FLIGHT SAFETY TECHNOLOGIES INC
Form 10QSB
October 08, 2004

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-QSB

x QUARTERLY REPORT UNDER SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For The Quarterly Period Ended August 31, 2004

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

Commission File Number: 000-33305

FLIGHT SAFETY TECHNOLOGIES, INC.

(Exact name of small business issuer as specified in its charter)

Nevada	95-4863690
(State or other jurisdiction of incorporation or organization)	(IRS Employer Identification No.)

28 Cottrell Street, Mystic, Connecticut 06355

(Address of principal executive offices)

(860) 245-0191

(Issuer's telephone number)

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

Check whether the issuer (1) filed all reports required to be filed by Section 13 or 15(d) of the Exchange Act during the past 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes x No o

The number of shares of common stock outstanding as of October 8, 2004 was 8,215,110 shares.

Transitional Small Business Disclosure Format: Yes o No x

FLIGHT SAFETY TECHNOLOGIES, INC.
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PART I - FINANCIAL INFORMATION

Item 1. Financial Statements.

FLIGHT SAFETY TECHNOLOGIES, INC.

Balance Sheets
August 31, 2004 and May 31, 2004

		(Unaudited) August 31, 2004		(Audited) May 31, 2004
Assets				
Current assets:				
Cash	$	2,760,786	$	2,180,863
Contract receivables		406,950		532,043
Other receivables		257,108		194,479
Investments		5,842,389		6,871,424
Other Current Assets		20,847		28,840
Total current assets		9,288,080		9,807,649
Property and equipment, net of accumulated depreciation of $242,881 and $216,356 respectively		289,237		259,252
Other Assets:				
Intangible assets, net of accumulated amortization of $36,909 and $33,969 respectively		147,050		149,990
Investments		500,002		500,002
		647,052		649,992
	$	10,224,369	$	10,716,893
Liabilities and Stockholders' Equity				
Current liabilities:				
Accounts payable	$	377,872	$	615,911

Accrued expenses	135,440	141,259
Total current liabilities	513,312	757,170
Stockholders' equity:		
Preferred Stock, $0.001 par value, 5,000,000 shares authorized	----	-----
Common stock, $0.001 par value, 50,000,000 shares authorized, 8,331,410 shares issued.	8,331	8,331
Additional paid-in-capital	13,105,863	13,105,863
Treasury Stock, 116,300 shares at cost	(199,827)	----
Accumulated other comprehensive loss	(134,754)	(119,501)
Unearned stock compensation	(134,992)	(150,733)
Accumulated deficit	(2,933,564)	(2,884,237)
	9,711,057	9,959,723
	$ 10,224,369	$ 10,716,893

The accompanying notes are an integral part of these financial statements

FLIGHT SAFETY TECHNOLOGIES, INC.

Statements of Operations
(Unaudited)
For The Three Month Period Ended August 31, 2004 and 2003

	Three Months Ended August 31	
	2004	2003
Contract Revenues	$ 1,435,952	$ 532,215
Cost and expenses:		
Cost of revenues	1,011,844	358,884
Research and development	82,555	27,826
Selling, general and administrative	410,437	353,711
Depreciation and amortization	21,783	18,961
	1,526,619	759,382
Loss from operations	(90,667)	(227,167)
Other income (Expense):		
Interest income	48,255	978
Interest expense	--	--
	48,255	978
Loss before provision for income taxes	(42,412)	(226,189)
Provision for income taxes	6,915	452
Net Loss	$(49,327)	$(226,641)
Unrealized losses on investments: Unrealized holding, losses on investments arising during the period	(15,253)	0
Comprehensive (loss)	(64,580)	(226,641)
Net Loss Per Share		

Basic	$ (.01)	$ (.04)

Weighted Average Number of Shares Outstanding

Basic	8,215,110	5,078,179

The accompanying notes are an integral part of these financial statements

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FLIGHT SAFETY TECHNOLOGIES, INC.

