AEROSONIC CORP /DE/
Form 10-Q
September 13, 2004

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended July 30, 2004

OR

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TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(D) OF THE SECURITIES EXCHANGE ACT OF 1934

For the transition period from

to

Commission file number 1-11750

AEROSONIC CORPORATION

(Exact name of registrant as specified in its charter)

Delaware 74-1668471

(State or other jurisdiction of incorporation or organization) (I.R.S. Employer Identification No.)

1212 North Hercules Avenue

Clearwater, Florida 33765

(Address of principal executive offices and Zip Code)

Registrant s telephone number, including area code: (727) 461-3000

Not Applicable

(Former name, former address and former fiscal year, if changed since last report)

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 S No £

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Act). Yes £ No

As of September 10 , 2004, the issuer had 3,921,019 shares of Common Stock outstanding, net of treasury shares.

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PART I FINANCIAL INFORMATION

Forward-Looking Statements

THIS DOCUMENT INCLUDES CERTAIN FORWARD-LOOKING STATEMENTS WITHIN THE MEANING OF THE PRIVATE SECURITIES LITIGATION REFORM ACT OF 1995. THESE FORWARD-LOOKING STATEMENTS INCLUDE, BUT ARE NOT LIMITED TO OUR PLANS, OBJECTIVES, EXPECTATIONS AND INTENTIONS AND OTHER STATEMENTS CONTAINED IN THIS REPORT THAT ARE NOT HISTORICAL FACTS AS WELL AS STATEMENTS IDENTIFIED BY WORDS SUCH AS EXPECTS, ANTICIPATES, INTENDS, PLANS, BELIEVES, SEEKS, ESTIMATES OR OF SIMILAR MEANING. THESE STATEMENTS ARE BASED ON OUR CURRENT BELIEFS OR EXPECTATIONS AND ARE INHERENTLY SUBJECT TO SIGNIFICANT UNCERTAINTIES AND CHANGES IN CIRCUMSTANCES, MANY OF WHICH ARE BEYOND OUR CONTROL. ACTUAL RESULTS MAY DIFFER MATERIALLY FROM THESE EXPECTATIONS DUE TO CHANGES IN GLOBAL POLITICAL, ECONOMIC, BUSINESS, COMPETITIVE, MARKET AND REGULATORY FACTORS.

Significant Events

On February 25, 2004, Aerosonic Corporation (the **Company**) refinanced all of its short-term and long-term bank debt obligations with Wachovia Bank, N.A. Note 4 of Item 1 of Part I includes a discussion of the nature and certain details of the debt refinancing.

Note 6 of Item 1 of Part I of this report include discussions of: (i) an investigation by the U.S. Securities and Exchange Commission (**SEC**) regarding certain accounting issues, (ii) securities class action lawsuits filed against the Company, PricewaterhouseCoopers LLP, the Company s former independent accountant, and four former employees of the Company, two of whom were directors, and (iii) action by the U.S. Internal Revenue Service (the **IRS**) with respect to the Company s amendments to its federal income tax returns for its fiscal years ended January 31, 1998 and 1999. Item 1 of Part II of this report also includes discussions of the above-mentioned SEC investigation and securities class action lawsuits.

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Item 1 Financial Statements

AEROSONIC CORPORATION AND SUBSIDIARY

CONDENSED CONSOLIDATED BALANCE SHEETS (unaudited)

