

MECHANICAL TECHNOLOGY INC  
Form 10-K/A  
March 22, 2005

UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D.C. 20549  
FORM 10-K/A  
AMENDMENT NO. 2

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

For the fiscal year ended December 31, 2003

or

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

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission file number 0-6890

MECHANICAL TECHNOLOGY INCORPORATED

(Exact name of registrant as specified in its charter)

New York	14-1462255
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
431 New Karner Road, Albany, New York	12205
(Address of principal executive offices)	(Zip Code)

Registrant's telephone number, including area code: (518) 533-2200

Securities registered pursuant to Section 12(b) of the Act: NONE

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

\$1.00 Par Value Common Stock

NA

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(Title of class)

(Name of exchange on which registered)

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

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K (Section 229.405 of this chapter) is not contained herein, and will not be contained, to the best of Registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K/A or any amendment to this Form 10-K/A.

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

The aggregate market value of the voting and non-voting Registrant's common stock held by non-affiliates of the Registrant on June 30, 2003 (based on the last sale price of \$3.10 per share for such stock reported by NASDAQ for that date) was approximately \$65,436,028.

As of April 28, 2004, the Registrant had 29,224,666 shares of common stock outstanding.

\*Please see the Explanatory Note below.

DOCUMENTS INCORPORATED BY REFERENCE: None

#### EXPLANATORY NOTE

This Annual Report on Form 10-K/A ("Form 10-K/A") is being filed as Amendment No. 2 to the Registrant's Annual Report on Form 10-K for the fiscal year ended December 31, 2003. This Form 10-K/A is filed with the Securities and Exchange Commission (the "Commission") for the purpose of filing financial statements of Plug Power Inc. and SatCon Technology Corporation in accordance with the requirements of Rule 3-09 of Regulation S-X and filing the Consents from their auditors. And revisions to Note 14, Equity in Holdings' Losses, Net of Tax.

#### PART II

#### ITEM 8: FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

The financial statements filed herewith are set forth on the Index to

Consolidated Financial Statements on Page F-1 of the separate financial section.



MECHANICAL TECHNOLOGY INCORPORATED AND SUBSIDIARIES

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REPORT OF INDEPENDENT AUDITORS

To the Board of Directors and Shareholders  
of Mechanical Technology Incorporated

In our opinion, the accompanying consolidated balance sheets and the related consolidated statements of operations, shareholders' equity and comprehensive income (loss) and of cash flows present fairly, in all material respects, the financial position of Mechanical Technology Incorporated at December 31, 2003 and 2002, and the results of their operations and their cash flows for the years ended December 31, 2003 and 2002, the three month period ended December 31, 2001, and for the year ended September 30, 2001, in conformity with accounting principles generally accepted in the United States of America. These financial statements are the responsibility of the Company's management; our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits of these statements in accordance with auditing standards generally accepted in the United States of America, which require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

As discussed in Note 1 to the financial statements, the Company adopted Statement of Financial Accounting Standards No. 142, *Goodwill and Other Intangible Assets*, on January 1, 2002, Emerging Issues Task Force Issue 00-19, *Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in a Company's own Stock* on June 30, 2001, and Financial Accounting Standards No. 133, *Accounting for Derivative Instruments and Hedging Activities* on October 1, 2000. Additionally, as discussed in Note 1, the Company changed its method of accounting for its investments in Plug Power Inc. and SatCon Technology Corporation on December 20, 2002 and July 1, 2002, respectively.

/s/PricewaterhouseCoopers LLP

Albany, New York

February 13, 2004

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## MECHANICAL TECHNOLOGY INCORPORATED AND SUBSIDIARIES

## CONSOLIDATED BALANCE SHEETS

December 31, 2003 and 2002

(Dollars in thousands)

	<u>2003</u>	<u>2002</u>
Assets		
Current Assets:		
Cash and cash equivalents	\$12,380	\$ 7,320
Securities available for sale	44,031	37,332
Accounts receivable, less allowances of \$0 in 2003 and 2002	962	1,445
Inventories	1,300	1,378
Prepaid expenses and other current assets	<u>514</u>	<u>668</u>
Total Current Assets	59,187	48,143

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Derivative assets	-	6
Property, plant and equipment, net	1,999	1,558
Deferred income taxes	4,652	2,677
Notes receivable - noncurrent, less allowance of \$660 in 2003 and 2002	=	=
Total Assets	<u>\$65,838</u>	<u>\$52,384</u>



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

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MECHANICAL TECHNOLOGY INCORPORATED AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS

December 31, 2003 and 2002

(Dollars in thousands)

2003

2002

Liabilities and Shareholders' Equity

Current Liabilities:

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Accounts payable	\$ 692	\$ 761
Accrued liabilities	1,528	1,543
Accrued liabilities - related parties	48	190
Income taxes payable	12	92
Deferred income taxes	<u>14,481</u>	<u>8,876</u>
Total Current Liabilities	16,761	11,462
Long-Term Liabilities:		
Other credits	<u>24</u>	<u>24</u>
Total Liabilities	<u>16,785</u>	<u>11,486</u>
Commitments and Contingencies		
Minority interests	<u>787</u>	<u>150</u>
Shareholders' Equity		
Common stock, par value \$1 per share, authorized 75,000,000; 35,776,510 issued in 2003 and 35,648,135 issued in 2002	35,776	35,648
Paid-in-capital	68,708	67,479
Accumulated deficit	<u>(62,433)</u>	<u>(61,874)</u>
	)	)
	42,051	41,253
Accumulated Other Comprehensive Income:		
Unrealized gain on available for sale securities, net of tax	19,944	13,170
Restricted stock grant	-	(40)
Common stock in treasury, at cost,		

8,035,974 shares in 2003 and

8,020,250 shares in 2002	<u>(13,729)</u>	<u>(13,635)</u>
	)	)
Total Shareholders' Equity	<u>48,266</u>	<u>40,748</u>
Total Liabilities and Shareholders' Equity	<u>\$ 65,838</u>	<u>\$ 52,384</u>

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

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MECHANICAL TECHNOLOGY INCORPORATED AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF OPERATIONS

For the Years Ended December 31, 2003 and 2002,

Three Months Ended December 31, 2001 and the Year Ended September 30, 2001

(Dollars in thousands, except per share)

Year Ended	Year Ended	Three Months Ended	Year Ended
Dec. 31,	Dec. 31,	Dec. 31,	Sept. 30,
<u>2003</u>	<u>2002</u>	<u>2001</u>	<u>2001</u>

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Product revenue	\$ 5,547	\$ 5,362	\$ 1,246	\$ 7,298
Funded research and development revenue	<u>2,311</u>	<u>1,573</u>	<u>90</u>	=
Total revenue	7,858	6,935	1,336	7,298
Operating costs and expenses:				
Cost of product revenue	2,382	2,428	688	3,150
Research and product development expenses:				
Funded research and product development	3,763	2,560	187	-
Unfunded research and product development	<u>4,585</u>	<u>4,055</u>	<u>874</u>	<u>3,684</u>
Total research and product development expenses	8,348	6,615	1,061	3,684
Selling, general and administrative expenses	<u>5,837</u>	<u>4,951</u>	<u>1,357</u>	<u>6,159</u>
Operating loss	(8,709)	(7,059)	(1,770)	(5,695)
Interest	(7)	(46)	(15)	(1,970)
Loss on derivatives	(6)	(188)	(26)	(1,266)
Gain on derivatives, Company stock	-	-	165	922
Gain (loss) on sale of securities available for sale, net	7,483	(444)	-	-
Gain on sale of holdings, net	-	6,369	-	28,838
Gain on exchange of securities	-	8,006	-	-
Impairment losses	(418)	(8,127)	(15,433)	-
Other expense, net	<u>(74)</u>	<u>(80)</u>	<u>(82)</u>	<u>(93)</u>
	)	)	)	)
(Loss) income from continuing operations before income taxes, equity in holdings' losses and minority				

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interests	(1,731)	(1,569)	(17,161)	20,736
Income tax benefit (expense)	669	636	6,788	(7,524)
Equity in holdings' losses (net of tax benefit of \$4,550 in 2002, \$2,169 in Transition Period and \$9,722 in 2001)	-	(6,671)	(3,316)	(17,072)
Minority interests in losses of consolidated subsidiary	<u>490</u>	<u>418</u>	<u>104</u>	<u>123</u>
Loss from continuing operations	(572)	(7,186)	(13,585)	(3,737)
Income from discontinued operations (net of taxes of \$8 in 2003 and \$154 in 2002)	<u>13</u>	<u>225</u>	=	=
Loss before cumulative effects of changes in accounting principles	(559)	(6,961)	(13,585)	(3,737)
Cumulative effect of accounting change for derivative financial instruments for Company's own stock, net of tax expense of \$1,000	-	-	-	1,468
Cumulative effect of accounting change for derivative financial instruments, net of tax expense of \$3,876	=	=	=	<u>6,110</u>
Net (loss) income	<u>\$(559)</u>	<u>\$(6,961)</u>	<u>\$(13,585)</u>	<u>\$ 3,841</u>

)

(Loss) Earnings per Share (Basic and Diluted):

Loss from continuing operations	\$ (.02)	\$ (.21)	\$ (.38)	\$ (.10)
Income from discontinued operations	-	.01	-	-

Cumulative effect of accounting change for derivative financial instruments for Company's own stock	-	-	-	.04
Cumulative effect of accounting change for derivative financial instruments	=	=	=	<u>.17</u>
(Loss) earnings per share	\$ <u>(.02)</u>	\$ <u>(.20)</u>	\$ <u>(.38)</u>	\$ <u>.11</u>

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

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MECHANICAL TECHNOLOGY INCORPORATED AND SUBSIDIARIES  
CONSOLIDATED STATEMENTS OF SHAREHOLDERS' EQUITY  
AND COMPREHENSIVE INCOME (LOSS)

For the Years Ended December 31, 2003 and 2002,

Three Months Ended December 31, 2001 and the Year Ended September 30, 2001

(Dollars in thousands)

	Year Ended	Year Ended	Three Months Ended	Year Ended
	Dec. 31,	Dec. 31,	Dec. 31,	Sept. 30,
COMMON STOCK	<u>2003</u>	<u>2002</u>	<u>2001</u>	<u>2001</u>
Balance, beginning	\$ 35,648	\$ 35,505	\$ 35,505	\$ 35,437
Issuance of shares - options	128	93	-	68
Issuance of shares - restricted stock	=	<u>50</u>	=	=
Balance, ending	\$ <u>35,776</u>	\$ <u>35,648</u>	\$ <u>35,505</u>	\$ <u>35,505</u>

## PAID-IN-CAPITAL

Balance, beginning	\$ 67,479	\$ 67,045	\$ 65,103	\$ 54,790
Issuance of shares - options	93	18	-	3
MTI MicroFuel Cell investment	881	(28)	46	1,163
Plug Power holding, net of taxes	-	430	131	8,678
SatCon holding, net of taxes	-	(90)	1,677	2,506
Compensatory options	32	49	13	(14)
Reclassification of common stock warrants from equity to liability, net of taxes	-	-	75	(2,207)
Stock option exercises recognized differently for financial reporting and tax purposes	<u>223</u>	<u>55</u>	=	<u>184</u>
Balance, ending	<u>\$ 68,708</u>	<u>\$ 67,479</u>	<u>\$ 67,045</u>	<u>\$ 65,103</u>

## ACCUMULATED DEFICIT

Balance, beginning	\$(61,874)	\$(54,913)	\$(41,328)	\$(45,169)
Net (loss) income	<u>(559)</u>	<u>(6,961)</u>	<u>(13,585)</u>	<u>3,841</u>
	)	)	)	)
Balance, ending	<u>\$(62,433)</u>	<u>\$(61,874)</u>	<u>\$(54,913)</u>	<u>\$(41,328)</u>

ACCUMULATED OTHER  
COMPREHENSIVE INCOME

(LOSS):

UNREALIZED GAIN (LOSS) ON  
AVAILABLE FOR

## SALE SECURITIES, NET OF TAXES

Balance, beginning	\$ 13,170	\$ -	\$ (5,204)	\$ -
Change in unrealized gain (loss) on				

available for sale securities (net of taxes of \$6,705 in 2003, \$8,781 in 2002, \$3,469 in Transition Period and \$(3,469) in 2001)	10,057	13,170	5,204	(5,204)
Less reclassification adjustment for gains included in net income (net of taxes of \$(2,189) in 2003)	<u>(3,283)</u>	=	=	=
)				
Balance, ending	<u>\$ 19,944</u>	<u>\$ 13,170</u>	<u>\$ -</u>	<u>\$ (5,204)</u>
TREASURY STOCK				
Balance, beginning	\$(13,635)	\$ (29)	\$ (29)	\$ (29)
Stock acquisition	<u>(94)</u>	<u>(13,606)</u>	=	=
)		)		
Balance, ending	<u>\$(13,729)</u>	<u>\$(13,635)</u>	<u>\$ (29)</u>	<u>\$ (29)</u>
RESTRICTED STOCK GRANTS				
Balance, beginning	\$ (40)	\$ -	\$ -	\$ -
Grants issued	-	(50)	-	-
Grants vested	<u>40</u>	<u>10</u>	=	=
Balance, ending	<u>\$ -</u>	<u>\$ (40)</u>	<u>\$ -</u>	<u>\$ -</u>
TOTAL SHAREHOLDERS' EQUITY	<u>\$ 48,266</u>	<u>\$ 40,748</u>	<u>\$ 47,608</u>	<u>\$ 54,047</u>
TOTAL COMPREHENSIVE INCOME (LOSS):				
Net (loss) income	\$ (559)	\$ (6,961)	\$(13,585)	\$ 3,841
Other comprehensive income (loss):				
Change in unrealized gain (loss) on available for sale securities, net	<u>6,774</u>	<u>13,170</u>	<u>5,204</u>	<u>(5,204)</u>

)



Total comprehensive income (loss)	\$ <u>6,215</u>	\$ <u>6,209</u>	\$ <u>(8,381)</u>	\$ <u>(1,363)</u>
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The accompanying notes are an integral part of the consolidated financial statements.

