,000 of our $15,000 Term Loan. The effective date of the interest rate swap was September 28, 2012, and it is scheduled to expire on September 28, 2017. The notional amount of $5,000 will decrease ratably over the duration of the interest rate swap agreement. The interest rate swap effectively fixes our LIBOR interest rate on the notional amount at a rate of 0.74% in excess of the margin. We have recognized the fair value of our interest rate swap as a long-term liability of approximately $28 as of November 23, 2012.

We recognize any differences between the variable interest rate payments and the fixed interest rate settlements from our swap counterparty as an adjustment to interest expense over the life of the swap. We have designated the swap as a cash flow hedge and we record the changes in the estimated fair value of the swap to accumulated other comprehensive loss. If our interest rate swap became ineffective, we would immediately recognize the change in the estimated fair value of our swap in earnings. Since inception, we have not recognized any gains or losses on these swaps through income and there has been no effect on income from hedge ineffectiveness.

Failure of our swap counterparty would result in the loss of any potential benefit to us under our swap contracts. In this case, we would still be obligated to pay the variable interest payments underlying the Term Loan. Additionally, failure of our swap counterparty would not eliminate our obligation to continue to make payments under our existing swap contract if we continue to be in a net pay position.

10. Subsequent Events

On December 19, 2012, the Company entered into an Export Import Loan Agreement through PNC Bank, whereby the Company has an Export Import Committed Line of Credit through which it may borrow against eligible export inventory and eligible export accounts receivable up to a maximum of $2,000. The agreement expires on October 31, 2015. Interest on advances under the agreement will be at the LIBOR rate plus 2.5%. The agreement includes covenants that are generally consistent with its Line of Credit with PNC Bank.

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

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

FORWARD-LOOKING STATEMENTS

Discussions of some of the matters contained in this Quarterly Report on Form 10-Q for ETC may constitute forward-looking statements within the meaning of the Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities and Exchange Act of 1934, as amended (the "Exchange Act"), and, as such, may involve risks and uncertainties. We have based these forward-looking statements on our current expectations and projections about future events or future financial performance, which include implementing our business strategy, developing and introducing new technologies, obtaining, maintaining and expanding market acceptance of the technologies we offer, and competition in our markets. These forward-looking statements are subject to known and unknown risks, uncertainties and assumptions about ETC and its subsidiaries that may cause actual results, levels of activity, performance or achievements to be materially different from any future results, levels of activity, performance or achievements expressed or implied by these forward-looking statements.

These forward-looking statements include statements with respect to the Company's vision, mission, strategies, goals, beliefs, plans, objectives, expectations, anticipations, estimates, intentions, financial condition, results of operations, future performance and business of the Company, including, but not limited to, (i) projections of revenues, costs of materials, income or loss, earnings or loss per share, capital expenditures, growth prospects, dividends, capital structure, other financial items and the effects of currency fluctuations, (ii) statements of our plans and objectives of the Company or its management or Board of Directors, including the introduction of new products, or estimates or predictions of actions of customers, suppliers, competitors or regulatory authorities, (iii) statements of future economic performance, (iv) statements of assumptions and other statements about the Company or its business, (v) statements made about the possible outcomes of litigation involving the Company, (vi) statements regarding the Company's ability to obtain financing to support its operations and other expenses, and (vii) statements preceded by, followed by or that include terminology such as "may," "will," "should," "expect," "plan," "anticipate," "believe," "estimate "predict," "potential," "intend," or "continue," and similar expressions. These forward-looking statements involve risks anc uncertainties which are subject to change based on various important factors. Some of these risks and uncertainties, in whole or in part, are beyond the Company's control. Factors that might cause or contribute to such a material difference include, but are not limited to, those discussed in our Annual Report on Form 10-K for the 2012 fiscal year, in the sections entitled "Risk Factors" and "Management's Discussion and Analysis of Financial Condition and Results of Operations." Shareholders are urged to review these risks carefully prior to making an investment in the Company's Common Stock.

The Company cautions that the foregoing list of factors that could affect forward-looking statements by ETC is not exclusive. Except as required by federal securities law, the Company does not undertake to update any forward-looking statement, whether written or oral, that may be made from time to time by or on behalf of the Company.

References to 2013 third quarter are references to the thirteen week period ended November 23, 2012. References to 2012 third quarter are references to the thirteen week period ended November 25, 2011. References to 2013 first three quarters are references to the thirty-nine week period ended November 23, 2012. References to 2012 first three quarters are references to the thirty-nine week period ended November 25, 2011. References to fiscal 2013 or the 2013 fiscal year are references to the fifty-two week period ending February 22, 2013. References to fiscal 2012 or the 2012 fiscal year are references to the fifty-two week period ended February 24, 2012.

Overview

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

We operate in two business segments – Aerospace and CIS.