	July 30, 2004	January 31, 2004 (restated)
ASSETS		
Current assets:		
Cash and cash equivalents ..	$ 432,000	$ 1,276,000
Receivables, net of allowance for doubtful accounts of		
$12,000 and $152,000 .	4,855,000	3,896,000
Income taxes receivable .	279,000	969,000
Costs and estimated profits in excess of billings	1,939,000	1,398,000
Inventories ..	5,704,000	5,683,000
Prepaid expenses	188,000	190,000
Deferred income taxes ...	619,000	619,000
Total current assets	14,016,000	14,031,000
Property, plant and equipment, net	3,983,000	3,954,000
Capitalized software costs and other assets, net .	200,000	127,000
Total assets .	$ 18,199,000	$ 18,112,000
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Long-term debt and notes payable due within one year .	$ 269,000	$ 200,000
Revolving credit facilities	600,000	1,000,000
Accounts payable, trade ..	1,627,000	2,910,000
Compensation and benefits .	1,011,000	779,000
Income taxes payable ..	387,000	-
Accrued expenses and other liabilities	1,620,000	2,343,000
Total current liabilities	5,514,000	7,232,000
Long-term debt and notes payable due after one year	2,909,000	2,216,000
Deferred income taxes	22,000	22,000

Total liabilities	8,445,000	9,470,000
Commitments and contingencies		
Stockholders equity:		
Common stock $0.40 par value: authorized 8,000,000; shares issued 3,986,262; shares outstanding 3,921,019 ..	1,595,000	1,595,000
Additional paid-in capital	4,559,000	4,559,000
Retained earnings	4,296,000	3,184,000
Less treasury stock: 65,243 shares at July 30, 2004 and January 31, 2004, at cost ..	(696,000)	(696,000)
Total stockholders equity ...	9,754,000	8,642,000
Total liabilities and stockholders equity	$ 18,199,000	$ 18,112,000

The accompanying notes are an integral part of these condensed consolidated financial statements

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AEROSONIC CORPORATION AND SUBSIDIARY

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS (unaudited)

	Three Months Ended		Six Months Ended	
	July 30, 2004	**July 31, 2003**	**July 30, 2004**	**July 31, 2003**
Revenue, net ..	$ 7,937,000	$ 7,746,000	$ 15,033,000	$ 16,490,000
Cost of sales ...	5,220,000	5,550,000	10,308,000	11,382,000
Gross profit	2,717,000	2,196,000	4,725,000	5,108,000
Selling, general and administrative expenses	2,273,000	2,494,000	4,052,000	4,837,000
Operating income ..	444,000	(298,000)	673,000	271,000
Other income (expense):				
Interest expense, net .	(46,000)	(53,000)	(52,000)	(106,000)
Miscellaneous income ...	1,058,000	(3,000)	1,179,000	1,000
	1,012,000	(56,000)	1,127,000	(105,000)
Income before income taxes ..	1,456,000	(354,000)	1,800,000	166,000
Income tax (expense) benefit	(553,000)	12,000	(688,000)	(5,000)
Net income	$ 903,000	$ (342,000)	$ 1,112,000	$ 161,000
Basic and diluted earnings per share	$ 0.23	$ (0.09)	$ 0.28	$ 0.04
Basic and diluted weighted average shares outstanding	3,921,019	3,921,019	3,921,019	3,921,019

The accompanying notes are an integral part of these condensed consolidated financial statements

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AEROSONIC CORPORATION AND SUBSIDIARY
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (unaudited)

	Six Months Ended	
	July 30, 2004	July 31, 2003
Cash flow from operating activities:		
Net income	$ 1,112,000	$ 161,000
Adjustments to reconcile net income to net cash provided by/ (used in) operating activities:		
Allowance for doubtful accounts	(140,000)	-
Depreciation .	303,000	365,000
Amortization .	27,000	121,000
Deferred income taxes ..	-	(65,000)
Changes in assets and liabilities		
Receivables .	(819,000)	355,000
Income taxes receivable and payable ...	1,077,000	273,000
Costs and estimated profits in excess of billings .	(541,000)	(1,399,000)
Inventories	(21,000)	(86,000)
Prepaid expenses ...	2,000	11,000
Capitalized software costs and other assets .	(73,000)	(80,000)
Accounts payable, trade	(1,283,000)	504,000
Compensation and benefits ...	232,000	87,000
Accrued expenses and other liabilities .	(723,000)	1,394,000
Net cash provided by/ (used in) operating activities	(847,000)	1,641,000
Cash flow from investing activities:		
Capital expenditures ..	(148,000)	(253,000)
Net cash used in investing activities ..	(148,000)	(253,000)
Cash flow from financing activities:		
Proceeds/ (payments) from revolving credit facilities ..	(400,000)	245,000
Proceeds from issuance of long-term debt ...	621,000	-
Principal payments on long-term debt and notes payable	(70,000)	(524,000)
Net cash provided by/ (used in) financing activities .	151,000	(279,000)