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MECHANICAL TECHNOLOGY INCORPORATED AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS

For The Years Ended December 31, 2003 and 2002,

Three Months Ended December 31, 2001 and the Year Ended September 30, 2001

(Dollars in thousands)

	Year Ended Dec. 31, <u>2003</u>	Year Ended Dec. 31, <u>2002</u>	Three Months Ended Dec. 31, <u>2001</u>	Year Ended Sept. 30, <u>2001</u>
<b>OPERATING ACTIVITIES</b>				
Net (loss) income excluding discontinued operations	\$ (572)	\$(7,186)	\$(13,585)	\$ 3,841
Adjustments to reconcile net (loss) income to net cash used by operating activities:				
Cumulative effect of accounting change for derivative financial instruments, gross	-	-	-	(9,986)
Cumulative effect of accounting change for derivative financial instruments for Company's own stock, gross	-	-	-	(2,468)
Loss on derivatives	6	188	26	1,266
Gain on derivatives, Company stock	-	-	(165)	(922)
Loss on retirement of subsidiary treasury stock	5	-	-	-
Impairment losses	418	8,127	15,433	-

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Loss on warrant issued by subsidiary	-	-	98	-
Stock dividend	-	-	-	(827)
Capitalized interest	-	-	-	107
(Gain) loss on sale of securities available for sale, net	(7,483)	444	-	-
Gain on sale of holdings, net	-	(6,369)	-	(28,838)
Gain on exchange of securities	-	(8,006)	-	-
Depreciation and amortization	599	592	128	1,761
Minority interests in losses of consolidated subsidiary	(490)	(418)	(104)	(123)
Equity in holdings' losses, gross	-	11,221	5,485	26,794
Allowance for bad debts	-	-	-	(250)
Loss on disposal of fixed assets	26	15	-	4
Deferred income taxes and other credits	(671)	(4,974)	(9,034)	2,197
Stock based compensation	72	59	13	(14)
Changes in operating assets and liabilities net of effects from discontinued operations:				
Accounts receivable	483	(543)	(316)	107
Inventories	78	132	164	(481)
Prepaid expenses and other current assets	161	266	52	(166)
Accounts payable	(68)	116	(164)	524
Income taxes	(80)	64	3	16
Accrued liabilities - related parties	(142)	89	98	(6)
Accrued liabilities	<u>(15)</u>	<u>(89)</u>	<u>(313)</u>	<u>342</u>
	)	)		

Net cash used by operating activities excluding

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discontinued operations	(7,673)	(6,272)	(2,181)	(7,122)
Discontinued Operations:				
Income from discontinued operations	13	225	-	-
Deferred income taxes and other credits	8	154	-	-
Changes in net liabilities/assets	=	<u>(356)</u>	<u>(2)</u>	<u>127</u>
	)	)		
Net cash provided (used) by discontinued operations	<u>21</u>	<u>23</u>	<u>(2)</u>	<u>127</u>
	)	)		
Net cash used by operating activities	<u>(7,652)</u>	<u>(6,249)</u>	<u>(2,183)</u>	<u>(6,995)</u>
	)	)		
INVESTING ACTIVITIES				
Purchases of property, plant & equipment	(1,070)	(527)	(81)	(1,318)
Proceeds from sale of securities available for sale	11,654	865	-	-
Proceeds from sale of holdings	-	9,969	-	37,842
Change in restricted cash equivalents, net	-	14	64	1,064
Principal payments from notes receivable	=	<u>25</u>	<u>225</u>	<u>191</u>
Net cash provided by investing activities	<u>10,584</u>	<u>10,346</u>	<u>208</u>	<u>37,779</u>
FINANCING ACTIVITIES				
Proceeds from stock option exercises	221	111	-	71
Net proceeds from subsidiary stock issuance	2,001	-	295	867
Purchase of common stock for treasury	(94)	-	-	-
Treasury stock purchase by subsidiary	-	(15)	-	-
Financing costs	-	-	-	(1,360)
Net payments on related party debt	-	-	-	(107)
Payments under lines-of-credit	-	(1,000)	(4,000)	(23,200)

Borrowings under lines-of-credit	=	=	=	<u>1,200</u>
Net cash provided (used) by financing activities	<u>2,128</u>	<u>(904)</u>	<u>(3,705)</u>	<u>(22,529)</u>
	)	)		
Increase (decrease) in cash and cash equivalents	5,060	3,193	(5,680)	8,255
Cash and cash equivalents - beginning of year	<u>7,320</u>	<u>4,127</u>	<u>9,807</u>	<u>1,552</u>
Cash and cash equivalents - end of year	<u>\$12,380</u>	<u>\$ 7,320</u>	<u>\$ 4,127</u>	<u>\$ 9,807</u>

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

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## MECHANICAL TECHNOLOGY INCORPORATED AND SUBSIDIARIES

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

#### 1. Accounting Policies

##### Principles of Consolidation

The consolidated financial statements include the accounts of the Company and its majority-owned subsidiaries. The equity method of accounting is used for holdings in entities over which the Company has significant influence, generally this represents common stock ownership or partnership equity of at least 20% and not more than 50%, or where the Company has the ability to exercise significant influence over operating and financial policies of the underlying entity. All significant intercompany transactions are eliminated in consolidation.

Minority interest in subsidiaries consists of equity securities issued by a subsidiary of the Company. No gain or loss was recognized as a result of the issuance of these securities, and the Company owned a majority of the voting equity of the subsidiary both before and after the transactions.

Under the equity method of accounting, the Company recognized its proportionate share of income or loss of holdings. Holdings' losses were generally recognized only to the extent of holdings. Changes in equity of holdings, other than income or loss, which changed the Company's proportionate interest in the underlying equity of holdings, were generally accounted for as changes in holdings and additional paid-in-capital. Non-monetary contributions to equity holdings were recorded at book value, and if the Company's calculated share of net assets of holdings exceeded the book value of non-monetary contributions, the difference was accounted for as a basis difference. Original differences between the Company's carrying amount of an equity holding and its calculated share of the holding's net assets were treated as an embedded difference if the Company's carrying amount was higher, or as a basis difference if lower. Until January 1, 2002, embedded differences were amortized into net income (loss) from holdings generally over a five-year period while basis differences were generally not amortized due to the research and development nature of holdings. Upon an equity holdings' initial public offering, basis differences were eliminated in connection with the change in equity. Impairment was measured in accordance with the Company's Asset Impairment Policy.

##### Change in Year-End

On February 13, 2002, the Company changed its fiscal year-end from September 30 to December 31, effective with the calendar year beginning January 1, 2002. A three-month transition period from October 1, 2001

through December 31, 2001 (the "Transition Period") precedes the start of the 2002 fiscal year. "2001" refers to the year ended September 30, the Transition Period refers to the three months ended December 31, 2001, and "2003" and "2002" refer to the twelve months ended December 31. This new fiscal year made the Company's annual and quarterly reporting periods consistent with those used by Plug Power Inc. ("Plug Power") and permitted the Company to continue to account for its holdings in Plug Power on a timely basis through December 20, 2002, the date of its change in accounting for Plug Power from the equity method to the fair value method.

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## MECHANICAL TECHNOLOGY INCORPORATED AND SUBSIDIARIES

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

#### 1. Accounting Policies

(Continued)

##### Change in Accounting for Holdings

SatCon Technology Corporation ("SatCon")

The Company's holdings in SatCon were accounted for on a one-quarter lag under the equity method of accounting from their acquisition date through

July 1, 2002. On July 1, 2002, the Company determined that it no longer had the ability to exercise significant influence over the operating and financial policies of SatCon as a result of waiving the Company's right to nominate and recommend directors to SatCon's board and our reduction

of ownership in SatCon and, therefore, accounted for its investment

in SatCon since July 1, 2002 using the fair value method as set forth in Statement of Financial Accounting Standards ("SFAS") No. 115, *Accounting for Certain Debt and Equity Securities*. The Company was no longer required to record its share of any losses from SatCon and the investment was carried at fair value, designated as available for sale and any unrealized holding gains or losses were included in stockholders' equity as a component of accumulated other comprehensive income (loss) until the investment was sold during 2003.

##### Plug Power

The Company's holdings in Plug Power were accounted for under the equity method of accounting from their acquisition date through December 20, 2002. On December 20, 2002, the Company determined that it no longer had the ability to exercise significant influence over the operating and financial policies of Plug Power as a result of its reduced ownership in Plug Power and, therefore, accounted for its investment in Plug Power since December 20, 2002 using the fair value method as set forth in SFAS No. 115, *Accounting for Certain Debt and Equity Securities*. The Company was no longer required to record its share of any losses from Plug Power and the holding was carried at fair value, designated as available for sale and any unrealized holding gains or losses were included in stockholders' equity as a component of accumulated other comprehensive income (loss).

##### Use of Estimates

The preparation of the consolidated financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the consolidated financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

#### Fair Value of Financial Instruments

The Company's financial instruments consist of cash and cash equivalents, marketable securities, accounts receivable, unbilled contract costs and fees, warrants to purchase shares of common stock and accounts payable. The estimated fair value of these financial instruments approximate their carrying values at December 31, 2003 and 2002. The estimated fair values have been determined through information obtained from market sources, where available, or Black-Scholes valuations.

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## MECHANICAL TECHNOLOGY INCORPORATED AND SUBSIDIARIES

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

#### **1. Accounting Policies**

(Continued)

#### Accounting for Derivative Instruments

On October 1, 2000, the Company adopted Statement of Financial Accounting Standards ("SFAS") No. 133, *Accounting for Derivative Instruments and Hedging Activities*, which establishes a new model for accounting for derivatives and hedging activities. It requires an entity to recognize all derivatives as either assets or liabilities in the statement of financial position and measure these instruments at fair value. Upon adoption of SFAS No. 133, the Company recorded an unrealized gain on its investment in derivatives, consisting of warrants to purchase SatCon and Beacon Power Corporation ("Beacon Power") common stock, in its results of operations as a cumulative effect of a change in accounting principle of \$6.110 million, net of tax, to reflect the impact of adopting this accounting standard on October 1, 2000.