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

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

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

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

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

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

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

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

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

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

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

Production under U.S. Government contracts

The Base Realignment and Closure (BRAC) Act passed by Congress in 2005 mandated base closures and consolidations through all the U.S. defense services. As a result of this Act, we were awarded three major contracts for pilot training simulators. Our fiscal 2013 opening backlog of firm orders included approximately $39.0 million for three significant contracts including one from the U.S. Navy for a research disorientation device and two from the U.S. Air Force to provide a high performance human centrifuge and a suite of research altitude chambers. As a result of engineering and production activity on these three contracts beginning to wind down, sales to the U.S. Government decreased by $4.4 million or 19.3% during the 2013 first three quarters compared to the 2012 first three quarters. Although at the current time we still have a significant sales backlog with the U.S. Government for equipment being procured under the BRAC Act, given the current domestic economic conditions and political environment, it should not be assumed that any additional contracts will be awarded to us.

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

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

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Critical Accounting Policies

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

Critical accounting policies are defined as those that reflect significant judgments and uncertainties, and potentially result in materially different results under different assumptions and conditions. For a detailed discussion on the application of these and other accounting policies, see Note 2 to the Consolidated Financial Statements, entitled Summary of Significant Accounting Policies, in the Company's Annual Report on Form 10-K for the 2012 fiscal year.

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Results of Operations

Thirteen weeks ended November 23, 2012 compared to thirteen weeks ended November 25, 2011

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

Summary Table of Results
(amounts in thousands)
(unaudited)

	Thirteen weeks ended			
	November 23, 2012	November 25, 2011	Variance $	Variance %
Net sales:				
Domestic	$4,305	$4,024	$281	7.0
U.S. Government	5,390	6,818	(1,428)	(20.9)
International	5,453	6,417	(964)	(15.0)
Total net sales	15,148	17,259	(2,111)	(12.2)
Gross profit	6,491	5,653	838	14.8
Selling and marketing expenses	1,508	1,386	122	8.8
General and administrative expenses	2,038	2,060	(22)	(1.1)
Research and development expenses	258	171	87	50.9
Operating income	2,687	2,036	651	32.0
Interest expense, net	319	195	124	63.6
Other expense, net	91	26	65	250.0
Income before income taxes	2,277	1,815	462	25.5
Provision for income taxes	1,074	996	78	7.8
Income attributable to non-controlling interest	(25)	(10)	(15)	150.0
Net income attributable to ETC	$1,178	$809	$369	45.6
Per share information:				
Basic earnings per common and participating share:				
Distributed earnings per share:				
Common	$-	$-	$-	
Preferred	$0.04	$0.05	$(0.01)	(20.0)
Undistributed earnings per share:				
Common	$0.05	$0.01	$0.04	400.0
Preferred	$0.05	$0.01	$0.04	400.0
Diluted earnings per share	$0.05	$0.01	$0.04	400.0

Net Income Attributable To ETC

Net income attributable to ETC was $1.2 million, or $0.05 diluted earnings per share, in the 2013 third quarter, compared to $0.8 million or $0.01 diluted earnings per share, during the 2012 third quarter, representing an increase of $0.4 million, or 45.6% in dollars and 400.0% based on diluted earnings per share. The increase in net income attributable to ETC reflects an increase in income before income taxes of $462 thousand, a result of an $838 thousand

increase in gross profit, which was offset by a $187 thousand increase in operating expenses, a $124 thousand increase in interest expense, a $65 thousand increase in other expense, and a $78 increase in the provision for income taxes. The significant increase in diluted earnings per share was due in part to increased income and also to reduced shares outstanding following the repurchase of 386 shares of Series D Preferred Stock, representing all of the Company's issued and outstanding shares of Series D Preferred Stock, and 9,614 shares of Series E Preferred Stock, representing a significant portion of the Company's issued and outstanding Series E Preferred Stock.

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Net Sales

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

	Thirteen weeks ended November 23, 2012				Thirteen weeks ended November 25, 2011			
	Domestic	U.S. Gov't	International	Total	Domestic	U.S. Gov't	International	Total
Aerospace Solutions								
ATS	$ 3	$ 2,619	$ 2,725	$ 5,347	$ 73	$ 3,926	$ 3,887	$ 7,886
Chambers	-	2,771	615	3,386	-	2,892	710	2,892
Simulation (ADMS)	513	-	576	1,089	510	-	156	666
ETC-PZL and other	27	-	720	747	-	-	706	706
Subtotal	543	5,390	4,636	10,569	583	6,818	5,459	12,860
Commercial/Industrial Systems								
Environmental	945	-	9	954	608	-	291	1,609
Sterilizers	1,348	-	244	1,592	1,912	-	-	1,912
Hyperbaric	1,044	-	550	1,594	453	-	642	1,095
Service and spares	425	-	14	439	468	-	25	493
Subtotal	3,762	-	817	4,579	3,441	-	958	4,399
Total net sales	$ 4,305	$ 5,390	$ 5,453	$ 15,148	$ 4,024	$ 6,818	$ 6,417	$ 17,259

Net sales for the 2013 third quarter were $15.2 million, a decrease of $2.1 million, or 12.2%, compared to 2012 third quarter net sales of $17.3 million. The decrease reflects decreased sales to the U.S. Government and to International customers, offset in part, by increased sales to Domestic customers.