Statements of Changes in Stockholders Equity (Deficit)
(Unaudited)
For The Three Months Ended August 31, 2004 and 2003

	Common Stock		Accumulated Other Comprehensive loss	Treasury Stock	Additional Paid-In Capital	Unearned Stock Compensation
	Shares	Amount				
Balance at May 31, 2003	14,757,104	$ 14,757	---	$ ---	$ 3,687,523	$ (96,192)
Amortization of unearned stock comp.	--	--	--	--	--	8,396
Net proceeds from issuance of	850,000	850	--	--	1,699,150	--

common stock											
Minority Interest	294,129		294		--		--		882		--
Net Loss	--		--		--		--		--		--
Balance at August 31, 2003	15,901,233	$	15,901	$	--	$	--	$	5,387,655	$	(87,796)
Balance at May 31, 2004	8,331,410	$	8,331	$	(119,501)	$	--	$	13,105,863	$	(150,733)
Amortization of unearned stock comp.	--		--		--		--		--		15,741
Other Comprehensive loss	--		--		(15,253)		--		--		--
Purchase of Treasury stock	--		--		--		(199,827)		--		--
Net loss	--		--		--		--		--		--
Balance at August 31, 2004	8,331,410	$	8,331		(134,754)	$	(199,827)	$	13,105,863	$	(134,992)

The accompanying notes are an integral part of these financial statements

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FLIGHT SAFETY TECHNOLOGIES, INC.

Statements of Cash Flows
(Unaudited)
For The Three Months Ended August 31, 2004 and 2003

	Three Months Ended August 31	
	2004	2003
Cash flows from operating activities:		
Net loss	$ (49,327)	$ (226,641)
Adjustments to reconcile net loss to net cash provided by operating activities:		
Depreciation and amortization	29,465	18,961
Non-cash compensation - common stock	15,741	8,396
Changes in operating assets and liabilities:		
(Increase) decrease in contract receivables	125,093	(74,160)

	(Increase) decrease in other receivables	(62,629)	1,210
	(Increase) decrease in other current assets and other assets	7,993	(58,242)
	Increase (decrease) in accounts payable and accrued expense	(243,858)	18,926
Net cash used in operating activities		(177,522)	(311,550)
Cash flows from investing activities:			
Purchases of property and equipment		(56,510)	(153,606)
Payments for patents and other costs		--	(12,801)
Net cash used in investing activities		(56,510)	(166,407)
Cash flows from financing activities:			
Proceeds from Sale of Investments		1,013,782	--
Purchase of Treasury Stock		(199,827)	--
Proceeds from issuance of common stock		--	1,700,000
Net cash provided by financing activities		813,955	1,700,000
Net increase (decrease) in cash and cash equivalents		579,923	1,222,043
Cash and cash equivalents at beginning of year		2,180,863	1,039,693
Cash and cash equivalents at end of quarter		$ 2,760,786	$ 2,261,736
Supplemental disclosures of cash flow information:			
Cash paid during the quarter for			
Income taxes paid		$ 16,663	$ --
Interest		--	--

The accompanying notes are an integral part of these financial statements

FLIGHT SAFETY TECHNOLOGIES, INC. AND SUBSIDIARY

Notes To The Financial Statements
(Unaudited)
For The Three Months Ended August 31, 2004 and 2003

The financial statements presented herein are unaudited. In the opinion of our management, these financial statements included all adjustments necessary for a fair presentation of the financial position. Results for the three months ended August 31, 2004 and 2003 are not necessarily indicative of results for the entire year. The accompanying financial statements should be read in conjunction with our financial statements and related footnotes for the years ended May 31, 2004 and May 31, 2003 which are included in our annual report on Form 10-KSB filed on August 25, 2004.

Note 1. Summary of Significant Accounting Policies

:

Cash

Cash represents cash on hand of $234,013 in checking accounts, $501,773 in money market accounts and $2,025,000 in mutual funds as of August 31, 2004. Money market accounts earn interest at approximately 1.05% and mutual funds at approximately 1.70% (per annum).