In September 2000, the Emerging Issues Task Force ("EITF") issued EITF Issue No. 00-19, *Accounting for Derivative Financial Instruments Indexed to and Potentially Settled in, a Company's Own Stock*, which requires

freestanding contracts that are settled in a company's own stock, including common stock warrants, to be designated as an equity instrument, asset or a liability. Under the provisions of EITF Issue No. 00-19, a contract designated as an asset or a liability must be carried at fair value, with any changes in fair value recorded in the results of

operations. A contract designated as an equity instrument must be included within equity, and no fair value adjustments are required. In accordance with EITF Issue No. 00-19, the Company determined that outstanding warrants as of September 30, 2001 to purchase 300,000 shares of the Company's common stock issued to SatCon should be designated as a liability. Effective June 30, 2001, all warrants designated as a liability must be recorded as a liability and therefore, the Company reclassified the warrants designated as a liability from equity to liabilities, which had a fair value on the issuance date of \$3.678 million, using the Black Scholes option-pricing model.

Additionally on June 30, 2001, the Company recorded the warrants at the current fair value of \$1.210 million, using the Black-Scholes option-pricing model, and recorded a \$1.468 million gain, net of tax in its results of operations as a cumulative effect of a change in accounting principle. Effective December 28, 2001, the Company amended these warrants, removing the provisions providing the warrant holders with rights that rank higher than those of common stockholders. As a result of the amendment, these warrants meet the criteria of equity instruments in accordance with EITF Issue No. 00-19 and, therefore, the Company reclassified the value of these warrants to equity from liabilities.

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MECHANICAL TECHNOLOGY INCORPORATED AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

**1. Accounting Policies**

(Continued)

The Company held or has outstanding the following derivative financial instruments:

	Dec. 31, <u>2003</u>	Dec. 31, <u>2002</u>	<u>Expiration</u>
Derivatives issued:			
Warrants, immediately exercisable, to purchase the Company's common stock issued to SatCon at a purchase price of \$12.56 per share	-	108,000	October 21, 2003
Warrants, immediately exercisable, to purchase the Company's common stock issued to SatCon at a purchase price of \$12.56 per share	192,000	192,000	January 31, 2004

Derivatives held:

Warrants, immediately exercisable, to purchase

SatCon common stock at a purchase

price of \$7.84 per share - 36,000 October 21, 2003

Warrants, immediately exercisable, to purchase

SatCon common stock at a purchase price of \$7.84

per share 64,000 64,000 January 31, 2004

Inventories

Inventories are stated at the lower of cost (first-in, first-out) or market.

Property, Plant, and Equipment

Property, plant and equipment are stated at cost and depreciated using primarily the straight-line method over their estimated useful lives:

Leasehold improvements	Lesser of the life of the lease or the useful life of the improvement
Machinery and equipment	2 to 10 years
Office furniture, equipment and fixtures	2 to 10 years

Significant additions or improvements extending assets' useful lives are capitalized; normal maintenance and repair costs are expensed as incurred. The costs of fully depreciated assets remaining in use are included in the respective asset and accumulated depreciation accounts. When items are sold or retired, related gains or losses are included in net income.

Income Taxes

The Company accounts for taxes in accordance with SFAS No. 109, *Accounting for Income Taxes*, which requires the use of the asset and liability method of accounting for income taxes. Under the asset and liability method, deferred income taxes are recognized for the tax consequences of "temporary differences" by applying enacted statutory tax rates applicable for future years to differences between financial statement and tax bases of existing assets and liabilities. Under SFAS No. 109, the effect of tax rate changes on deferred taxes is recognized in the income tax provision in the period that includes the enactment date. The provision for taxes is reduced by investment and other tax credits in the years such credits become available. A valuation allowance is recorded to reduce the carrying amounts of deferred tax assets unless it is more likely than not that such assets will be realized.



MECHANICAL TECHNOLOGY INCORPORATED AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

**1. Accounting Policies**

(Continued)

Revenue Recognition

The Company recognizes revenue from product sales in accordance with Staff Accounting Bulletins ("SAB") No. 104, *Revenue Recognition*. Product revenue is recognized when there is persuasive evidence of an arrangement, delivery of the product to the customer or distributor has occurred, at which time title generally is passed to the customer or distributor, and the Company has determined that collection of a fixed fee is probable, all of which occur upon shipment of the product. If the product requires installation to be performed by the Company, all revenue related to the product is deferred and recognized upon the completion of the installation.

The Company performs funded research and development for government agencies and companies under cost reimbursement contracts, which generally require the Company to absorb up to 50% of the total costs incurred. Cost reimbursement contracts provide for the reimbursement of allowable costs. Revenues are generally recognized in proportion to the reimbursable costs incurred. When government agencies are providing funding they do not expect the government to be the only significant end user of the resulting products. These contracts do not require delivery of products that meet defined performance specifications, but are best efforts arrangements to achieve overall research and development objectives. Included in accounts receivable are billed and unbilled work-in-progress on cost reimbursed contracts.

While the Company's accounting for these contract costs is subject to audit by the sponsoring entity, in the opinion of management, no material adjustments are expected as a result of such audits. Cost of

product revenue includes material, labor and overhead. Costs incurred in connection with funded research and development arrangements are included in funded research and product development expenses.

Deferred revenue consists of payments received from customers in advance of services performed, products shipped or installation completed.

Warranty

The Company records a warranty reserve at the time product revenue is recorded based on a historical rate. The reserve is reviewed during the year and is adjusted, if appropriate, to reflect new product offerings or changes in experience. Actual warranty claims are tracked by product.

Accounting for Goodwill and Other Intangible Assets

Intangible assets include patents and trade names. Effective January 1, 2002, with the adoption of SFAS No. 142, *Goodwill and Other Intangible Assets*, amortization of goodwill and intangible assets with indefinite lives ceased. Intangible assets with finite useful lives will continue to be amortized over those periods. Indefinite lived intangible assets will be tested for impairment annually, and will be tested for impairment between annual tests if an event

occurs or circumstances change that would indicate that the carrying amount may be impaired. Definite lived assets are tested for impairment whenever events or circumstances indicate that a carrying amount of an asset may not be recoverable. An

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## MECHANICAL TECHNOLOGY INCORPORATED AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

**1. Accounting Policies**

(Continued)

impairment loss would be recognized when the carrying amount of an asset exceeds the estimated undiscounted cash flows used in determining the fair value of the asset. Then the amount of the impairment loss to be recorded is calculated by the excess of the assets carrying value over its fair value. Fair value is generally determined using a discounted cash flow analysis. Costs related to internally-developed intangible assets are expensed as incurred.

As a result of the adoption of this Statement, the Company stopped amortizing goodwill associated with its equity holdings in SatCon.

The Company recorded expense related to the amortization of goodwill associated with its holdings in SatCon of \$0, \$0, \$688 and \$2,755 thousand, respectively, during 2003, 2002, the Transition Period, and 2001, respectively. The Company has no intangible assets.

The Pro Forma effects of the Company adopting SFAS No. 142 as if SFAS No. 142 had been applied for all periods presented would be as follows:

(Dollars in thousands, except per share data)	Three Months			
	Year Ended	Year Ended	Ended	Year Ended
	<u>Dec. 31, 2003</u>	<u>Dec. 31, 2002</u>	<u>Dec. 31, 2001</u>	<u>Sept. 30, 2001</u>
Reported net (loss) income	\$ (559)	\$(6,961)	\$(13,585)	\$ 3,841
Add back goodwill amortization, net of taxes	=	=	<u>416</u>	<u>1,763</u>
Adjusted net (loss) income	\$ <u>(559)</u>	\$ <u>(6,961)</u>	\$ <u>(13,169)</u>	\$ <u>5,604</u>

## Basic and Diluted (Loss) Earnings per Share:

Reported net (loss) income	\$ (0.02)	\$ (0.20)	\$ (0.38)	\$ 0.11
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Goodwill amortization	=	=	<u>0.01</u>	<u>0.05</u>
Adjusted (loss) earnings per share	\$ <u>(0.02)</u>	\$ <u>(0.20)</u>	\$ <u>(0.37)</u>	\$ <u>0.16</u>

#### Accounting for Impairment or Disposal of Long-Lived Assets

In August 2001, the Financial Accounting Standards Board ("FASB") issued SFAS No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets, which supersedes SFAS No. 121, Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to be Disposed Of, and the accounting and reporting provisions of Accounting Principles Board ("APB") Opinion No. 30. This Statement addresses financial accounting and reporting for the impairment or disposal of long-lived assets and was adopted as of January 1, 2002. This Statement specifies how impairment will be measured and how impaired assets will be classified in the financial statements.

#### Cash and Cash Equivalents

Cash and cash equivalents consist of cash and highly liquid short-term investments with original maturities of less than three months.

#### Securities Available for Sale

Management determines the appropriate classification of its investments in marketable securities at the time of purchase and reevaluates such determinations at each balance sheet date. Marketable securities for

which the Company does not have the intent or ability to hold to maturity are classified as available for sale. Securities available for sale are carried at fair value, with the unrealized gains and losses, net of income taxes, reported as a separate component of shareholders'

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## MECHANICAL TECHNOLOGY INCORPORATED AND SUBSIDIARIES

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

#### **1. Accounting Policies**

(Continued)

equity. The Company has had no investments that qualify as trading or held to maturity. Realized gains and losses are included in "Gain (loss) on sale of securities available for sale, net" in the Consolidated Statements of Operations. The cost of securities sold is based on the specific identification method.

#### Net (Loss) Income per Basic and Diluted Common Share

The Company reports net (loss) income per basic and diluted common share in accordance with SFAS No. 128, *Earnings Per Share*, which establishes standards for computing and presenting (loss) income per share. Basic (loss) income per share is computed by dividing net (loss) income attributable to common stockholders by the weighted-average number of common shares outstanding for the period. Diluted (loss) income per share reflects the potential dilution, if any, which would occur if securities or other contracts to issue common stock were exercised or converted into common stock or resulted in the issuance of common stock that then shared in the (loss) income of the Company.

Stock Based Compensation

At December 31, 2003, the Company has two stock-based employee compensation plans, which are described more fully in Note 13. SFAS No.

123, *Accounting for Stock-Based Compensation*, requires the measurement of the fair value of stock options or warrants granted to employees to be included in the consolidated statement of operations or, alternatively, disclosed in the notes to consolidated financial statements. The Company accounts for stock-based compensation of employees under the intrinsic value method of APB Opinion No. 25, *Accounting for Stock Issued to Employees*, and related Interpretations and has elected the disclosure-only alternative under SFAS No. 123. The Company records the fair market value of stock options and warrants granted to non-employees in exchange for services in accordance with EITF No. 96-18, *Accounting for Equity Instruments That Are Issued to Other Than Employees for Acquiring, or in Conjunction with Selling, Goods or Services*, in the Consolidated Statement of Operations. The Company does not intend to adopt the transition provisions of SFAS No. 148, *Accounting for Stock- Based Compensation- Transition and Disclosure*.

**1. Accounting****Policies** (Continued)

The following table illustrates the effect on net (loss) income and (loss) earnings per share if the Company had applied the fair value recognition provisions of SFAS Statement No. 123, *Accounting for Stock-Based Compensation*, to stock-based employee compensation.

	Year Ended	Year Ended	Three Months Ended	Year Ended
(Dollars in thousands, except per share data)	Dec. 31, <u>2003</u>	Dec. 31, <u>2002</u>	Dec. 31, <u>2001</u>	Sept. 30, <u>2001</u>
Net (loss) income, as reported	\$ (559)	\$(6,961)	\$(13,585)	\$3,841
Add: Total stock-based employee compensation expense already recorded in financial statements, net of related tax effects	20	30	8	(9)
Deduct: Total stock-based employee compensation expense determined under fair value based method for all awards, net of related tax effects	<u>(1,032)</u>	<u>(1,891)</u>	<u>(397)</u>	<u>(1,690)</u>
Pro forma net (loss) income	<u>\$(1,571)</u>	<u>\$(8,822)</u>	<u>\$(13,974)</u>	<u>\$2,142</u>
(Loss) Earnings per Share:				
Basic and diluted - as reported	\$ <u>(.02)</u>	\$ <u>(.20)</u>	\$ <u>(.38)</u>	\$ <u>.11</u>
Basic and diluted - pro forma	\$ <u>(.06)</u>	\$ <u>(.25)</u>	\$ <u>(.39)</u>	\$ <u>.06</u>

**Advertising**

The costs of advertising are expensed as incurred. Advertising expense was approximately \$25, \$37, \$10 and \$67 thousand in 2003, 2002, the Transition Period, and 2001, respectively.

### Concentration of Credit Risk

Financial instruments that subject the Company to concentrations of credit risk principally consist of cash equivalents, marketable securities, trade accounts receivable and unbilled contract costs.