Domestic Sales

Domestic sales in the 2013 third quarter were $4.3 million, an increase of $0.3 million, or 7.0%, over 2012 third quarter sales of $4.0 million. The increase in Domestic sales is due primarily to an increase in Environmental and Hyperbaric sales, offset in part, by decreased Sterilizer sales, within the CIS segment. Domestic sales as a percentage of the Company's total net sales increased to 28.4% in the 2013 third quarter compared to 23.3% in the 2012 third quarter.

U.S. Government Sales

U.S. Government sales in the 2013 third quarter were $5.4 million, a decrease of $1.4 million, or 20.9%, compared to 2012 third quarter sales of $6.8 million, and represented 35.6% of total net sales in the 2013 third quarter compared to 39.5% for the 2012 third quarter. This decrease is the result of lower ATS sales. Given the existing progress made on U.S. Government sales contracts in the Company's backlog, the Company anticipates the concentration of sales to the U.S. Government will continue to lessen in fiscal 2013.

International Sales

International sales for the 2013 third quarter, including those of the Company's foreign subsidiaries, were $5.4 million compared to $6.4 million in the 2012 third quarter, a decrease of $1.0 million, or 15.0%, and represented 36.0% of

total net sales in the 2013 third quarter compared to 37.2% in the 2012 third quarter. The decrease in International sales reflects a decrease in ATS sales, offset in part, by an increase in Simulation sales. International sales in the 2013 third quarter included $1.3 million in sales to the Korean government. International sales in the 2012 third quarter included $3.7 million in sales to the Korean government.

Gross Profit

Gross profit for the 2013 third quarter was $6.5 million as compared to $5.7 million in the 2012 third quarter, an increase of $0.8 million, or 14.8%. The increase in gross profit was achieved despite a decrease in net sales, due to the increase in gross profit margin as a percentage of net sales to 42.9% in the 2013 third quarter from 32.8% in the 2012 third quarter. The increase in gross profit margin as a percentage of net sales was due to several high margin completed contract sales recognized in the 2013 third quarter, compared to a reduced margin in the 2012 third quarter due to an increase in costs related to a U.S. Government contract.

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Selling and Marketing Expenses

Selling and marketing expenses for the 2013 third quarter were $1.5 million, an increase of $0.1 million, or 8.8%, compared to $1.4 million for the 2012 third quarter. As a percentage of net sales, selling and marketing expenses increased to 10.0% in the 2013 third quarter from 8.0% in the 2012 third quarter. The increase is primarily the result of an increase in commission expense as there was an increase in commission generating revenue in the 2013 third quarter compared to the 2012 third quarter; thus, commission expense as a percentage of net sales was higher in the 2013 third quarter compared to the 2012 third quarter.

General and Administrative Expenses

General and administrative expenses for the 2013 third quarter of $2.0 million remained unchanged compared to the 2012 third quarter. As a percentage of net sales, general and administrative expenses increased to 13.5% in the 2013 third quarter from 11.9% in the 2012 third quarter.

Research and Development Expenses

Research and development expenses include spending for potential new products and technologies, and internationally, work performed under government grant programs. This spending, net of grant payments from the Polish and Turkish governments, totaled $0.3 million for the 2013 third quarter compared to $0.2 million for the 2012 third quarter, an increase of $0.1 million. The increase was a result of less research and development employees being assigned to specific contracts; thus, expenses related to these employees were included in research and development expenses in the 2013 third quarter. Most of the Company’s research efforts, which were and continue to be a significant cost of its business, are included in cost of sales for applied research for specific contracts, as well as research for feasibility and technology updates. As a percentage of sales, research and development expenses were 1.7% in the 2013 third quarter compared to 1.0% in the 2012 third quarter.

Operating Income

Operating income increased by $0.7 million, or 32.0%, to $2.7 million for the 2013 third quarter compared to $2.0 million in the 2012 third quarter. Operating income as a percentage of net sales increased to 17.7% from 11.8% in the 2012 third quarter. On a segment basis, Aerospace had operating income of $2.9 million for the 2013 third quarter, a $1.1 million increase from operating income of $1.8 million in the 2012 third quarter. CIS had operating income of $0.7 million in the 2013 third quarter, a $0.2 million decrease from operating income of $0.9 million in the 2012 third quarter. These segment operating results were offset, in part, by unallocated corporate expenses of $0.9 million and $0.7 million in the 2013 third quarter and the 2012 third quarter, respectively.

Interest Expense, Net

Interest expense, net, for the 2013 third quarter was $0.3 million compared to $0.2 million in the 2012 third quarter, representing a higher level of bank borrowing that now includes the recently entered into Term Loan.

Other Expense, Net

Other expense, net for the 2013 third quarter was $91 thousand compared to other expense, net of $26 thousand in the 2012 third quarter, an increase of $65 thousand. Other expense, net consists primarily of bank and letter of credit fees, as well as foreign currency exchange gains and losses.