Income Taxes

As of May 31, 2004 we had federal and state net operating loss carryforwards of approximately $1,900,000, to reduce future taxable income, if any. The federal operating losses expire in various years through 2024 and the state operating losses expire in various years through 2009. We also have state tax credit carryforwards of approximately $10,000, which expire in the year 2009.

Research and Development

Our sponsored research and development costs, including proposal costs and unreimbursed expenditures for developmental activities are charged against income in the year incurred.

Revenue and Cost Recognition

We recognize income from contracts under the percentage of completion method of accounting for financial reporting purposes. Revenues are measured by the ratio of the costs incurred to date divided by the estimated total costs for each contract. Contracting costs include all direct material, labor and subcontracting costs. General and administrative costs are charged to expense as incurred. Provisions for estimated losses on uncompleted contracts are made in the period in which such losses are determined. Changes in job performance, job conditions and estimated profitability and final contract settlements may result in revisions to costs and income and are recognized in the period in which the revisions are determined. Revenue related to claims is recorded at the lesser of actual costs incurred or the amount expected to realized.

Intangible Assets

Intangible assets consist of patent costs totaling $183,959 with accumulated amortization of $36,909. Amortization expense for the three months ended August 31, 2004 was $2,940. Amortization expense for each of the next five years is expected to be approximately $11,760.

Note 2. Interim Financial Information (Unaudited):

Our interim financial statements for the three months ended August 31, 2004 and 2003, included herein, have been prepared by us, without audit, pursuant to the rules and regulations of the SEC. Certain information and footnote disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States of America have been condensed or omitted pursuant to the rules and regulations relating to interim financial statements.

Note 3. Equity Transactions:

During the three months ended August 31, 2003, 850,000 common stock warrants were exercised at $2.00 resulting in proceeds to us of $1,700,000. As of June 27, 2003, we acquired 100% of the common and preferred stock of our subsidiary, FSTO and, effective that date, FSTO was merged into us pursuant to a short form merger under Delaware and Nevada law.

We completed a 3-for-1 reverse stock split effective December 31, 2003. On February 4, 2004, in conjunction with a public underwritten offering, we sold 1,350,000 units at $6.00 per unit, each unit consisting of two shares of common stock and a warrant to purchase one share of common stock at $3.30 a share. On February 13, 2004, we issued an additional 164,300 units at the request of the managing underwriter to cover over-allotments. As a result of these issuances, our common stock outstanding increased by 3,028,600 shares to 8,331,410 shares. We received gross proceeds of $9,085,800 and had expenses for this issuance of $1,491,482 resulting in net proceeds from the issuances of $7,594,318. Below is a summary of shares issued.

Common stock on May 31, 2003	14,757,104
Common stock warrants exercised July 10 to August 8, 2003	850,000
Merger shares July 11, 2003 - minority shares tendered	294,129
Reverse stock split 3 for 1 - December 31, 2003	(10,598,423)
Common stock issuance - February 5, 2004	2,700,000
Common stock issuance - February 13, 2004	328,600
Total common stock issued as of August 31, 2004	8,331,410

Note 4. Investments Available-for-Sale:

We classify our debt and marketable equity securities into held-to-maturity, trading, or available-for-sale categories according to the provisions of Financial Accounting Standards Board Statement No. 115, "Accounting for Certain Investments in Debt and Equity Securities". Debt securities are classified as held-to-maturity when we have the positive intent and ability to hold the securities to maturity. Debt securities for which we do not have the intent or ability to hold to maturity are classified as available for sale. Held-to-maturity securities are recorded as either short-term or long-term on the balance sheet based on contractual maturity date and are stated at amortized cost. Marketable securities that are bought and held principally for the purpose of selling them in the near term are classified as trading securities and are reported at fair value, with unrealized gains and losses recognized in earnings. Debt and marketable equity securities not classified as held-to-maturity or as trading are classified as available-for-sale and are carried at fair market value, with the unrealized gains and losses, net of tax, included in the determination of comprehensive income or loss and reported in shareholders' equity. A summary of these investments is as follows:

August 31, 2004
Available for Sale

Description	Cost	Fair Value	Unrealized Holding Gain/(Losses)
Mutual bond funds	$999,256	$864,502	$(134,754)