The Company's trade accounts receivable and unbilled contract costs and fees are primarily from sales to commercial customers and U.S. government and state agencies. The Company does not require collateral and has not historically experienced significant credit losses related to receivables or unbilled contract costs and fees from individual customers or groups

of customers in any particular industry or geographic area.

The Company deposits its cash and invests in marketable securities

primarily through commercial banks and investment companies. Credit exposure to any one entity is limited by Company policy.

### Research and Development Costs

The Company expenses research and development costs as incurred.

### Comprehensive Income (Loss)

Comprehensive income (loss) includes net income (loss), as well as changes in stockholders' equity, other than those resulting from investments by shareholders (i.e., issuance or repurchase of common shares and dividends).

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## MECHANICAL TECHNOLOGY INCORPORATED AND SUBSIDIARIES

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

#### **1. Accounting Policies**

(Continued)

#### Effect of Recent Accounting Pronouncements

In June 2001, FASB issued SFAS No. 143, *Accounting for Asset Retirement Obligation*. SFAS No. 143 requires entities to record the fair value of a liability for an asset retirement obligation in the period in which it is incurred. When the liability is initially recorded, an entity capitalizes a cost by increasing the carrying amount of the long-lived asset. Over time, the liability is accreted to its present value each period and the capitalized cost is depreciated over the useful life of the related asset. Upon settlement of the liability, an entity either settles the obligation for its recorded amount or incurs a gain or loss upon settlement.

SFAS No. 143 is effective for fiscal years beginning after June 15, 2002. The adoption of this Statement did not have a material impact on the Company's consolidated financial statements.

In April 2002, the FASB issued SFAS No. 145, *Rescission of FASB Statements Nos. 4, 44, and 64, Amendment of FASB Statement No. 13, and Technical Corrections*. SFAS No. 145 rescinds SFAS No. 4, *Reporting Gains and Losses from Extinguishment of Debt*, and an amendment of that Statement, SFAS No. 44, *Accounting for Intangible Assets of Motor Carriers*, and SFAS No. 64, *Extinguishment of Debt Made to Satisfy Sinking-Fund Requirements*. This Statement amends SFAS No. 13, *Accounting for Leases*, to eliminate an inconsistency between the required accounting for sale-leaseback transactions. This Statement also amends other existing authoritative pronouncements to make various technical corrections, clarify meanings, or describes their applicability under changed conditions and is effective for fiscal years beginning after May 15, 2002. The adoption of this Statement did not have a material impact on the Company's consolidated financial statements.

In July 2002, the FASB issued SFAS No. 146, *Accounting for Costs Associated with Exit or Disposal Activities*. SFAS No. 146 addresses financial accounting and reporting for costs associated with exit or disposal activities and nullifies EITF Issue No. 94-3, *Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity (including Certain Costs Incurred in a Restructuring)*. This Statement is effective for exit and disposal activities initiated after December 31, 2002. The adoption of this Statement did not have a material impact on the Company's consolidated financial statements.

In November 2002, the FASB issued FASB Interpretation No. 45, *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others, an interpretation of FASB Statements Nos. 5, 57, and 107 and Rescission of FASB Interpretation No. 34 ("FIN 45")*. FIN 45 clarifies the requirements of SFAS No. 5, *Accounting for Contingencies*, relating to the guarantor's accounting for, and disclosure of, the issuance of certain types of guarantees. FIN 45 requires that upon issuance of a guarantee, the guarantor must recognize a liability for the fair value of the obligation it assumes under that guarantee. FIN 45 covers guarantee contracts that have any of the following four characteristics: (a) contracts that contingently require the guarantor to make payments to the guaranteed party based on changes in an underlying that is related to an asset, a liability, or an equity security of the guaranteed party (e.g., financial and market value guarantees), F-16

## MECHANICAL TECHNOLOGY INCORPORATED AND SUBSIDIARIES

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

#### 1. Accounting Policies

(Continued)

(b) contracts that contingently require the guarantor to make payments to the guaranteed party based on another entity's failure to perform under an obligating agreement (performance guarantees), (c) indemnification agreements that contingently require the indemnifying party (guarantor) to make payments to the indemnified party (guaranteed party) based on changes in an underlying that is related to an asset, a liability, or an equity security of the indemnified party, such as an adverse judgment in a lawsuit or the imposition of additional taxes due to either a change in the tax law or an adverse interpretation of the tax law, and (d) indirect guarantees of the indebtedness of others. FIN 45 specifically excludes certain guarantee contracts from its scope. Additionally, certain guarantees are not subject to FIN 45's provisions for initial recognition and measurement but are subject to its disclosure requirements. The initial recognition and measurement provisions are effective for guarantees issued or modified after December 31, 2002. The adoption of this Statement did not have a material impact on the Company's consolidated financial statements.

In November 2002, the EITF issued EITF Issue No. 00-21, *Accounting for Revenue Arrangements with Multiple Deliverables*, effective for arrangements entered into after June 15, 2003. This Issue defines units of accounting for arrangements with multiple deliverables resulting in revenue being allocated over the units of accounting for revenue recognition purposes. The adoption of this Issue did not have a material impact on the Company's consolidated financial statements.

In January 2003, the FASB issued FASB Interpretation No. 46, *Consolidation of Variable Interest Entities* ("FIN 46"). FIN 46 requires a variable interest entity to be consolidated by a company if that company is subject to a majority of the risk of loss from the variable interest entity's activities or entitled to receive a majority of the entity's residual returns or both. FIN 46 also requires disclosures about variable interest entities that a company is not required to consolidate but in which it has a significant variable interest. The consolidation requirements apply to variable interest entities at the end of the first reporting period that ends after March 15, 2004. Certain of the disclosure requirements apply in all financial statements initially issued after December 15, 2003, regardless of the date on which the variable interest entity was created. The adoption of this Statement is not expected to have a material impact on the Company's consolidated financial statements.

In April 2003, the FASB issued SFAS No. 149, *Amendment of Statement 133 on Derivative Instruments and Hedging Activities*, to provide clarification on the meaning of an underlying, the characteristics of a derivative that contains financing components and the meaning of an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors. SFAS No. 149 will be applied prospectively and is effective for contracts entered into or modified after June 30, 2003. This Statement will be applicable to existing contracts and new

contracts entered into after June 30, 2003 if those contracts related to forward purchases or sales of when-issued securities or other securities that do not yet exist. The adoption of this Statement did not have a

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## MECHANICAL TECHNOLOGY INCORPORATED AND SUBSIDIARIES

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

#### **1. Accounting Policies**

(Continued)

material impact on the Company's consolidated financial statements.

In May 2003, the FASB issued SFAS No. 150, *Accounting for Certain Financial Instruments with characteristics of both Liabilities and Equity*, to establish standards for how an issuer classifies and measures

certain financial instruments with characteristics of both liabilities and equity. An issuer is required to classify a financial instrument that is within the Standard's scope as a liability (or an asset in some circumstances). The requirements of this Statement apply to freestanding financial instruments, including those that comprise more

than one option or forward contract. This Statement does not apply to features that are embedded in a financial instrument that is not a derivative in its entirety. This Statement is effective for financial instruments entered into or modified after May 31, 2003, and otherwise

effective at the beginning of the first interim period beginning after June 15, 2003. The adoption of this Statement did not have a material impact on the Company's consolidated financial statements.



Reclassification

Certain 2002, Transition Period and 2001 amounts have been reclassified to conform to the 2003 presentation. The reclassifications have no effect on total revenues, total expenses, net loss or stockholders' equity as previously reported.

The reclassifications impact our consolidated statements of operations in the following ways:

- Selling, general and administrative expenses now include amortization of restricted stock compensation previously included in other expense, net.
- Gain (loss) on sale of securities available for sale, net, now includes gains and losses previously included in gain on sale of holdings, net.

**2. Contracts Receivable**

Included in accounts receivable are the following at December 31:

(Dollars in thousands)	<u>2003</u>	<u>2002</u>
U.S. and State Government:		
Amount billable	\$272	\$300
Amount billed	282	503
Retainage	<u>65</u>	<u>25</u>
	<u>\$619</u>	<u>\$828</u>

The balances billed but not paid by customers pursuant to retainage provisions in contracts are due upon completion of the contracts and acceptance by the customer. Based on the Company's experience, most retainage amounts are expected to be collected within the ensuing year.

**3. Issuance of Stock by Subsidiary**

MTI MicroFuel Cells Inc. ("MTI Micro") was formed on March 26, 2001. The Company owns approximately 90% of MTI Micro as of December 31, 2003.

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MECHANICAL TECHNOLOGY INCORPORATED AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

**3. Issuance of Stock by Subsidiary**

(Continued)

On September 19, 2003, MTI Micro entered into a strategic alliance agreement with The Gillette Company ("Gillette") whereby Gillette

purchased 1,088,278 shares of MTI Micro common stock at a price of \$.92 per share for \$1 million pursuant to an equity investment agreement (the

"Investment Agreement"). In addition to the foregoing referenced \$1 million investment in MTI Micro common stock, Gillette may make

additional investments of up to \$4 million subject to agreed milestones. The Company has agreed to invest \$20 million in MTI Micro before September 19, 2005 if other sources of funding are not available. Immediately prior to the Gillette transaction closing, the Company invested \$11 million (\$7.4 million in cash and \$3.6 million through the conversion of a loan receivable to equity), to develop direct methanol micro fuel cells, of its \$20 million commitment in MTI Micro common stock. The Company's remaining investment guaranty is \$8 million as of December 31, 2003.

In connection with the Gillette transaction, MTI Micro converted its Junior Convertible Preferred Class A and Senior Convertible Preferred Class B stock into common stock and treasury stock of \$15 thousand was retired.

On October 29, 2003, Jeong Kim, a member of the board of directors of MTI Micro, purchased 1,088,278 shares of MTI Micro common stock at a price of \$.92 per share for \$1 million.

During 2002, MTI Micro purchased treasury shares from former employees with a total value of \$15 thousand.

On March 26, 2001, MTI Micro sold approximately 200,000 shares of its Junior Convertible Preferred Class A stock to founding employees of MTI Micro at a price of \$.50 per share which raised cash proceeds of \$117 thousand. In July 2001, MTI Micro sold approximately 1.3 million shares of its senior convertible preferred class B stock to E.I. du Pont de Nemours and Company ("Dupont"), in connection with the establishment of a strategic partnership, at a price of \$1.18 per share which resulted in cash proceeds of \$750 thousand and \$750 thousand of prepaid materials.

On November 1, 2001, MTI Micro sold approximately 100,000 shares of its senior convertible preferred Class B stock to Dupont, at a price of \$2.325 per share which raised proceeds of approximately \$295 thousand.

Preferred shares were convertible into common shares on a one-for-one basis and there were no dividend rights.

The increase (decrease) in the Company's paid-in-capital of \$881, \$(28), \$46 and \$1,163 thousand in 2003, 2002, the Transition Period and 2001, respectively, represents the changes in the Company's equity investment in MTI Micro, which results from third-party stock transactions in MTI Micro.

#### 4. Inventories

Inventories consist of the following at December 31:

(Dollars in thousands)	<u>2003</u>	<u>2002</u>
Finished goods	\$ 300	\$ 313
Work in process	316	253
Raw materials, components and assemblies	<u>684</u>	<u>812</u>
	<u>\$1,300</u>	<u>\$1,378</u>

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

5. Property, Plant and Equipment

Property, plant and equipment consist of the following at December 31:

(Dollars in thousands)	<u>2003</u>	<u>2002</u>
Leasehold improvements	\$ 899	\$ 547
Machinery and equipment	2,683	2,642
Office furniture and fixtures	333	233
Construction in progress	<u>3</u>	<u>5</u>
	3,918	3,427
Less accumulated depreciation	<u>1,919</u>	<u>1,869</u>
	<u>\$1,999</u>	<u>\$1,558</u>

Depreciation expense was \$599, \$497, \$113 and \$262 thousand for 2003, 2002, the Transition Period, and 2001, respectively. Repairs and maintenance expense was \$83, \$71, \$9 and \$52 thousand for 2003, 2002, the Transition Period, and 2001, respectively.