Income Taxes

As of November 23, 2012, the Company reviewed the components of its deferred tax assets and determined, based upon all available information, that its current and expected future operating income will more likely than not result in the realization of its deferred tax assets relating to its federal net operating loss carryforwards. The Company has a net deferred tax asset related primarily to its federal net operating loss carryforwards of $5.5 million as of November 23, 2012. Income tax provisions of $1.1 million and $1.0 million were recorded in the 2013 third quarter and the 2012 third quarter, respectively.

As of November 23, 2012, the Company had approximately $15.7 million of federal net loss carryforwards available to offset future income tax liabilities, which begin to expire in 2025. In addition, the Company has the ability to offset deferred tax assets against deferred tax liabilities created for such items as depreciation and amortization.

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Thirty-nine weeks ended November 23, 2012 compared to thirty-nine weeks ended November 25, 2011

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

Summary Table of Results
(amounts in thousands)
(unaudited)

	Thirty-nine weeks ended			
	November 23, 2012	November 25, 2011	Variance $	Variance %
Net sales:				
Domestic	$14,774	$11,055	$3,719	33.6
U.S. Government	18,520	22,935	(4,415)	(19.3)
International	14,426	15,394	(968)	(6.3)
Total net sales	47,720	49,384	(1,664)	(3.4)
Gross profit	19,036	18,070	966	5.3
Selling and marketing expenses	4,125	4,013	112	2.8
General and administrative expenses	5,943	5,935	8	0.1
Research and development expenses	905	552	353	63.9
Operating income	8,063	7,570	493	6.5
Interest expense, net	764	552	212	38.4
Other expense, net	27	110	(83)	(75.5)
Income before income taxes	7,272	6,908	364	5.3
Provision for income taxes	3,082	2,940	142	4.8
Income attributable to non-controlling interest	(19)	(28)	9	(32.1)
Net income attributable to ETC	$4,171	$3,940	$231	5.9
Per share information:				
Basic earnings per common and participating share:				
Distributed earnings per share:				
Common	$-	$-	$-	
Preferred	$0.14	$0.15	$(0.01)	(6.7)
Undistributed earnings per share:				
Common	$0.14	$0.11	$0.03	27.3
Preferred	$0.14	$0.11	$0.03	27.3
Diluted earnings per share	$0.14	$0.11	$0.03	27.3

Net Income Attributable To ETC

Net income attributable to ETC was $4.2 million, or $0.14 diluted earnings per share, in the 2013 first three quarters, compared to $3.9 million or $0.11 diluted earnings per share, during the 2012 first three quarters, representing an increase of $231 thousand, or 5.9% in dollars and 27.3% based on diluted earnings per share. The increase in net income attributable to ETC reflects an increase in income before income taxes of $364 thousand, a result of a $966 thousand increase in gross profit, which was offset by a $473 thousand increase in operating expenses and a $212

thousand increase in interest expense, offset by a $142 thousand increase in the provision for income taxes. The significant increase in diluted earnings per share was due in part to increased income and also to reduced shares outstanding following the repurchase of 386 shares of Series D Preferred Stock, representing all of the Company's issued and outstanding shares of Series D Preferred Stock, and 9,614 shares of Series E Preferred Stock, representing a significant portion of the Company's issued and outstanding Series E Preferred Stock.

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Net Sales

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

	Thirty-nine weeks ended November 23, 2012				Thirty-nine weeks ended November 25, 2011			
	Domestic	U.S. Gov't	International	Total	Domestic	U.S. Gov't	International	Total
Aerospace Solutions								
ATS	$251	$8,169	$ 9,139	$17,559	$611	$16,447	$ 8,984	$26,042
Chambers	-	10,351	1,188	11,539	-	6,488	1,615	8,103
Simulation (ADMS)	724	-	713	1,437	1,285	-	389	1,674
ETC-PZL and other	218	-	1,433	1,651	-	-	1,602	1,602
Subtotal	1,193	18,520	12,473	32,186	1,896	22,935	12,590	37,421
Commercial/Industrial Systems								
Environmental	2,518	-	491	3,009	839	-	376	1,215
Sterilizers	7,529	-	285	7,814	5,563	-	57	5,620
Hyperbaric	1,995	-	1,099	3,094	1,125	-	2,253	3,378
Service and spares	1,539	-	78	1,617	1,632	-	118	1,750
Subtotal	13,581	-	1,953	15,534	9,159	-	2,804	11,963
Total net sales	$14,774	$18,520	$ 14,426	$47,720	$11,055	$22,935	$ 15,394	$49,384

Net sales for the 2013 first three quarters were $47.7 million, a decrease of $1.7 million, or 3.4%, compared to 2012 first three quarters net sales of $49.4 million. The decrease reflects decreased sales to the U.S. Government and to International customers, offset in part, by increased sales to Domestic customers.