Held to Maturity

Description	Carrying Amount	Fair Value	Unrecognized Holding Gain/(Losses)
Corporate bonds	$4,978,125	$4,982,210	$ 4,085
U.S. Government	500,002	493,595	(6,407)
Securities	$5,478,127	$5,475,805	$(2,322)

Contractual maturities of held-to-maturity securities at May 31, 2004 are as follows:

	Carrying Amount
Due in one year or less	$4,978,125
Due in 2-5 years	500,002
	$5,478,127

Note 5. Treasury Stock

During the period from June 2, 2004 to June 17, 2004 we purchased 116,300 shares of our common stock in the open market at an average price of $1.71 for a total price of $199,827. The repurchase was authorized pursuant to a stock repurchase plan approved by our Board of Directors.

Item 2. Management's Discussion and Analysis or Plan of Operation.

Cautionary Statement Pursuant to Safe Harbor Provisions of the Private Securities Litigation Reform Act of 1995:

Except for the historical information presented in this document, the matters discussed in this quarterly report on Form 10-QSB for the three month period ending August 31, 2004 or otherwise incorporated by reference into this document, contain "forward-looking statements" (as such term is defined in the Private Securities Litigation Reform Act of 1995). These statements are identified by the use of forward-looking terminology such as "believes", "plans", "intend", "scheduled", "potential", "continue", "estimates", "hopes", "goal", "objective", "could", "can", expects", "may", "will", "should" or "anticipates" or the negative thereof or other variations thereon or comparable terminology, or by discussions of strategy that involve risks and uncertainties. The safe harbor provisions of Section 21E of the Securities Exchange Act of 1934, as amended, and Section 27A of the Securities Act of 1933, as amended, apply to forward-looking statements made by us. We caution you that no statements contained in this Form 10-QSB should be construed as a guarantee or assurance of future performance or results. Such statements are based on currently available information which management has assessed but which is dynamic and subject to rapid change due to risks and uncertainties that affect our business, including, but not limited to, the outcome of an informal inquiry by the SEC that appears to be in connection with certain analysts reports about us and our press releases, the outcome of pending class action litigation alleging violations of federal securities laws, whether the government will implement WVAS at all or with the inclusion of a SOCRATES wake vortex sensor, the impact of competitive products and pricing, limited visibility into future product demand, slower economic growth generally, difficulties inherent in the development of complex

technology, new products sufficiency, availability of capital to fund operations, research and development, fluctuations in operating results, and other risks detailed from time to time in our filings with the Securities and Exchange Commission. Any statements that express or involve discussions with respect to predictions, expectations, beliefs, plans, projections, objectives, goals, assumptions or future events or performance are not statements of historical fact and may be forward looking statements. Forward looking statements involve a number of risks and uncertainties which could cause actual results or events to differ materially from those presently anticipated. These forward-looking statements are based on current expectations, and, except as required by law, we assume no obligation to update this information whether as a result of new information, future events or otherwise. Readers are urged to carefully review and consider the various disclosures made by us in this Form 10-QSB and in our other reports filed with the Securities and Exchange Commission that attempt to advise interested parties of the risks and factors that may affect our business.

Overview

Our current operations have been funded substantially by U.S. Congressional appropriations resulting in three successive sole source contracts with agencies of the federal government for research, development, and testing of our SOCRATES wake vortex sensor and related work pertaining to a wake vortex advisory system, sometimes known as WVAS, that NASA is developing. We estimate the appropriations to the FAA totaled approximately $9.6 million in U.S. fiscal years 1997 through 2000 for research and development of our SOCRATES wake vortex sensor; and NASA appropriations for research and development of our SOCRATES wake vortex sensor totaled approximately $13.5 million in U.S. fiscal years 2001 through 2003. From these amounts, we have received three contracts aggregating approximately $13 million. As of August 31, 2004, we have recognized an aggregate of approximately $12.9 million of contract revenue, of which we have been paid $12.3 million. Our current SOCRATES government contract backlog is approximately $0.1 million.