**6. Notes Receivable**

Notes receivable consist of the following at December 31:

(Dollars in thousands)	2003	2002
Notes receivable with interest at prime (4% at December 31, 2003 and 4.25% at December 31, 2002), interest and principal due May 18, 2005	\$ 660	\$ 660
Less: Current portion	-	-
Less: Allowance for bad debt	<u>(660)</u>	<u>(660)</u>
	)	)

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• **Securities Available for Sale**

Securities available for sale are classified as current assets and accumulated net unrealized gains (losses) are charged to other comprehensive income (loss).

The principal components of the Company's securities available for sale consist of the following:

(Dollars in thousands, except share data)

<u>Security</u>	<u>Book Basis</u>	<u>Fair Value Adjustment</u>	<u>Recorded Fair Value</u>	<u>Quoted Market Price Per NASDAQ</u>	<u>Ownership</u>	<u>Shares</u>
<u>December 31, 2003</u>						
Plug Power	\$ <u>10,791</u>	\$ <u>33,240</u>	\$ <u>44,031</u>	\$ 7.25	8.36%	6,073,227
<u>December 31, 2002</u>						
Plug Power	\$14,344	\$21,905	\$36,249	\$ 4.49	15.83%	8,073,227
SatCon	<u>1,037</u>	<u>46</u>	<u>1,083</u>	1.40	4.58%	773,600
Total	\$ <u>15,381</u>	\$ <u>21,951</u>	\$ <u>37,332</u>			

The book basis roll forward of Plug Power, SatCon and Beacon Power common stock is as follows:

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MECHANICAL TECHNOLOGY INCORPORATED AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

**7. Securities Available for Sale**

(Continued)

Plug Power (beginning December 20, 2002)

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(Dollars in thousands)	Dec. 31, <u>2003</u>	Dec. 31, <u>2002</u>
Securities available for sale, beginning of period	\$14,344	\$ -
Transfer asset from holdings, at equity on December 20, 2002	-	14,416
Sale of shares	<u>(3,553)</u>	<u>(72)</u>
		)
Securities book basis	10,791	14,344
Unrealized gain on marketable securities	<u>33,240</u>	<u>21,905</u>
Securities available for sale, end of period	<u>\$44,031</u>	<u>\$36,249</u>
SatCon (beginning July 1, 2002)		

(Dollars in thousands)	Dec. 31, <u>2003</u>	Dec. 31, <u>2002</u>
Securities available for sale, beginning of period	\$ 1,037	\$ -
Transfer asset from holdings, at equity on July 1, 2002	-	2,193
Sale of shares	(619)	(488)
Impairment loss (Note 8)	<u>(418)</u>	<u>(668)</u>
		)
Securities book basis	-	1,037
Unrealized gain on marketable securities	=	<u>46</u>
Securities available for sale, end of period	\$ <u>-</u>	\$ <u>1,083</u>

Beacon Power

(Dollars in thousands)	Dec. 31, <u>2003</u>	Dec. 31, <u>2002</u>
Securities available for sale, beginning of period	\$ -	\$ 5,734
Impairment loss (Note 8)	-	(4,984)
Sale of shares	=	<u>(750)</u>

	)	
Securities book basis	-	-
Unrealized gain on marketable securities	=	=
Securities available for sale, end of period	\$-	\$-

Accumulated unrealized gains and (losses) related to securities available for sale are as follows:

	Three Months			
	Year Ended	Year Ended	Ended	Year Ended
	Dec. 31,	Dec. 31,	Dec. 31,	Sept. 30,
(Dollars in thousands)	<u>2003</u>	<u>2002</u>	<u>2001</u>	<u>2001</u>
Accumulated unrealized gains (losses)	\$ 33,240	\$21,951	\$ -	\$(8,673)
Accumulated deferred tax (expense)				
benefit on unrealized gains (losses)	<u>(13,296)</u>	<u>(8,781)</u>	=	<u>3,469</u>
	)	)		
Accumulated net unrealized gains				
(losses)	<u>\$ 19,944</u>	<u>\$13,170</u>	\$-	<u>\$(5,204)</u>

#### 8. Impairment Losses

The Company regularly reviews its securities available for sale and holdings to determine if any declines in value of those securities available for sale and holdings are other than temporary. The Company assesses whether declines in the value of its securities and holdings in publicly traded companies, measured by comparison of the current market price of the securities to the carrying value of the Company's securities and holdings, are considered to be other than temporary based on factors that include (1) the length of time carrying value exceeds fair market value, (2) the Company's assessment of the financial condition and the near term prospects of the companies, and (3) the Company's intent with respect to the securities and holdings.

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### MECHANICAL TECHNOLOGY INCORPORATED AND SUBSIDIARIES

#### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

##### • Impairment Losses

(Continued)

The sluggish economy over the last few years has had a negative impact on the equity value of companies in the new energy sector. In light of these circumstances and based on the results of the reviews described above, the Company

recorded other than temporary impairment charges with respect to its securities available for sale and holdings in publicly traded companies. The pre-tax impairment losses were recorded as follows:

	Three Months			
	Year Ended	Year Ended	Ended	Year Ended
	Dec. 31,	Dec. 31,	Dec. 31,	Sept. 30,
(Dollars in thousands)	<u>2003</u>	<u>2002</u>	<u>2001</u>	<u>2001</u>
Securities available for sale (Beacon)	\$ -	\$(4,984)	\$ (9,643)	\$ -
Securities available for sale (SatCon)	(418)	(668)	-	-
Holdings, at equity (SatCon)	=	<u>(2,475)</u>	<u>(5,790)</u>	=
	)	)		
	<u>\$ (418)</u>	<u>\$ (8,127)</u>	<u>\$ (15,433)</u>	<u>\$ -</u>

## 9. Income Taxes

Deferred tax assets and liabilities are determined based on the temporary differences between the financial statement and tax bases of assets and liabilities as measured by the enacted tax rates.

Income tax benefit (expense) consists of the following:

	Three Months			
	Year Ended	Year Ended	Ended	Year Ended
	Dec. 31,	Dec. 31,	Dec. 31,	Sept. 30,
(Dollars in thousands)	<u>2003</u>	<u>2002</u>	<u>2001</u>	<u>2001</u>
Continuing operations before equity holdings'				
losses and changes in accounting principle				
Federal		\$ -	\$ 625	\$ (16)
State		(2)	(264)	(85)
Deferred		<u>671</u>	<u>275</u>	<u>(7,043)</u>

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	<u>669</u>	<u>636</u>	<u>6,788</u>	<u>(7,524)</u>
Equity in holdings' losses				
Deferred	=	<u>4,550</u>	<u>2,169</u>	<u>9,722</u>
	=	<u>4,550</u>	<u>2,169</u>	<u>9,722</u>
Total continuing operations	<u>669</u>	<u>5,186</u>	<u>8,957</u>	<u>2,198</u>
Change in accounting principle for derivative financial instruments				
Deferred	=	=	=	<u>(3,876)</u>
Change in accounting principle	=	=	=	<u>(3,876)</u>
Change in accounting principle for derivative financial instruments in Company's own stock				
Deferred	=	=	=	<u>(1,000)</u>
				)
Change in accounting principle	=	=	=	<u>(1,000)</u>
				)
Discontinued operations				
Deferred	<u>(8)</u>	<u>(154)</u>	=	=
				)
Total discontinued operations	<u>(8)</u>	<u>(154)</u>	=	=
	)	)		
Total	<u>\$ 661</u>	<u>\$ 5,032</u>	<u>\$ 8,957</u>	<u>\$(2,678)</u>



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## MECHANICAL TECHNOLOGY INCORPORATED AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

**8. Income Taxes**

(Continued)

	Year Ended	Year Ended	Three Months Ended	Year Ended
	Dec. 31,	Dec. 31,	Dec. 31,	Sept. 30,
(Dollars in thousands)	<u>2003</u>	<u>2002</u>	<u>2001</u>	<u>2001</u>
Income tax (expense) benefit allocated directly to shareholders' equity:				
Increase in additional paid-in capital for equity holdings, and warrants and options issued -		\$ -	\$ (227)	\$ (1,206)
Deferred tax expense			\$ (1,206)	\$ (7,456)
Increase in unrealized (gain) loss on available for sale securities - Deferred tax (expense) benefit		(4,516)	(8,781)	(3,469)
Expenses for employee stock options recognized differently for financial reporting/tax purposes -				
Federal tax benefit		223	55	-
Decrease in additional paid-in capital for				184

cumulative effect of change in accounting for

derivative financial instruments for Company's own

stock - Deferred tax benefit - - - 1,471

Increase in additional paid-in-capital for

reclassification of common stock warrants from

liability to equity - Deferred tax expense = = (49 =

)

\$ (4,293) \$ (8,953) \$ (4,724) \$ (2,332)

The significant components of deferred income tax benefit (expense) consist of the following:

	Year Ended	Year Ended	Three Months Ended	Year Ended
	Dec. 31,	Dec. 31,	Dec. 31,	Sept. 30,
(Dollars in thousands)	<u>2003</u>	<u>2002</u>	<u>2001</u>	<u>2001</u>
Continuing operations				
Deferred tax (expense) benefit	\$ (1,324)	\$ 294	\$ 6,133	\$ 3,157
Net operating loss carryforward	1,995	673	756	(10,200)
Valuation allowance	=	<u>(692)</u>	=	=
		)		
	<u>671</u>	<u>275</u>	<u>6,889</u>	<u>(7,043)</u>
			)	
Equity in holdings' losses				
Deferred tax benefit	-	4,550	2,169	8,705
Net operating loss carryforward	=	=	=	<u>1,017</u>

	=	<u>4,550</u>	<u>2,169</u>	<u>9,722</u>
Change in accounting principle for derivative financial instruments				
Deferred tax expense	=	=	=	<u>(3,876)</u>
			)	
	=	=	=	<u>(3,876)</u>
Change in accounting principle for derivative financial instruments in Company's own stock				
Deferred tax expense	=	=	=	<u>(1,000)</u>
			)	
	=	=	=	<u>(1,000)</u>
Discontinued operations				
Deferred tax expense	<u>(8)</u>	<u>(154)</u>	=	=
	)	)		
	<u>\$ 663</u>	<u>\$ 4,671</u>	<u>\$ 9,058</u>	<u>\$ (2,197)</u>

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

**9. Income Taxes**

(Continued)

The Company's effective income tax rate from continuing operations, including equity in holdings' losses, differed from the Federal statutory rate:

	Year Ended	Year Ended	Three Months	Year	
	Dec. 31,	Dec. 31,	Ended	Ended	
	<u>2003</u>	<u>2002</u>	<u>2001</u>	<u>2001</u>	
Federal statutory tax rate		34%	34%	34%	(34)%
State taxes, net of federal tax effect		6	5	6	(6)
Change in valuation allowance		-	(5)	-	-
Research and development credit		-	-	-	(1)
Other, net		<u>(1)</u>	<u>7</u>	<u>-</u>	<u>5</u>
		<u>39</u>	<u>41</u>	<u>40</u>	<u>(36)</u>
		%	%	%	)%

Pre-tax loss from continuing operations before minority interests, including pre-tax losses from equity holdings, was \$1,731, \$12,790, \$22,646 and \$6,058 thousand for 2003, 2002, the Transition Period, and 2001, respectively.

The deferred tax assets and liabilities consist of the following tax effects relating to temporary differences and carryforwards as of December 31:

(Dollars in thousands)

Current deferred tax (liabilities) assets:	<u>2003</u>	<u>2002</u>
Bad debt reserve	\$ 264	\$ 264
Inventory valuation	3	12
Inventory capitalization	20	19
Securities available for sale	(15,289)	(9,659)

Vacation pay	181	94
Warranty and other sale obligations	11	22
Stock options	269	256
Other reserves and accruals	<u>60</u>	<u>116</u>
Net current deferred tax liabilities	<u>\$(14,481)</u>	<u>\$(8,876)</u>
Noncurrent deferred tax assets (liabilities):		
Net operating loss	\$ 5,785	\$ 3,790
Property, plant and equipment	(145)	(123)
Derivatives	-	(2)
Other	239	239
Research and development tax credit	459	459
Alternative minimum tax credit	<u>150</u>	<u>150</u>
	6,488	4,513
Valuation allowance	<u>(1,836)</u>	<u>(1,836)</u>
	)	)
Noncurrent net deferred tax assets	<u>\$ 4,652</u>	<u>\$ 2,677</u>
Other credits	<u>\$(24)</u>	<u>\$(24)</u>

The valuation allowance at December 31, 2003 and 2002 was \$1,836 thousand. The valuation allowance reflects the estimate that it is more likely than not that certain net operating losses may be unavailable to offset future taxable income.