Net increase/ (decrease) in cash and cash equivalents	(844,000)	1,109,000
Cash and cash equivalents at beginning of period	1,276,000	260,000
Cash and cash equivalents at end of period ..	$ 432,000	$ 1,369,000
Supplemental disclosure of cash flow information:		
Cash paid during the period for:		
Interest	$ 94,000	$ 111,000
Income taxes ...	300,000	29,000
Non cash investing and financing activities:		
Debt refinance .	$ 3,537,000	$ -
Acquisition of property under a capital lease .	$ -	$ 45,000
Acquisition of property through issuance of note payable .	$ 211,000	$ -

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

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AEROSONIC CORPORATION AND SUBSIDIARY

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Unaudited)

Note 1 Basis of Presentation

The accompanying unaudited condensed consolidated financial statements of Aerosonic Corporation (the **Company**) have been prepared in accordance with generally accepted accounting principles for interim financial reporting and with the instructions to Form 10-Q and in accordance with Regulation S-X of the U.S. Securities and Exchange Commission (**SEC**). Accordingly, they do not include all of the information and footnotes required by generally accepted accounting principles for complete financial statements. The restated January 31, 2004 consolidated balance sheet has been derived from the audited consolidated financial statements that the Company plans to amend (as described in Note 6), but does not include all of the disclosures required by generally accepted accounting principles. The financial statements are prepared on a consistent basis (including normal recurring adjustments) and should be read in conjunction with the impact of the proposed amendment described in Note 6 upon the audited consolidated financial statements and related notes contained in the Annual Report on Form 10-K for the fiscal year ended January 31, 2004 (the **2004 Form 10-K**) that the Company filed with the SEC on April 6, 2004. Operating results for the three months and the six months ended July 30, 2004 are not necessarily indicative of the results that may be expected for the year ending January 31, 2005. The Company has changed its quarterly periods to coincide with the last Friday of each fiscal quarter for the first three fiscal quarters of each year. This is to more economically and conveniently use the Company s resources in calculating the closing figures for each quarter for which a Form 10-Q Report is required. This will not affect the January 31 fiscal yearend of the Company. Thus, this year s second quarter Form 10-Q ending on July 30, 2004 is contrasted with last year s July 31, 2003 second quarter.

Note 2 Business

The Company is principally engaged in one business segment: The manufacture and service of aircraft instruments. The Company consists of four operating divisions in three locations. The divisions are: the Clearwater, Florida Instrument Division (**Clearwater Instruments**), the Aerosonic Wichita, Kansas Division (**Kansas Instruments**), Avionics Specialties, Inc., a Virginia corporation wholly owned by the Company (**Avionics**), and the Precision Component Division (**Precision Components**).

Clearwater Instruments primarily manufactures altimeters, airspeed indicators, rate of climb indicators, microprocessor controlled air data test sets, and a variety of other flight instrumentation. Kansas Instruments is the source inspection location for our Wichita customers and is the primary location for Clearwater Instruments repair business. Avionics maintains three major product lines: (1) angle of attack stall warning systems; (2) integrated multifunction probes, which are integrated air data sensors; and (3) other aircraft sensors and monitoring systems. In August 1998, the Company formed a new division called Precision Components, to perform high volume precision machining of mechanical components, which was less than 10% of operations during the three months and the six months ended July 30, 2004 and July 31, 2003.