We have entered into these contracts with the Volpe National Transportation Systems Center of the U.S. Department of Transportation ("Volpe"). Volpe funds our contracts when, as, and if it and other sponsoring federal agencies approve a statement of work and specific task orders under the statement of work. When funded, we invoice the federal government monthly based on our direct costs, including overhead and general and administrative plus a fixed fee for that month and typically receive payment by electronic wire transfer within two weeks of invoicing. Certain costs, such as lobbying, product development, and business development expenses that are not allowable under these contracts, R&D costs we incur over certain cost caps set by the U.S. government, or costs incurred while our contracts are not funded, are not reimbursable under our government contracts and have been funded primarily by proceeds of offerings of our equity.

Without notice to, or opportunity for prior review by us, Volpe circulated a report in October 2001 which recommended curtailing further government expenditure on our SOCRATES wake vortex sensor due to a high risk assessment of achieving operational feasibility. Together with our major subcontractor, Lockheed Martin Corp., we vigorously disputed and extensively discussed its assertions with Volpe and NASA. Subsequent to these discussions, NASA requested and we submitted a proposal for $2,221,068 of additional SOCRATES wake vortex sensor research, development and testing with an immediate objective of better characterizing the wake acoustics and background noise. In November 2002, Volpe approved and funded a new work order in the amount of $1,229,650 for the first phase of this proposal and in March 2003, a second work order was approved and funded in the amount of $991,418. Included in the funding was a 7% fixed fee over and above our research and development costs plus overhead, general and administrative costs. The statement of work continued our previous contract to develop and test our SOCRATES wake vortex sensor. This funding ended an 11-month period, from December 15, 2001 to November 19, 2002, without government funding to develop our SOCRATES wake vortex sensor.

On September 30, 2003, we received our third successive sole source contract from Volpe, titled Phase III SOCRATES, for an aggregate of $3.975 million to continue work on developing our SOCRATES wake vortex sensor. We used these funds to expand our current SOCRATES wake vortex sensor from its present four beam configuration (which was tested at the Denver International Airport in September of 2003) to eight beams and began further expansion to sixteen beams. This contract is being funded from a U.S. fiscal year 2003 Omnibus Appropriation of $4.5 million to the NASA budget for research, development and testing of our SOCRATES wake vortex sensor as part of a NASA/DOT/FAA development of WVAS for use at major airports.

For U.S. fiscal year 2004, an additional $5 million NASA appropriation specifically for continued work on project SOCRATES has been enacted into law. If and when our sponsoring agencies approve an extension of our contract, statements of work, and appropriate work orders, we expect to receive a contract extension for a substantial portion of this funding which would complete the expansion to 16 beams and include an airport test of the expanded 16-beam SOCRATES wake vortex sensor. As of August 31, 2004, we believe our portion of the $5 million will be approximately $3.2 million and that the funding should be available before November 30, 2004.

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On July 22, 2004 the US House of Representatives Committee on Appropriations recommend an additional $5 million to be added to the U.S. fiscal year 2005 NASA budget for continued research and development on Project SOCRATES. The full House of Representatives and the US Senate have not yet acted on this appropriations bill and are not expected to do so until the U.S. Congress reconvenes after the November elections. If each chamber approves a bill, any differences would be reconciled in a House/Senate conference. Following Senate/House conference approval, the appropriations bill must then be passed in final form by each house and signed by the President into law. Thereafter, we must negotiate and execute a contract and obtain approval for specific work orders before we receive contract revenue from such funding. While we expect to receive a portion of these funds there is no assurance as to how much, if any, of these funds will be received by us.