Domestic Sales

Domestic sales for the 2013 first three quarters were $14.8 million, an increase of $3.7 million, or 33.6%, over 2012 first three quarters sales of $11.1 million. The increase in Domestic sales is due primarily to an increase in Environmental, Sterilizer, and Hyperbaric sales within the CIS segment, offset in part, by a decrease in Simulation and ATS sales within the Aerospace segment. Domestic sales represented 31.0% of the Company's total net sales in the 2013 first three quarters compared to 22.4% of the Company's total net sales in the 2012 first three quarters.

U.S. Government Sales

U.S. Government sales for the 2013 first three quarters were $18.5 million, a decrease of $4.4 million, or 19.3%, compared to sales in the 2012 first three quarters of $22.9 million, and represented 38.8% of total net sales in the 2013 first three quarters compared to 46.4% for the 2012 first three quarters. This decrease is the result of lower ATS sales, offset in part, by an increase in sales related to a suite of research altitude chambers. Given the existing progress made on U.S. Government sales contracts in the Company's backlog, the Company anticipates the concentration of sales to the U.S. Government will continue to lessen in fiscal 2013.

International Sales

International sales for the 2013 first three quarters, including those of the Company's foreign subsidiaries, were $14.4 million a decrease of $1.0 million, or 6.3%, compared to sales in the 2012 first three quarters of $15.4 million, and represented 30.2% of total net sales in the 2013 first three quarters compared to 31.2% in the 2012 first three quarters. This decrease is primarily the result of lower Chambers and Hyperbaric sales, offset in part, by an increase in Simulation sales. International sales in the 2013 first three quarters included $5.9 million in sales to the Korean government. International sales in the 2012 first three quarters included $7.6 million in sales to the Korean government.

Gross Profit

Gross profit for the 2013 first three quarters was $19.0 million compared to $18.1 million in the 2012 first three quarters, an increase of $0.9 million, or 5.3%. The increase in gross profit was achieved despite a decrease in net sales, due to the increase in gross profit margin as a percentage of net sales to 39.9% in the 2013 first three quarters from 36.6% in the 2012 first three quarters. The increase in gross profit margin as a percentage of net sales was due to several high margin completed contract sales recognized primarily in the 2013 third quarter, compared to a reduced margin in the 2012 first three quarters due to an increase in costs related to a U.S. Government contract.

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Selling and Marketing Expenses

Selling and marketing expenses for the 2013 first three quarters were $4.1 million, an increase of $0.1 million, or 2.8%, compared to $4.0 million for the 2012 first three quarters. As a percentage of net sales, selling and marketing expenses increased to 8.6% in the 2013 first three quarters from 8.1% in the 2012 first three quarters. The increase is primarily the result of salaries and benefits related to an increase in headcount of sales and marketing employees.

General and Administrative Expenses

General and administrative expenses for the 2013 first three quarters of $5.9 million remained unchanged compared to the 2012 first three quarters. As a percentage of net sales, general and administrative expenses increased to 12.5% in the 2013 first three quarters from 12.0% in the 2012 first three quarters. Although the dollar amount of general and administrative expenses did not change, there was an increase in expenses related to our foreign operating subsidiaries, offset by a decrease in consulting expenses and the absence of a one-time charge to vacation expense in the 2012 first three quarters.

Research and Development Expenses

Research and development expenses include spending for potential new products and technologies, and internationally, work performed under government grant programs. This spending, net of grant payments from the Polish and Turkish governments, totaled $0.9 million for the 2013 first three quarters compared to $0.6 million for the 2012 first three quarters, an increase of $0.3 million, or 63.9%. The increase was a result of less research and development employees being assigned to specific contracts; thus, expenses related to these employees were included in research and development expenses in the 2013 first three quarters. Most of the Company's research efforts, which were and continue to be a significant cost of its business, are included in cost of sales for applied research for specific contracts, as well as research for feasibility and technology updates. As a percentage of sales, research and development expenses were 1.9% in the 2013 first three quarters compared to 1.1 % in the 2012 first three quarters.

Operating Income

Operating income increased by $0.5 million, or 6.5%, to $8.1 million for the 2013 first three quarters compared to $7.6 million in the 2012 first three quarters. Operating income as a percentage of net sales increased to 16.9% in the 2013 first three quarters from 15.3% in the 2012 first three quarters. On a segment basis, Aerospace had operating income of $6.9 million for the 2013 first three quarters, a $0.1 million increase from operating income of $6.8 million in the 2012 first three quarters. CIS had operating income of $3.4 million in the 2013 first three quarters, a $0.5 million increase from operating income of $2.9 million in the 2012 first three quarters. These segment operating results were offset, in part, by unallocated corporate expenses of $2.2 million and $2.1 million in the 2013 first three quarters and the 2012 first three quarters, respectively.

Interest Expense, Net

Interest expense, net, for the 2013 first three quarters was $0.8 million as compared to $0.6 million in the 2012 first three quarters, representing a higher level of bank borrowing that now includes the recently entered into Term Loan.