During the three months ended July 30, 2004, sales to Lockheed Martin Corporation represented approximately 14% of total revenues and sales to Mid-Continent Instrument Company Inc. represented approximately 10% of total revenues. During the six months ended July 30, 2004, sales to Lockheed represented approximately 17% of total revenues.

The Company has a January 31 fiscal year end. Accordingly, all references in this quarterly report on Form 10-Q to the second quarter mean the second quarter ended on July 30 of the referenced fiscal year. For example, references to the second quarter of fiscal year 2005 mean the second quarter ended July 30, 2004.

Note 3 Inventories

Inventories are stated at the lower of cost or market. Cost is determined using a method that approximates the first-in, first-out method. Provisions are made for any inventory deemed excess or obsolete. Management employs certain methods to estimate the value of work in process inventories for financial reporting purposes. At fiscal year end, these estimates are affected by the nature of the operation at which the items are located and the time at which a physical inventory is conducted, and are subject to judgment. This practice was employed for the fiscal year ended January 31, 2004. For interim reporting periods, the Company utilizes monthly work in process inventory reports to estimate the value of such inventories.

Inventories at July 30, 2004 and January 31, 2004 consisted of the following:

		July 30, 2004	**January 31, 2004**
Raw materials	.	$ 3,495,000	$ 3,756,000
Work in process	..	2,209,000	1,719,000
Finished goods		-	208,000
		$ 5,704,000	$ 5,683,000

Note 4 Long Term Debt and Notes Payable

The Company completed a refinancing of its existing debt with Wachovia Bank, N.A. (**Wachovia**) on February 25, 2004. The new facilities total approximately $5.7 million, and include a 15 year term loan of approximately $3.0 million that is collateralized by the Company s real estate in Clearwater, Florida (the **Clearwater real estate**), a revolving credit facility of approximately $2.5 million, and a seven year equipment loan of approximately $0.2 million. All of the Company s other assets (i.e., other than the Clearwater real estate) are subject to liens securing all three of the loans from Wachovia. This includes all assets of Avionics Specialties, Inc., the Company s wholly owned subsidiary. These facilities replace all of the Company s debt that was previously held by First Commercial Bank and SunTrust Bank, N.A.

Long term debt and notes payable at July 30, 2004 and January 31, 2004 consisted of the following:

		July 30, 2004	**January 31, 2004**(1)
Mortgage note payable Wachovia	...	$ 2,933,000	$ -
Equipment note payable Wachovia	.	206,000	-

Note payable First Commercial Bank .	-	717,000
Industrial development revenue bonds ...	-	668,000
Mortgage note payable SunTrust	-	391,000
Note payable, equipment First Commercial Bank ..	-	205,000
Note payable, II First Commercial Bank .	-	353,000
Capitalized leases	39,000	82,000
	3,178,000	2,416,000
Less current maturity .	269,000	1,497,000
Long-term debt and notes payable, less current maturity	$ 2,909,000	$ 919,000

(1)

The debt table described above reflects the repayment obligations as of January 31, 2004, but the financial statements reflect current maturities based upon the new debt agreements that were established in February 2004, as described above.

Covenants

The Company s long-term debt agreements with Wachovia contain certain financial and other restrictive covenants, including the requirement to maintain: (i) at all times, a ratio of total liabilities to tangible net worth that does not exceed 1.30 to 1.00: and (ii) at the end of each fiscal quarter, a cash flow coverage ratio (with regard to the debt service) of at least 1.25 to 1.00. As of July 30, 2004, the Company was in compliance with these financial covenants.

The Wachovia loan agreement subjects the Company to a number of additional covenants that, among other things, require the Company to obtain consent from the lender prior to making a material change of management, guarantee or otherwise become responsible for obligations of any other person or entity or assuming or becoming liable for any debt, contingent or direct, in excess of $100,000.