At December 31, 2003, the Company has unused Federal net operating loss carryforwards of approximately \$14,393 thousand. The Federal net operating F-24

## MECHANICAL TECHNOLOGY INCORPORATED AND SUBSIDIARIES

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

#### 9. Income Taxes

(Continued)

loss carryforwards, if unused, will begin to expire in 2009. The use of \$1,467 thousand of loss carryforwards is limited on an annual basis, pursuant to the Internal Revenue Code, due to certain changes in ownership and equity

transactions, which occurred in 1997. For the year ended December 31, 2003, the Company has approximately \$459 thousand of research and development tax credit carryforwards, which begin to expire in 2018, and approximately \$150 thousand of alternative minimum tax credit carryforwards, which have no expiration date.

#### 10. Accrued Liabilities

Accrued liabilities consist of the following at December 31:

(Dollars in thousands)	<u>2003</u>	<u>2002</u>
Salaries, wages and related expenses	\$ 556	\$ 513
Acquisition and disposition costs	363	363
Legal and professional fees	300	159
Warranty and other sale obligations	28	54
Commissions	54	38
Interest expense	-	3
Deferred revenue	50	175
Other	<u>177</u>	<u>238</u>
	<u>\$1,528</u>	<u>\$1,543</u>

#### 11. Shareholders' Equity

##### Common Shares

Changes in common shares are as follows:

	Three Months			
	Year Ended	Year Ended	Ended	Year Ended
	Dec. 31,	Dec. 31,	Dec. 31,	Sept. 30,
	<u>2003</u>	<u>2002</u>	<u>2001</u>	<u>2001</u>
Balance, beginning	35,648,135	35,505,235	35,505,010	35,437,285
Issuance of shares for stock				
option exercises	128,375	92,900	225	67,725
Issuance of shares for restricted				

stock grant	=	<u>50,000</u>	=	=	
Balance, ending		<u>35,776,510</u>	<u>35,648,135</u>	<u>35,505,235</u>	<u>35,505,010</u>

Treasury Stock

Changes in treasury stock are as follows:

	Three Months			
	Year Ended	Year Ended	Ended	Year Ended
	Dec. 31,	Dec. 31,	Dec. 31,	Sept. 30,
	<u>2003</u>	<u>2002</u>	<u>2001</u>	<u>2001</u>
Balance, beginning	8,020,250	20,250	20,250	20,250
Shares acquired for cash	15,724	-	-	-
Shares acquired as part of a share exchange transaction (see Note 17)	=	<u>8,000,000</u>	=	=
Balance, ending	<u>8,035,974</u>	<u>8,020,250</u>	<u>20,250</u>	<u>20,250</u>

Warrants Issued

The Company issued to SatCon warrants to purchase 108,000 and 192,000 shares of the Company's common stock on October 21, 1999 and January 31,

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MECHANICAL TECHNOLOGY INCORPORATED AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

**11. Shareholders' Equity**

(Continued)

2000, respectively. The warrants were immediately exercisable at \$12.56 per share. The estimated fair value of these warrants at the dates issued were \$4.94 and \$16.38 per share, respectively, using a Black-Scholes option pricing model and assumptions similar to those used for valuing the Company's stock options. The warrants to purchase the 108,000 shares expired on October 21, 2003 and the warrants to purchase the 192,000 shares expired unexercised on January 31, 2004.

Reservation of Shares

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The Company has reserved common shares for future issuance as of December 31, 2003 as follows:

Stock options outstanding	2,875,150
Stock options available for issuance	3,703,582
Warrants outstanding	<u>192,000</u>
Number of common shares reserved	<u>6,770,732</u>

Sale of Common Stock

On January 26, 2004, the Company entered into an agreement for the sale of 1,418,842 shares of common stock, see Note 25.

12. Earnings per Share

The following is the reconciliation of the numerators and denominators of the basic and diluted per share computations of loss from continuing operations:

	Year Ended	Year Ended	Three Months Ended	Year Ended
(Dollars in thousands, except per share data)	Dec. 31, <u>2003</u>	Dec. 31, <u>2002</u>	Dec. 31, <u>2001</u>	Sept. 30, <u>2001</u>
Loss from continuing operations	\$ <u>(572)</u>	\$ <u>(7,186)</u>	\$ <u>(13,585)</u>	\$ <u>(3,737)</u>
Basic EPS:				
Common shares outstanding, beginning of period	27,627,885	35,484,760	35,484,760	35,417,035
Weighted average common shares i ssued during the period	30,905	47,893	-	38,747
Unvested restricted common stock	-	(9,726)	-	-
Weighted average common shares reacquired during the period	<u>(2,800)</u>	<u>(263,014)</u>	=	=
	)			
	<u>27,655,990</u>	<u>35,259,913</u>	<u>35,484,760</u>	<u>35,455,782</u>



Weighted average shares  
outstanding

Loss from continuing operations  
per

weighted average share	\$ <u>(.02)</u>	\$ <u>(.21)</u>	\$ <u>(.38)</u>	\$ <u>(.10)</u>
------------------------	-----------------	-----------------	-----------------	-----------------

Diluted EPS:

Common shares outstanding,

beginning of period	27,627,885	35,484,760	35,484,760	35,417,035
---------------------	------------	------------	------------	------------

Weighted average common shares

i	30,905	47,893	-	38,747
---	--------	--------	---	--------

issued during the period

Weighted average common shares

reacquired during the period	<u>(2,800)</u>	<u>(263,014)</u>	=	=
------------------------------	----------------	------------------	---	---

)

Weighted average shares outstanding	<u>27,655,990</u>	<u>35,269,639</u>	<u>35,484,760</u>	<u>35,455,782</u>
--	-------------------	-------------------	-------------------	-------------------

Loss from continuing operations  
per

weighted average share	\$ <u>(.02)</u>	\$ <u>(.21)</u>	\$ <u>(.38)</u>	\$ <u>(.10)</u>
------------------------	-----------------	-----------------	-----------------	-----------------

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MECHANICAL TECHNOLOGY INCORPORATED AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

11. **Earnings per Share** (Continued)

During 2003, options to purchase 2,875,150 shares of common stock at prices ranging from \$0.54 to \$20.92 per share and warrants to purchase 192,000 shares of common stock at \$12.56 per share were outstanding but were not included in the computation of earnings per share-assuming dilution because the Company incurred a loss from continuing operations during this period and inclusion would be anti-dilutive. The options expire between December 20, 2006, and September 8, 2013. The warrants expired unexercised on January 31, 2004.

During 2002, options to purchase 3,327,525 shares of common stock at prices ranging from \$0.54 to \$21.92 per share and warrants to purchase

300,000 shares of common stock at \$12.56 per share were outstanding but were not included in the computation of earnings per share-assuming dilution because the Company incurred a loss from continuing operations

during this period and inclusion would be anti-dilutive. The options expire between December 20, 2006 and November 19, 2012. Warrants for the purchase of 108,000 shares expired October 21, 2003 and warrants for the purchase of 192,000 shares expired unexercised on January 31 2004.

During the Transition Period, options to purchase 3,199,175 shares of common stock at prices ranging from \$.54 to \$21.92 per share and warrants to purchase 300,000 shares of common stock at \$12.56 per share were outstanding but were not included in the computation of earnings per share-assuming dilution because the Company incurred a loss during this period and inclusion would be anti-dilutive. The options expire between December 20, 2006 and December 5, 2011. Warrants for the purchase of 108,000 shares expired October 21, 2003 and warrants for the purchase of 192,000 shares expired unexercised on January 31 2004.

During 2001, options to purchase 3,182,900 shares of common stock at prices ranging from \$0.54 to \$21.92 per share and warrants to purchase 300,000 shares of common stock at \$12.56 per share were outstanding but were not included in the computation of earnings per share-assuming dilution because the Company incurred a loss from continuing operations before accounting changes during this period and inclusion would be anti-dilutive. The options expire between December 20, 2006, and April 2, 2011. Warrants for the purchase of 108,000 shares expired October 21, 2003 and warrants for the purchase of 192,000 shares expired unexercised on January 31 2004.

### 13. Stock Based Compensation

The 1999 Employee Stock Incentive Plan ("1999 Plan") was approved by shareholders during March 1999. The 1999 Plan provides that an initial aggregate number of 1 million shares of common stock may be awarded or issued. The number of shares which may be awarded under the 1999 Plan have been adjusted for stock splits, and during 2003, 2002, the Transition Period and 2001 the total number of shares which may be awarded under the 1999 Plan were 4,500,000 shares. Under the 1999 Plan, the Board of Directors is authorized to award stock options to officers, employees and others.

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## MECHANICAL TECHNOLOGY INCORPORATED AND SUBSIDIARIES

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

#### 11. Stock Based Compensation

(Continued)

The 1996 Stock Incentive Plan ("1996 Plan") was approved by shareholders during December 1996. The 1996 Plan provides that an initial aggregate number of 500,000 shares of common stock may be awarded or issued. The number

of shares which may be awarded under the 1996 Plan may be increased by 10% of any increase in the number of outstanding shares of common stock for reasons other than shares issued under this 1996 Plan.

The number of shares which may be awarded under the 1996 Plan have been adjusted for stock splits and rights offerings, and during 2003, 2002, the Transition Period and 2001, the total number of shares which may be awarded under the 1996 Plan were 3,478,746 shares. Under the 1996 Plan, the Board of Directors is authorized to award stock options, stock appreciation rights, restricted stock, and other stock-based incentives to officers, employees and others.

Options are generally exercisable in from one to four cumulative annual amounts beginning 12 months after the date of grant. Certain options granted may be exercisable immediately or begin vesting immediately. Option exercise prices are not less than 85 percent of the market value of the Company's common stock on the date of grant. Unexercised options generally terminate ten years after date of grant. The Company has elected to follow APB Opinion No. 25, *Accounting for Stock Issued to Employees*, and related Interpretations, in accounting for employee stock-based compensation and to provide the disclosures required under SFAS No. 123, *Accounting for Stock Based Compensation*. APB Opinion No. 25 requires no recognition of compensation expense for most of the stock-based compensation arrangements provided by the Company, namely, broad-based employee stock purchase plans and option grants where the exercise price is equal to or not less than 85 percent of the market value at the date of grant. However, APB Opinion No. 25 requires recognition of compensation expense for variable award plans over the vesting periods of such plans, based upon the then-current market values of the underlying stock. In contrast, SFAS No. 123 requires recognition of compensation expense for grants of stock, stock options, and other equity instruments, over the vesting periods of such grants, based on the estimated grant-date fair values of those grants.

On December 22, 2003, the Company announced the successful completion of the first phase of its stock option exchange offer. A total of 757,000 options with an average exercise price of approximately \$19 were tendered by employees and then cancelled by the Company in exchange for the future issuance of options at a one-for-two ratio. New options will be issued in the final phase of the exchange offer on or after June 23, 2004 at the then current market price to employees and directors who are employed by the Company or serve as directors of the Company from the acceptance date through the date that the new options are granted. As of March 5, 2004, the Company anticipates issuing 341,000 options associated with the exchange.

During 2002, the Company awarded 50,000 restricted shares of common stock which vested over a one-year period. During 2000, the Company awarded 60,000 options to consultants. Certain of these shares under option vest over a four-year period. Presented below is a summary of

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MECHANICAL TECHNOLOGY INCORPORATED AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

**13. Stock Based Compensation**

(Continued)

compensation expense (income) recorded in "Selling, general and administrative expenses" in the Consolidated Statements of Operations.