Other Expense, Net

Other expense, net for the 2013 first three quarters was $27 thousand compared to other expense, net of $110 thousand in the 2012 first three quarters, a decrease of $83 thousand. Other expense, net consists primarily of bank and letter of credit fees, as well as foreign currency exchange gains and losses.

Income Taxes

As of November 23, 2012, the Company reviewed the components of its deferred tax assets and determined, based upon all available information, that its current and expected future operating income will more likely than not result in the realization of its deferred tax assets relating to its federal net operating loss carryforwards. The Company has a net deferred tax asset related primarily to its federal net operating loss carryforwards of $5.5 million as of November 23, 2012. Income tax provisions of $3.1 million and $2.9 million were recorded in the 2013 first three quarters and the 2012 first three quarters, respectively.

As of November 23, 2012, the Company had approximately $15.7 million of federal net loss carryforwards available to offset future income tax liabilities, which begin to expire in 2025. In addition, the Company has the ability to offset deferred tax assets against deferred tax liabilities created for such items as depreciation and amortization.

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Liquidity and Capital Resources

As a result of the 2012 Financial Restructuring (as defined below under "Outlook"), the Company reduced the amount outstanding on its line of credit during the 2013 first three quarters. The Company's availability under its line of credit with PNC Bank at November 23, 2012 was $1.2 million which has increased to $7.7 million at January 3, 2013. The Company expects the availability to increase as several of our long-term contracts with back loaded cash receipts continue to wind down. Working capital, or current assets less current liabilities, was $31.6 million at November 23, 2012 compared with $27.8 million at February 24, 2012. The increase in working capital was primarily the result of an increase in accounts receivable, which increased due to certain milestones on long-term contracts becoming billable, offset in part, by an increase in the current portion of long-term debt obligations due to the recently entered into Term Loan. The Company's current ratio, current assets divided by current liabilities, improved to 2.7:1 at November 23, 2012 from 2.4:1 at February 24, 2012.

With unused availability under the PNC Bank line of credit and the Company's ability to generate cash from operations, the Company anticipates these sources of liquidity will be sufficient to fund its operating activities, anticipated capital expenditures, and debt repayment obligations for the twelve months subsequent to November 23, 2012.

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

	As of November 23, 2012			As of February 24, 2012		
Credit facility*	Total Facility	Amount Borrowed	Amount Available**	Total Facility	Amount Borrowed	Amount Available**
PNC Bank line of credit	$ 15,000	$ 12,985	$ 1,237	$ 20,000	$ 16,716	$ 2,502
Dedicated line of credit	5,422	5,422	-	5,422	5,422	-
ETC-PZL line of credit	1,125	-	1,125	-	-	-
Total	$ 21,547	$ 18,407	$ 2,362	$ 25,422	$ 22,138	$ 2,502

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

** Amount available takes into account letters of credit outstanding against the PNC Bank line of credit of $778 thousand and $782 thousand as of November 23, 2012 and February 24, 2012, respectively.

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

Cash flows from operating activities

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

During the 2013 first three quarters, as a result of a decrease in costs and estimated earnings in excess of billings and the decrease in billings in excess of costs and estimated earnings on uncompleted long-term percentage of completion ("POC") contracts, the Company generated $0.3 million of cash from operating activities compared to cash used in operating activities of $7.9 million in the 2012 first three quarters. Under POC revenue recognition, these accounts represent the timing differences of spending on production activities versus collecting on long-term contracts. The aforementioned generation of cash was offset, in part, by cash utilized for the increase in accounts receivable, which increased due to certain milestones on long-term contracts becoming billable.

Cash flows from investing activities

Cash used for investing activities primarily relates to funds used for capital expenditures in equipment and software development. The Company's investing activities used $0.9 million in the 2013 first three quarters, and consisted primarily of costs for the acquisition of computer equipment and the manufacturing of demonstration simulators for our NASTAR Center, coupled with software enhancements for our Advanced Tactical Fighter Systems technology and Hyperbaric products. This is comparable to cash used in investing activities of $1.5 million in the 2012 first three quarters.

Cash flows from financing activities

The Company's financing activities used $0.6 million of cash in the 2013 first three quarters. This primarily reflected the repurchasing of Preferred Stock, repayments under the Company's PNC Bank line of credit, and dividends paid on Preferred Stock. The aforementioned usage of cash was offset, in part, by cash received from the recently entered into Term Loan. In the 2012 first three quarters, net cash provided by financing activities totaled $11.8 million, primarily for borrowings under the line of credit, offset in part, by dividends paid on Preferred Stock.