The Company s ability to maintain sufficient liquidity and compliance with covenants in fiscal year 2005 and beyond is highly dependent upon achieving expected operating results. Failure to achieve expected operating results and compliance with covenants could have a material adverse effect on the Company s liquidity and operations in fiscal year 2005 and beyond, and could require implementation of further measures, including deferring planned capital expenditures, reducing discretionary spending, and, if necessary, selling assets.

Note 5 Accrued Expenses

Accrued expenses as of July 30, 2004 and January 31, 2004 were approximately $1,620,000 and $2,343,000, respectively. A substantial portion of these expenses are related to amounts owed to subcontractors who participate in the Company s product development programs, as shown below:

	July 30, 2004	**January 31, 2004**
Product development programs	$ 904,000	$ 1,497,000
Other accrued expenses	716,000	846,000
	$ 1,620,000	$ 2,343,000

Note 6 Commitments, Contingencies and Subsequent Events

In accordance with a consent agreement with the Department of Environmental Protection signed by the Company in 1993, the Company s environmental consultant has developed an interim remedial action plan to contain and remediate certain contamination on and underlying the Company s property in Clearwater, Florida. During 1997, the Company recorded a provision of approximately $175,000 related to the estimated costs to be incurred under this plan. As of January 31, 2000, the Company had utilized all amounts originally recorded in other accrued expenses, and Phase I remediation had been completed.

During the third quarter of 2001, management determined the post-remediation monitoring expense related to the environmental cleanup of 1993 would cost approximately $125,000. This amount was accrued and expensed during the third quarter of 2001. As of January 31, 2004, all existing reserve balances had been utilized. Based upon information provided by the Company s environmental consultants, management estimates that the Company will incur post-remediation monitoring expenses of approximately $38,000, for which a reserve has been established as of January 31, 2004.

The Company s contractual obligations for future minimum payments under our purchase commitments, long term-debt and operating leases as of July 30, 2004 are as follows:

Contractual Obligations	Total	Payments Due by Period Less than One Year	1 - 3 years	4 - 5 years	> 5 years
Purchase commitments	$ 6,582,000	$ 6,283,000	$ 273,000	$ 26,000	$ -
Long-term debt	3,178,000	269,000	463,000	460,000	1,986,000
Operating leases	1,017,000	398,000	619,000	-	-
Total	$10,777,000	$ 6,940,000	$1,355,000	$ 486,000	$ 1,986,000

The Company is the subject of a Formal Order of Investigation issued by the U.S. Securities and Exchange Commission (the **SEC**) on May 13, 2003 with respect to potential violations of the federal securities laws in connection with the accounting misstatements and contributing causes disclosed by the Company in its 2003 Form 10-K that was filed with the SEC on October 31, 2003 and other potential issues. The Company brought these potential violations to the attention of the SEC in conjunction with management s internal investigation. The Company continues to cooperate fully with the SEC.

On November 12, 2003, a class action lawsuit was filed in the United States District Court for the Middle District of Florida by Sebastian P. Gaeta, individually and on behalf of all other similarly situated (the **Gaeta Suit**), against the Company, PricewaterhouseCoopers LLP, the Company s former independent accountant, J. Mervyn Nabors, a former director and former President and CEO of the Company, Eric J. McCracken, a former Chief Financial Officer of the Company, and Michael T. Reed, a former Controller of the Company. The action alleges violations of Sections 10(b) and 20(a) of the Securities Exchange Act of 1934 (the **Exchange Act**) and Rule 10b-5 promulgated under that act, including, among other things, that the Company made materially false statements concerning the Company s financial condition and its future prospects. The plaintiff alleges that he suffered damages as the result of his purchase and sale of the Company s Common Stock during the asserted Class Period from November 13, 1998 through March 17, 2003. The action seeks compensatory and other damages, and costs and expenses associated with the litigation.