Three Months

Year Ended      Year Ended      Ended      Year Ended

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	Dec. 31,	Dec. 31,	Dec. 31,	Sept. 30,
(Dollars in thousands)	<u>2003</u>	<u>2002</u>	<u>2001</u>	<u>2001</u>
SFAS 123 - Consultants	\$ 32	\$ 49	\$ 13	\$ 51
Restricted stock	40	10	-	-
APB No. 25 - Variable stock options	=	=	=	<u>(65</u>
				)
Total compensation expense (income)	<u>\$ 72</u>	<u>\$ 59</u>	<u>\$ 13</u>	<u>\$(14)</u>

Presented below is a summary of the stock option plans' activity:

	Three Months			
	Year Ended	Year Ended	Ended	Year Ended
	Dec. 31,	Dec. 31,	Dec. 31,	Sept. 30,
	<u>2003</u>	<u>2002</u>	<u>2001</u>	<u>2001</u>
Shares under option, beginning	3,327,525	3,199,175	3,182,900	2,703,375
Granted	439,750	280,000	16,500	583,000
Exercised	(128,375)	(92,900)	(225)	(67,725)
Canceled	<u>(763,750)</u>	<u>(58,750)</u>	=	<u>(35,750)</u>
	)	)	)	)
Shares under option, ending	<u>2,875,150</u>	<u>3,327,525</u>	<u>3,199,175</u>	<u>3,182,900</u>
Options exercisable	2,511,650	2,776,835	2,221,304	2,030,654
Remaining shares available for granting				
of options	3,703,582	3,379,582	3,650,832	3,667,332

The weighted average exercise price is as follows:

	Three Months			
	Year Ended	Year Ended	Ended	Year Ended
	Dec. 31,	Dec. 31,	Dec. 31,	Sept. 30,

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	<u>2003</u>	<u>2002</u>	<u>2001</u>	<u>2001</u>
Shares under option, beginning	\$ 7.01	\$7.15	\$7.17	\$7.85
Granted:				
Exercise price equal to fair market				
value at grant date	2.04	2.77	2.62	3.15
Exercised	1.72	1.19	1.78	1.03
Canceled	19.01	3.63	-	4.57
Shares under option, ending	3.29	7.01	7.15	7.17
Options exercisable, ending	3.45	6.60	6.30	6.66

The following table summarizes information for options outstanding and exercisable at December 31, 2003:

Options Outstanding

Options Exercisable

Exercise Price Range	Number	Weighted		Number	Weighted
		Average Remaining Contractual Life	Average Exercise Price		
\$ 0.54-\$ 0.76	309,475	3.5	\$ 0.67	309,475	\$ 0.67
\$ 0.98-\$ 1.33	559,375	5.0	\$ 1.27	534,375	\$ 1.29
\$ 1.65-\$ 2.03	638,550	7.4	\$ 1.87	414,800	\$ 1.82
\$ 2.62-\$ 3.42	681,250	7.2	\$ 3.05	569,000	\$ 3.07
\$ 4.17-\$ 4.56	400,000	5.2	\$ 4.20	397,500	\$ 4.20
\$ 6.27-\$ 9.25	37,500	6.3	\$ 8.06	37,500	\$ 8.06
\$10.65-\$12.96	189,000	6.5	\$10.82	189,000	\$10.82
\$20.92	<u>60,000</u>	3.9	\$20.92	<u>60,000</u>	\$20.92

2,875,1502,511,650

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## MECHANICAL TECHNOLOGY INCORPORATED AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

## 13. Stock Based Compensation

(Continued)

The fair value of options granted, which is amortized to expense over the option vesting period in determining the pro forma impact, is estimated on the date of grant using the Black-Scholes option-pricing model with the following weighted average assumptions:

	Three Months			
	Year Ended	Year Ended	Ended	Year Ended
	Dec. 31,	Dec. 31,	Dec. 31,	Sept. 30,
	<u>2003</u>	<u>2002</u>	<u>2001</u>	<u>2001</u>
Expected life of option	5 yrs	5 yrs	5 yrs	5 yrs
Risk-free interest rate	2.35-3.37%	2.97-4.69%	4.26%	4.66-5.71%
Expected volatility of the Company's stock	93.4%	97%	97%	96.5%
Expected dividend yield on the Company's stock	0%	0%	0%	0%

The weighted average fair value of options granted is as follows:

	Three Months			
	Year Ended	Year Ended	Ended	Year Ended
	Dec. 31,	Dec. 31,	Dec. 31,	Sept. 30,
	<u>2003</u>	<u>2002</u>	<u>2001</u>	<u>2001</u>
Fair value of each option granted	\$ 1.48	\$ 2.09	\$ 1.97	\$ 2.38
Number of options granted	439,750	280,000	16,500	583,000

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Fair value of all options granted	\$650,830	\$585,200	\$32,505	\$1,387,540
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In accordance with SFAS No. 123, the weighted average fair value of stock options granted is required to be based on a theoretical statistical model using the preceding Black-Scholes assumptions.

The weighted average fair value of restricted stock granted is as follows:

	Year Ended		Three Months	
	Year Ended	Year Ended	Ended	Year Ended
	Dec. 31,	Dec. 31,	Dec. 31,	Sept. 30,
	<u>2003</u>	<u>2002</u>	<u>2001</u>	<u>2001</u>
Fair value of each option granted	\$ -	\$ 1	\$ -	\$ -
Number of options granted	-	50,000	-	-
Fair value of all options granted	\$ -	\$50,000	\$ -	\$ -

**14. Equity in Holdings' Losses, Net of Tax**

The Company's proportionate share of losses, from holdings, net of tax, accounted for under the equity method is as follows:

(Dollars in thousands)	Year Ended		Three Months	
	Year Ended	Year Ended	Ended	Year Ended
	Dec. 31,	Dec. 31,	Dec. 31,	Sept. 30,
	<u>2003</u>	<u>2002</u>	<u>2001</u>	<u>2001</u>
Plug Power <sup>(A)</sup>	\$ -	\$(6,095)	\$(2,460)	\$(14,089)
SatCon <sup>(B)</sup>	=	<u>(576)</u>	<u>(856)</u>	<u>(2,983)</u>
			)	
	\$ -	<u>\$(6,671)</u>	<u>\$(3,316)</u>	<u>\$(17,072)</u>

(A)

The accounting for the Company's holdings in Plug Power was changed on December 20, 2002 to fair value from the equity method (see Note 1).

(B)

The Company's holdings in SatCon were accounted for on a one-quarter lag (through SatCon's quarter ended June 29, 2002) until accounting for the holding was changed on July 1, 2002 to fair value from the equity method (see Note 1).

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## MECHANICAL TECHNOLOGY INCORPORATED AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

**14. Equity in Holdings' Losses, Net of Tax**

(Continued)

<u>Holding</u>	<u>Description of Business</u>
Plug Power	Plug Power designs and develops on-site energy systems based on proton exchange membrane fuel cells. The foregoing description is based on our review of certain publicly available information.
SatCon	SatCon Technology Corporation manufactures and sells power control systems for military systems, alternative energy and high-reliability industrial automation applications. Products include inverter electronics from 5 kilowatts to 5 megawatts, power switches, and hybrid microcircuits for industrial, medical, military and aerospace applications. SatCon also develops and builds digital power electronics, high-efficiency machines and control systems for a variety of defense applications. The foregoing description is based on our review of certain publicly available information.
Plug Power	

Summarized below is financial information for Plug Power whose fiscal year ends December 31.

	Year Ended Dec. 31,	Year Ended Dec. 31,	Unaudited Three Months Ended
(Dollars in thousands)	<u>2002</u>	<u>2001</u>	<u>December 31, 2001</u>
Current assets	\$ 67,135	\$ 100,565	\$ 100,565
Noncurrent assets	41,548	50,809	50,809
Current liabilities	10,259	10,199	10,199
Noncurrent liabilities	5,727	6,172	6,172
Stockholders' equity	92,697	135,003	135,003



Gross revenue	11,818	5,742	2,505
Gross profit (loss)	478	(5,549)	(2,207)
Net loss	(47,218)	(73,112)	(17,070)

SatCon

Summarized below is financial information for SatCon. SatCon's fiscal year ends September 30. The Company's holdings in SatCon were accounted for on a one-quarter lag, except for sales of common stock, which were effected as of the sale date.

		Unaudited	Unaudited
	Year Ended	Nine Months Ended	Three Months Ended
(Dollars in thousands)	<u>September 30, 2002</u>	<u>June 29, 2002</u>	<u>December 29, 2001</u>
Current assets	\$22,189	\$25,046	\$35,352
Noncurrent assets	20,171	20,792	25,183
Current liabilities	11,217	11,445	12,131
Noncurrent liabilities	1,217	932	1,105
Stockholders' equity	29,926	33,461	47,299
Gross revenue	41,630	30,395	8,340
Gross profit	4,809	3,552	687
Net loss	(20,761)	(15,389)	(5,397)

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**• Gain (Loss) on Sale of Securities Available for Sale, Net**

The Company sold shares of the following securities and recognized gains (losses) and proceeds as follows:

		Three Months	
Year Ended	Year Ended	Ended	Year Ended

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	Dec. 31,	Dec. 31,	Dec. 31,	Sept. 30,
(Dollars in thousands, except shares)	<u>2003</u>	<u>2002</u>	<u>2001</u>	<u>2001</u>
<b>Plug Power</b>				
Shares sold	2,000,000	35,000	-	-
Proceeds	\$10,251	\$ 163	\$ -	\$ -
Gross gain on sales	\$ 6,698	\$ 91	\$ -	\$ -
<b>SatCon</b>				
Shares sold	773,600	313,900	-	-
Proceeds	\$ 1,403	\$ 392	\$ -	\$ -
Gross gain on sales	\$ 785	\$ -	\$ -	\$ -
Gross loss on sales	\$ -	\$ (95)	\$ -	\$ -
<b>Beacon Power</b>				
Shares sold	-	4,410,797	-	-
Proceeds	\$ -	\$ 310	\$ -	\$ -
Gross loss on sales	\$ -	\$ (440)	\$ -	\$ -
Total net gain (loss) on sales	<u>\$ 7,483</u>	<u>\$ (444)</u>	<u>\$ -</u>	<u>\$ -</u>

**16. Gain on Sale of Holdings, Net**

The Company sold shares of the following equity holdings and recognized gains (losses) and proceeds as follows:

	Three Months			
	Year Ended	Year Ended	Ended	Year Ended
(Dollars in thousands, except shares)	Dec. 31,	Dec. 31,	Dec. 31,	Sept. 30,
	<u>2003</u>	<u>2002</u>	<u>2001</u>	<u>2001</u>
<b>Plug Power</b>				
Shares sold	-	1,165,000	-	1,710,000

Proceeds	\$ -	\$ 9,059	\$ -	\$35,717
Gross gain on sales	\$ -	\$ 6,291	\$ -	\$31,009
SatCon				
Shares sold	-	212,500	-	500,000
Proceeds	\$ -	\$ 910	\$ -	\$ 2,125
Gross gain on sales	\$ -	\$ 78	\$ -	\$ -
Gross loss on sales	\$ -	\$ -	\$ -	\$(2,171)
Total net gain on sales	\$-	\$ <u>6,369</u>	\$-	\$ <u>28,838</u>

#### 17. Share Exchange Transaction

On December 20, 2002, the Company and First Albany Companies Inc.

("FAC") completed a share exchange transaction whereby 8 million shares of the Company's common stock owned by FAC were exchanged for 2,721,088 shares of Plug Power common stock owned by the Company. As a condition of the exchange, FAC agreed not to sell its remaining shares of the Company's common stock for two years. The Company recorded a gain on the exchange transaction of \$8,006 thousand and recorded treasury stock at a cost of \$13,606 thousand.

As a result of the transaction, effective December 20, 2002, the Company was no longer required to account for its remaining holdings in Plug Power under the equity method of accounting. Under the equity method of accounting, the Company was required to report its proportionate share of Plug Power's financial results.

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## MECHANICAL TECHNOLOGY INCORPORATED AND SUBSIDIARIES

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

#### 18. Retirement Plan

The Company maintains a voluntary savings and retirement plan (Internal Revenue Code Section 401(k) Plan) covering substantially all employees.

The Company plan allows eligible employees to contribute a percentage of their compensation; the Company makes additional voluntary contributions in amounts as determined by management and the Board of Directors. The investment of employee contributions to the plan is self-directed.

The cost of the plan was \$187, \$150, \$35 and \$116 thousand for 2003, 2002, the Transition Period, and 2001, respectively.