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Outlook

On September 28, 2012, the Company announced a financial restructuring agreement, referred to herein as the 2012 Financial Restructuring, that will reduce its annual net cash payments for dividends and interest by approximately $1.5 million, and reduce the number of participating preferred shares in the amount equating to 5,032,091 shares of Common Stock; as a result, positively impacting the Company's earnings. As part of the 2012 Financial Restructuring, the Company's revolving Line of Credit with PNC Bank was reduced from $20.0 million to $15.0 million, with the expiration date extended to October 31, 2015. The interest rate on the PNC Line of Credit will remain unchanged. PNC Bank also provided to the Company a five-year Term Loan of $15.0 million, which will expire on September 28, 2017. The Company utilized $10.0 million of the proceeds from the term loan to repurchase and retire 10,000 shares of 10% Preferred Stock, equivalent to 5,032,091 shares of Common Stock. The revolving Line of Credit will no longer be guaranteed by H.F. Lenfest, a major shareholder and member of our Board of Directors, and will instead be secured by substantially all of the Company's assets. Mr. Lenfest provided a guarantee on the new $15.0 million Term Loan for a period of thirty months, after which his guarantee will be removed. In addition, dividends on the remaining Series E Preferred Stock will be reduced from ten percent (10%) to four percent (4%), subject to shareholder approval.

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

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

Backlog

Below is a breakdown of the Company's November 23, 2012 and February 24, 2012 sales backlog (unaudited – amounts in thousands except percentages):

November 23, 2012:

	Business segment			
Geographic area	Aerospace	CIS	Total	%
Domestic	$ 967	$ 8,530	$ 9,497	15.8 %
U.S. Government	21,789	-	21,789	36.2
International	26,545	2,346	28,891	48.0
Total	$ 49,301	$ 10,876	$ 60,177	100.0 %
% of Total	81.9 %	18.1 %	100.0 %	

February 24, 2012:

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

Our sales backlog at November 23, 2012 and February 24, 2012 for work to be performed and revenue to be recognized under written agreements after such dates was $60.2 million and $74.5 million, respectively. Of the November 23, 2012 sales backlog, approximately $10.3 million represents two International contracts for multiple aircrew training simulators. Approximately 94.4% of the U.S. Government backlog relates to three contracts.

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

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Item 3. Quantitative and Qualitative Disclosures about Market Risk

This disclosure is not applicable to ETC because ETC is a smaller reporting company.

Item 4. Controls and Procedures

Disclosure Controls and Procedures

As of the end of the period covered by this report, our management, including our Chief Executive Officer and Chief Financial Officer, evaluated our disclosure controls and procedures (as defined in Rule 13a-15(e) under the Exchange Act). Disclosure controls and procedures are designed to provide reasonable assurance that the information required to be disclosed in the reports we file under the Exchange Act is (i) recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms and (ii) is accumulated and communicated to management, including our Chief Executive Officer and Chief Financial Officer, as appropriate to allow timely decisions regarding required disclosures. A control system cannot provide absolute assurances, however, that the objectives of the control system are met, and no evaluation of controls can provide absolute assurance that all control issues and instances of fraud, if any, within a company have been detected. Based on that evaluation, our Chief Executive Officer and Chief Financial Officer have concluded that our disclosure controls and procedures were not effective at November 23, 2012 because of the material weakness in internal control over financial reporting related to (i) a foreign subsidiary not having a uniform centralized system for recording personnel time and retaining source data for certain contracts, and (ii) this subsidiary's corporate governance structure, as more fully described in our Annual Report on Form 10-K for the 2012 fiscal year. We performed additional analysis and other post-closing procedures with regard to this foreign subsidiary to provide reasonable assurance that our Consolidated Financial Statements are prepared in accordance with generally accepted accounting principles.

Changes in Internal Control Over Financial Reporting

There was no change in our internal control over financial reporting (as such term is defined in Rule 13a-15(f) under the Exchange Act) during our fiscal quarter ended November 23, 2012 that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

During the fiscal quarter ended August 24, 2012, the Company reorganized the management composition of the foreign subsidiary so as to assist in the acculturation of the subsidiary into the Company's organizational culture. In addition, on a quarterly basis, Company management is now performing a detailed review of the recording of employee time, and the allocation of these personnel costs to the foreign subsidiary's contracts.

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

A uniform centralized system for recording personnel time will be implemented at the foreign subsidiary, and employees will be trained with respect to the system's functionality. Company management has met with representatives of the management of the foreign subsidiary and intends to implement the new system as of January 1, 2013.

While the Company expects to further reorganize the management composition of the foreign subsidiary to retain certain former officers of the foreign subsidiary and fill a vacancy, the Company also plans to implement a number of changes to the corporate governance structure of the foreign subsidiary to address the material weakness, including the following:

- The Company will issue a series of policies and procedures applicable to the foreign subsidiary, including but not limited to record retention, so as to improve the governance over the subsidiary. Company management has met with representatives of the management of the foreign subsidiary, reviewed the draft policies and procedures, and intends to implement the policies and procedures program in the last quarter of fiscal 2013.

- The Company's Chief Financial Officer will directly oversee all majority-owned foreign subsidiaries in so far as maintaining internal control over financial reporting, including compliance with the policies and procedures to be implemented.