Shortly after the Gaeta Suit was filed, two other putative class actions (the **"Pratsch Suit"** and **"Suarez Suit"**) were filed against the same defendants as in the Gaeta Suit and predicated upon alleged violations of the same securities laws, asserting that plaintiffs purchased the Company s stock at artificially inflated prices during the Class Period and have been damaged thereby. The Pratsch Suit and Suarez Suit assert a Class Period from May 3, 1999 through March 17, 2003. At a February 27, 2004 hearing, plaintiffs in the Suarez Suit voluntarily withdrew their complaint. On February 27, 2004, the Court entered an order consolidating the Gaeta Suit and Pratsch Suit into one case entitled "In re Aerosonic Corporation Securities Litigation," appointing Lead Plaintiffs (the "Miville Group"), and approving the selection of Lead Plaintiffs Counsel (Berger & Montague P.C.). On April 27, 2004, Lead Plaintiffs filed an amended and consolidated class action complaint that alleges violations of Sections 10(b) and 20(a) of the Exchange Act and Rule 10b-5 including, among other things, that the Company made materially false statements concerning the Company s financial condition and its future prospects. The amended complaint also added as a defendant Andrew Nordstrud, a former employee of the company. On June 28, 2004, the Company responded to the amended complaint by filing a motion to dismiss, and each of the other defendants also moved to dismiss the amended complaint. On August 27, 2004, Lead Plaintiffs filed a memorandum of law as a comprehensive opposition to the motion to dismiss.

The outcome of the consolidated class action lawsuit cannot be adequately determined, and the impact upon the Company cannot be assessed, at this time. Any resolution of such litigation could have a material adverse effect upon the Company s financial position, results of operations, and cash flow.

In June 2004, the Company received a notice from the IRS that disallowed refund claims made by the Company when it filed amended tax returns for the January 31, 1998 and 1999 tax years in December 2003. The Company prepared its July 30, 2004 Balance Sheet and revised its January 31, 2004 Balance Sheet that are presented in this Form 10-Q to reflect the impact of this event. The revisions include reductions of $873,000 in both Income taxes receivable and Stockholders equity . The impact of these changes will result in a prior period adjustment to the Company s January 31, 2000 balance sheet that flow through the balance sheets in each subsequent year. The Company is presently preparing amendments to its Annual Report on Form 10-K for the fiscal year ended January 31, 2004 and its Quarterly Report on Form 10-Q for the fiscal quarter ended April 30, 2004 to incorporate this change. The Company intends to continue working with its tax advisors to determine if any potential additional deferred tax benefits that result from this change can be realized in any periods subsequent to January 31, 2000, including any future periods.

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Item 2

Management s Discussion and Analysis of Financial Condition and Results of Operations (MD&A)

Results of Operations

Revenues for the second quarter increased approximately $191,000 when compared to the second quarter of fiscal year 2004. Increases in core instrument revenues and revenues from repairs and spare parts of approximately $682,000 and approximately $478,000, respectively, were offset by decreases in Precision Components revenues of approximately $383,000 and expected slower progress on the Joint Strike Fighter (**JSF**) development program of approximately $586,000.

Revenues for the six months ended July 30, 2004 decreased approximately $1,457,000 when compared to the six months ended July 31, 2003. This resulted primarily from reduced revenues on the JSF program of approximately $1,453,000.

Gross profit for the three months ended July 30, 2004 increased by approximately 24%, or approximately $521,000, when compared to the second quarter of fiscal year 2004. Approximately $54,000 of this change is due to an increase in volume, while the remaining change of approximately $467,000 is due to changes in the revenue mix due to revenue increases in core instruments, repairs and spare parts that yield higher margins than do revenues from development programs.

Gross profit for the six months ended July 30, 2004 decreased by approximately 8%, or approximately $383,000, when compared to the six months ended July 31, 2003. A volume-related reduction in gross profit margin of approximately $451,000 was partially offset by an increase in gross profit margin of approximately $67,000 due to changes in the revenue mix.