## **19. Commitments and Contingencies**

### Litigation

#### Lawrence

On September 9, 1998, Barbara Lawrence, the Lawrence Group, Inc. ("Lawrence"), and certain other Lawrence-related entities ("Plaintiffs") initially filed suit in the Bankruptcy Court and the United States District Court for the Northern District of New York which were subsequently consolidated in the District Court, against First Albany Corporation ("FAC"), Mechanical Technology, Dale Church, Edward Dohring, Beno Sternlicht, Alan Goldberg and George McNamee (former Directors of the Company), Marty Mastroianni (former President and Chief Operating Officer of the Company), and 33 other individuals ("Defendants") who purchased a total of 820,909 (2,462,727 shares post split) shares of the Company's stock from the Plaintiffs. The case concerns the Defendants' 1997 purchase of Mechanical Technology shares from the Plaintiffs at the price of \$2.25 per share (\$0.75 per share post split). FAC acted as Placement Agent for the Defendants in the negotiation and sale of the shares and in proceedings before the Bankruptcy Court for the Northern District of New York, which approved the sale in September 1997.

Plaintiffs claim that the Defendants failed to disclose material inside information concerning Plug Power, LLC to the Plaintiffs and therefore the \$2.25 per share (\$0.75 per share post split) purchase price was unfair. Plaintiffs are seeking damages of \$5 million plus punitive damages and costs. In April 1999, Defendants filed a motion to dismiss the amended complaint, which was denied by the Bankruptcy Court. On appeal in October 2000, Plaintiffs' cause of action was dismissed by the United States District Court for the Northern District of New York. In November 2000, Plaintiffs filed an appeal of that dismissal with the United States Court of Appeals for the Second Circuit. In June 2002, the Second Circuit Court of Appeals reversed the District Court decision and remanded the case for further consideration of the Plaintiff's claims as motions to modify the Bankruptcy Court sale order. The Plaintiff's claims have now been referred back to Bankruptcy Court for such consideration. In September 2003, the Bankruptcy Court issued an order permitting Plaintiffs to conduct limited discovery concerning how First Albany formed an opinion about the Company's stock up until the date the Stock Purchase Agreement was executed.

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## MECHANICAL TECHNOLOGY INCORPORATED AND SUBSIDIARIES

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

## **19. Commitments and Contingencies**

(Continued)

The Company believes the claims have no merit and intends to defend them vigorously. The Company cannot predict the outcome of the claims nor reasonably estimate a range of possible loss given the current status of the litigation. Accordingly, no amounts have been reserved for this matter.

Ling Electronics, Inc.

On July 8, 2003, Donald R. Gilillard, Sharon Gilillard, Vernon Dunham and Jean Dunham, owners of 4890 E. La Palma Avenue, Anaheim, CA 92870 ("Plaintiffs"), the former location of Ling Electronics, Inc. ("Ling"), filed suit in the Superior Court of California for Orange County against SatCon Power Systems, Inc., a subsidiary of SatCon Technology Corporation, and the Company. In September 2003, SatCon and the Company filed a joint answer to the complaint.

The Complaint alleges breach of the lease and, among other things, Ling's failure to maintain and repair the premises. Ling was a subsidiary of the Company until it was sold to SatCon Technology Corporation in 1999. The Plaintiffs allege that the correction and repair of the various breaches by SatCon and the Company of their obligations under the lease will exceed \$400,000. The building was leased from 1983 through lease expiration in 2003. The Company remained as a guarantor on the lease after the sale of Ling to SatCon.

The Company believes the claims have no merit and intends to defend them vigorously. The Company cannot predict the outcome of the claims nor

reasonably estimate a range of possible loss given the current status of

the litigation. Accordingly, no amounts have been reserved for this matter.

Leases

The Company and its subsidiaries lease certain manufacturing, laboratory and office facilities. The leases generally provide for the Company to pay either an increase over a base year level for taxes, maintenance, insurance and other costs of the leased properties or the Company's allocated share of insurance, taxes, maintenance and other costs of leased properties. The leases contain renewal provisions.

Future minimum rental payments required under non-cancelable operating leases are (dollars in thousands): \$620 in 2004; \$561 in 2005, \$441 in

2006, \$316 in 2007, \$316 in 2008, and \$289 thereafter. Rent expense under all leases was \$636, \$536, \$134 and \$453 thousand for 2003, 2002, the Transition Period, and 2001, respectively. Contingent rent included

in the rent expense amounts was \$46, \$31, \$8 and \$9 thousand for 2003, 2002, the Transition Period, and 2001, respectively.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

19. Commitments and Contingencies

(Continued)

Warranties

Below is a reconciliation of changes in product warranty liabilities at December 31:

(Dollars in thousands)	<u>2003</u>	<u>2002</u>
Balance, beginning of period	\$ 54	\$ 81
Accruals for warranties issued	55	54
Accruals related to pre-existing warranties (including changes in estimates)	(66)	(66)
Settlements made (in cash or in kind)	<u>(15)</u>	<u>(15)</u>
	)	)
Balance, end of period	<u>\$ 28</u>	<u>\$ 54</u>

Licenses

The Company licenses, on a non-exclusive basis, certain Direct Methanol Fuel Cell ("DMFC") technology from Los Alamos National Laboratory. Under this agreement, the Company is required to pay future minimum annual license fees of (dollars in thousands): \$200 in 2004 and \$250 in 2005. Once products are being sold, royalties will be based on 2% of the first \$50 million of net sales, 1% on net sales in excess of \$50 million but less than \$100 million and .5% on net sales in excess of \$100 million. License payments made in any year can be applied against royalties due and total annual fees in any year shall not exceed \$1 million.

Employment Agreements

The Company has employment agreements with certain employees that provide severance payments and accelerated vesting of certain options upon termination of employment under certain circumstances, as defined in the applicable agreements. As of December 31, 2003, the Company's potential minimum obligation to these employees was approximately \$786 thousand.

Guaranty of Subsidiary Funding

In connection with the Strategic Alliance Agreement between MTI Micro and Gillette, the Company guaranteed additional investments in its subsidiary, MTI Micro, of up to \$20 million before September 19, 2005, if other sources of funding are not available. Immediately prior to the Gillette transaction closing, the Company invested \$11 million

(\$7.4 million in cash and \$3.6 million through the conversion of a loan receivable to equity) of its \$20 million commitment in MTI Micro common stock. In October 2003, a related party invested \$1 million in MTI Micro common stock. The Company's remaining investment guaranty is \$8 million as of December 31, 2003.

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MECHANICAL TECHNOLOGY INCORPORATED AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

19. Commitments and Contingencies

(Continued)

Investment Company Act

The Company's securities available for sale constitute investment securities under the Investment Company Act of 1940 (the "Investment Company Act"). In general, a company may be deemed to be an investment company if it owns investment securities with a value exceeding 40% of its total assets, subject to certain exclusions and exemptions. Investment companies are subject to registration under, and compliance with, the Investment Company Act unless a particular exemption or safe harbor provision applies. If the Company were to be deemed an investment company, the Company would become subject to the requirements of the Investment Company Act. As a consequence, the Company would be prohibited from engaging in certain businesses or issuing certain securities, certain of our contracts might be voidable, and the Company might be subject to civil and criminal penalties for noncompliance.

Until fiscal 2001, the Company qualified for a safe harbor exemption under the Investment Company Act based upon the level of ownership of shares of Plug Power and influence over its management or policies. However, since the Company sold some of its shares of Plug Power during fiscal 2001, this safe harbor exemption may not be available.

On December 3, 2001, the Company made an application to the Securities and Exchange Commission ("SEC") requesting that they either declare that the Company is not an investment company because it is primarily engaged in another business or exempt it from the provisions of the Investment Company Act for a period of time. The Company amended this application on October 20, 2003. This application is pending. If the Company's application is not granted, the Company will have to find another safe harbor or exemption that it can qualify for, which may include a one-year safe harbor granted by the Investment Company Act, or become an investment company subject to the regulations of the Investment Company Act.

If the Company was deemed to be an investment company and could not find another safe harbor or exemption and failed to register as an investment company, the SEC could require the Company to sell its interest in Plug Power until the value of its securities available for sale are reduced below 40% of total assets. This could result in sales of securities in quantities of shares at depressed prices and the Company may never realize anticipated benefits from, or may incur losses on, these sales. Also, in connection with the strategic alliance agreement with Gillette, the Company has agreed to indemnify Gillette against any losses arising out of or related to the Company's noncompliance with the

Investment Company Act or any regulations thereunder.

Further, the Company may be unable to sell some securities due to contractual or legal restrictions or the inability to locate a suitable buyer. Moreover, the Company may incur tax liabilities when selling assets.

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## MECHANICAL TECHNOLOGY INCORPORATED AND SUBSIDIARIES

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

#### **20. Related Party Transactions**

Management believes transactions among related parties are as fair to the Company as obtainable from unaffiliated third parties.

On October 29, 2003, Jeong Kim, a member of the board of directors of MTI Micro, invested \$1 million in MTI Micro (see Note 3).

On September 19, 2003, Gillette invested \$1 million in MTI Micro pursuant to a strategic alliance agreement (see Notes 3 and 24).

On December 20, 2002, as a condition of the agreement to exchange 8 million shares of the Company's common stock owned by FAC for 2,721,088 shares of the Plug Power common stock owned by the Company, FAC agreed not to sell its remaining shares of the Company for two years ("lock-up agreement")(see Note 17). MTI waived this lock-up agreement in late December 2002 to permit FAC to gift shares.

During the twelve months ended December 31, 2002, FAC sold 662,705 shares of the Company's common stock in the public markets. FAC owns 2,991,040 shares or approximately 10.78% of the Company's common stock at December 31, 2003.

In July 2001, Dupont invested \$1.5 million worth of cash and prepaid materials in MTI Micro in connection with the establishment of a strategic partnership. Additionally, in November 2001, Dupont invested another \$295 thousand in MTI Micro (see Note 3).

In July 2001, MTI Micro entered into a Joint Venture Agreement with Dupont, a minority shareholder in MTI Micro, solely to undertake a research and development program funded by the Advanced Technology Program ("ATP") of the National Institute of Standards and Technology ("NIST"). As the program administrator, MTI Micro submits all bills from Dupont to NIST for payment. In connection with NIST billings, as

of December 31, 2003 and 2002, the Company has a liability to Dupont for approximately \$47 and \$173 thousand. The Company also purchases materials from Dupont; such purchases totaled \$190, \$29, \$5 and \$2 thousand in 2003, 2002, the Transition Period and 2001, respectively. The Company has a liability for materials purchases to Dupont as of December 31, 2003 and 2002 of \$1 and \$17 thousand, respectively. These liabilities are included in the financial statement line "Accrued liabilities - related parties."



In April 2000, the Company entered into a management services agreement with First Albany Corporation, a wholly owned subsidiary of FAC, to

provide certain services on a month-to-month basis. Under this agreement, FAC billed services to the Company (phone, network, postage, etc.) on a cost reimbursement basis. Billings under these agreements amounted to approximately \$0, \$11, \$13 and \$33 thousand for 2003, 2002, the Transition Period, and 2001, respectively.

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## MECHANICAL TECHNOLOGY INCORPORATED AND SUBSIDIARIES

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

#### **20. Related Party Transactions**

(Continued)

The Company had an ownership interest in Beacon Power from 2000 to December 30, 2002. Associated with this ownership, the Company received approximately \$183 thousand in preferred stock dividends from Beacon Power during fiscal 2001.

On September 28, 2001, the Company received 544,148 shares of Beacon Power Common Stock as a pro rata distribution by SatCon. The Company recognized a gain of \$827 thousand on this dividend distribution.

On December 27, 2000, the Company entered into a Put and Call with FAC to provide independent credit support for repayment of the then outstanding KeyBank loan ("FAC Credit Enhancement") for which the Company paid a fee of \$945 thousand. The FAC Credit Enhancement provided FAC with the option, if the price of Plug Power stock fell to \$4 per share, to either purchase 6.3 million Plug Power shares pledged as collateral on the loan or take an assignment of KeyBank, N.A.'s rights under the \$50 million Amended and Restated Credit Agreement. The FAC Credit Enhancement could be triggered in the event of a default and was amended on April 27, 2001, the original expiration date, to extend its expiration date to August 27, 2001. The Company paid a fee of \$200 thousand for this amendment. The Company and FAC could renew the FAC Credit Enhancement on a monthly basis upon mutually agreeable terms. If the FAC Credit Enhancement expired, and was not replaced, prior to November 3, 2001, the loan would be immediately due and payable. Upon expiration of the FAC Credit Enhancement, mandatory repayments on any outstanding balance would be required if the Plug Power stock price fell below \$20 per share. Th