- While the management of the foreign subsidiary will continue to be overseen by a three-member supervisory board, the majority of which will continue to be comprised of members of the Company, and the Company's Chief Financial Officer has been added to the supervisory board to join the Company's Chief Executive Officer.

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PART II – OTHER INFORMATION

Item 1. Legal Proceedings

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

Item 1A. Risk Factors

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

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

Approximately 38.8% of our revenues for the 2013 first three quarters were derived from U.S. Government contracts, and approximately 36.2% of our firm backlog as of November 23, 2012 is derived from U.S. Government contracts. The Budget Control Act of 2011 commits the U.S. Government to reduce the federal deficit over ten years through caps on discretionary spending. The Budget Control Act of 2011 also established a Congressional Joint Select Committee on Deficit Reduction (the "Super Committee") responsible for identifying an additional $1.2 to $1.5 trillion in deficit reductions by November 23, 2011. With the failure of the Super Committee to produce a deficit reduction proposal by this deadline, "sequestration" was triggered, which calls for automatic spending cuts split between defense and non-defense programs beginning in 2013 and continuing over a ten-year period. While Congress is discussing various options to prevent or defer sequestration, we cannot predict whether any such efforts will succeed. While the impact of sequestration on our U.S. Government contracts, if any, is unknown, a funding delay or cancellation could have a material adverse impact on our business, financial condition and results of operations.

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

None.

Item 3. Defaults upon Senior Securities

None.

Item 4. Mine Safety Disclosures

None.

Item 5. Other Information

None.

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Item 6. Exhibits

Number	Item
10.1	Loan Agreement, dated September 28, 2012, between Registrant and PNC Bank, with the Term Note and the Line of Credit Note (each as defined in such Loan Agreement) attached thereto as exhibits, which was filed on October 2, 2012 as Exhibit 10.1 to Form 8-K and is incorporated herein by reference.
10.2	Security Agreement by the Registrant in favor of PNC Bank, dated as of September 28, 2012, which was filed on October 2, 2012 as Exhibit 10.2 to Form 8-K and is incorporated herein by reference.
10.3	Pledge Agreement between the Registrant and PNC Bank, dated as of September 28, 2012, which was filed on October 2, 2012 as Exhibit 10.3 to Form 8-K and is incorporated herein by reference.
10.4	Open-End Mortgage and Security Agreement by the Registrant in favor of PNC Bank, dated as of September 28, 2012, which was filed on October 2, 2012 as Exhibit 10.4 to Form 8-K and is incorporated herein by reference.
10.5	Third Amended and Restated Reimbursement Agreement for Letters of Credit between the Registrant and PNC Bank, dated as of September 28, 2012, which was filed on October 2, 2012 as Exhibit 10.5 to Form 8-K and is incorporated herein by reference.
10.6	Preferred Stock Repurchase and Financial Restructuring Agreement between the Registrant and H.F. Lenfest, dated September 28, 2012, which was filed on October 2, 2012 as Exhibit 10.6 to Form 8-K and is incorporated herein by reference.
10.7	Amended and Restated Guaranty Agreement, dated September 28, 2012, by H.F. Lenfest in favor of PNC Bank, which was filed on October 2, 2012 as Exhibit 10.7 to Form 8-K and is incorporated herein by reference.
10.8	Export-Import Loan Agreement, dated December 19, 2012, between Registrant and PNC Bank, with the Borrower Agreement and the Export-Import Line of Credit Note (each as defined in such Loan Agreement) attached thereto, which was filed on December 26, 2012 as Exhibit 10.1 to Form 8-K and is incorporated herein by reference.
10.9	Export-Import Security Agreement by the Registrant in favor of PNC Bank, dated as of December 19, 2012, which was filed on December 26, 2012 as Exhibit 10.2 to Form 8-K and is incorporated herein by reference.
10.10	Export-Import Pledge Agreement between the Registrant and PNC Bank, dated as of December 19, 2012, which was filed on December 26, 2012 as Exhibit 10.3 to Form 8-K and is incorporated herein by reference.
31.1	Certification pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 made by William F. Mitchell, Chief Executive Officer.
31.2	Certification pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 made by Robert L. Laurent, Jr., Chief Financial Officer.
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	Certification pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 made by William F. Mitchell, Chief Executive Officer, and Robert L. Laurent, Jr., Chief Financial Officer.
101.INS*	XBRL Instance
101.SCH*	XBRL Taxonomy Extension Schema
101.CAL*	XBRL Taxonomy Extension Calculation
101.LAB*	XBRL Taxonomy Extension Labels
101.PRE*	XBRL Taxonomy Extension Presentation
101.DEF*	XBRL Taxonomy Extension Definition

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

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Signatures

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

ENVIRONMENTAL TECTONICS CORPORATION
(Registrant)

Date: January 7, 2013	By: /s/ William F. Mitchell William F. Mitchell President and Chief Executive Officer (Principal Executive Officer)
Date: January 7, 2013	By: /s/ Robert L. Laurent, Jr. Robert L. Laurent, Jr. Chief Financial Officer (Principal Financial and Accounting Officer)