Selling, general and administrative expenses for the second quarter decreased approximately $221,000 when compared to the three months ended July 31, 2003. This decrease is primarily attributable to the reductions in audit fees of approximately $407,000 and legal fees of approximately $203,000. These decreases were partially offset by an increase in engineering expenses of approximately $320,000 as the Company expands its Clearwater, Florida engineering capabilities in conjunction with its development of instrumentation for the Cessna Mustang business jet and an increase in sales-related travel and commissions of approximately $78,000.

Selling, general and administrative expenses for the six months ended July 30, 2004 decreased approximately $785,000 when compared to the six months ended July 31, 2003. This decrease is primarily attributable to the reductions in audit fees of approximately $674,000 and legal fees of approximately $473,000. These decreases were partially offset by an increase in engineering expenses of approximately $384,000 as the Company expands its

Clearwater, Florida engineering capabilities in conjunction with its development of instrumentation for the Cessna Mustang business jet.

Interest expense decreased approximately $7,000 for the three months ended July 30, 2004 when compared to the three months ended July 31, 2003. This decrease is partially due to lower interest rates as well as slightly lower average debt balances.

Interest expense decreased approximately $54,000 for the six months ended July 30, 2004 when compared to the six months ended July 31, 2003. This decrease is partially due to lower interest rates as well as slightly lower average debt balances, but is largely due to the receipt of interest payments of approximately $41,000 in conjunction with the Company s receipt of income tax refunds in April 2004.

Miscellaneous income increased approximately $1,061,000 for the three months ended July 30, 2004 when compared to the three months ended July 31, 2003. As disclosed in the Subsequent Events section of the Company s Quarterly Report on Form 10-Q for the period ended April 30, 2004, the Company submitted a claim to its insurance carrier in April 2004 for the reimbursement of additional business interruption expenses that were identified as having been incurred as a result of a small fire that had occurred in the Company s machine shop at its Clearwater, Florida operations. In May 2004, after further negotiations, the Company and the insurance carrier reached a settlement whereby the Company would be reimbursed a total of approximately $1,214,000 as a result of the business interruption. The Company received the remaining payment of approximately $997,000 on May 25, 2004.

Miscellaneous income increased approximately $1,178,000 for the six months ended July 30, 2004 when compared to the six months ended July 31, 2003. This increase is primarily due to the insurance recovery described in the preceding paragraph as well as the Company s sale of its Engine Vibration Monitoring System (**EVMS**) product line inventory in February 2004 that resulted in miscellaneous income of approximately $170,000.

Income tax expense increased approximately $565,000 for the three months ended July 30, 2004 when compared to the three months ended July 31, 2003. The Company recognized a non-recurring benefit through a reduction in its deferred tax asset valuation allowance in the three months ended July 31, 2003.

Income tax expense increased approximately $684,000 for the six months ended July 30, 2004 when compared to the six months ended July 31, 2003. The Company recognized a non-recurring benefit through a reduction in its deferred tax asset valuation allowance in the six months ended July 31, 2003.

Liquidity and Capital Resources

Cash used in operating activities was approximately $847,000 for the six months ended July 30, 2004 an increase of approximately $2,488,000 when compared to cash provided during the six months ended July 31, 2003. This increase in cash usage is primarily attributable to:

A decrease due to accounts payable of approximately $1,787,000 as the Company negotiated reductions in or paid the remainder of its aged audit and legal fees that existed as of July 31, 2003 that were related to the financial restatement as reported in the Company s Annual Report on Form 10-K for the fiscal year ended January 31, 2003

A decrease due to accrued expenses and other liabilities of approximately $2,117,000 primarily due to the Company s decreasing its liabilities to suppliers for the JSF contract by approximately $1,309,000, attorneys by approximately $170,000 and auditors by approximately $673,000 versus the increase in such liabilities that occurred for the six months ended July 31, 2003

A decrease due to accounts receivable of approximately $1,174,000 due to an increase in revenue plus the issuance of an invoice to Lockheed for $895,000 at the end of the quarter for a milestone billing on the JSF project

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A decrease of approximately $140,000 due to a reduction in the allowance for doubtful accounts for the write-off