We believe the federal government has indicated a long-term interest in the development of a wake vortex advisory system and our SOCRATES wake vortex sensor will be well positioned, successfully developed and tested, for inclusion in such a system. However, the federal government has in the past delayed or reduced and may in the future delay, reduce, or eliminate funding for research and development of our SOCRATES wake vortex sensor or the wake vortex advisory system as a result of, among other things, a reduction in support or opposition from supervising agencies or the U.S. Congress, changes in budgetary priorities, fiscal constraints caused by federal budget deficits, or decisions to fund competing systems or components of systems. Such delays or reductions will reduce our resources available for research and development of our proprietary technologies, new products or enhancements to SOCRATES or UNICORN technologies and to market our products. Reduction of or delays in contract funding from the federal government could delay achievement of or increase in profitability, if any, create a substantial strain on our liquidity, resources and product development, and have a material adverse effect on the progress of our research and development and our financial condition.

We also are pursuing development of a collision and ground proximity warning system for small aircraft we refer to as UNICORN. We believe that UNICORN may have application to unmanned air vehicles operated for a variety of private and governmental purposes. We have entered into three significant research and development contract commitments aggregating $350,000 for different aspects of this project.

We have experienced significant losses since our inception. The net loss for our fiscal year ended May 31, 2004 was $424,214 compared to the net loss of $943,974 in fiscal year ended May 31, 2003. The loss for our fiscal year ended May 31, 2003 was caused primarily by three factors: (1) unallowable expenses under our government contract, (2) rate ceilings; and (3) expenses during unfunded periods for SOCRATES research and development. With the reinstatement of the government contract funding, the loss for our fiscal year ended May 31, 2004 was caused by the remaining two factors: (1) rate ceilings during the first six months and (2) unallowable expenses under our government contract.

Our third consecutive government contract that we received on September 30, 2003 does not include rate ceilings. If the government deems our allowable expenses to be reasonable, the absence of rate ceilings should eliminate a second significant source of losses in previous years. We will continue to incur certain unallowable expenses or could incur allowable expenses the government deems unreasonable, and we remain subject to the risk of further delay, reduction or elimination in federal contract funding. However, it is our view that the elimination of rate ceilings is a significant improvement to our historical contract terms.

Critical Accounting Policies and Estimates

The discussion and analysis of our financial condition and results of operations are based on our financial statements that have been prepared according to accounting principles generally accepted in the United States of America. In preparing these financial statements, we are required to make estimates and judgements that affect the reported amounts of assets, liabilities, revenues and expenses and related disclosures of contingent assets and liabilities. We evaluate these estimates on an on-going basis. We base these estimates on historical experiences and on various other assumptions that we believe are reasonable under the circumstances, the results of which form the basis for making judgements about the carrying values of assets and liabilities. Actual results may differ from these estimates under different assumptions or conditions. Our management has discussed these estimates and assumptions with our finance and audit committee. At this point in our operations, subjective judgements do not have a material impact on our financial statements. However, the Federal Acquisitions Regulations require that, among other things, our reimbursable costs are reasonable. We have analyzed our actual overhead rate of 80% and general administrative rates of 35% for fiscal year 2004 and rates of 81% and 29% respectively for the three months ended August 31, 2004. We believe all component costs have been ordinary and necessary and are reasonable. The government, upon audit, may not support our view and may deem such expenses to be unreasonable for a company of our size. We have made certain adjustments to provide for such a contingency. Since there is a high degree of subjectivity in the judgment of what levels of cost are reasonable, we can make no assurance that the government will not require further adjustments. If any such adjustments are required, they would reduce the other receivables reflected on our balance sheet.

Results of Operations

For the periods ended August 31, 2004 and August 31, 2003

Revenues

. To date, our revenues have consisted almost entirely of revenues earned from our three successive SOCRATES wake vortex sensor research and development contracts with the federal government. Revenues under our government contracts are booked as contract sales when earned.

Contract revenue for the three month period ending August 31, 2004 was $1,435,952. This is a 170% increase compared to the contract revenue of $532,215 for the three month period ending August 31, 2003. These results principally reflect new government contract funding for SOCRATES and a larger amount of contract work that we completed and billed in our fiscal year 2004. As of August 31, 2004, our contract receivables against our government contracts are $406,950.

Direct Contract Costs

. Subcontractor, consultant and direct labor expenses comprise our direct contract costs. Direct contract costs for the three month period ending August 31, 2004 were $1,011,844, compared to $358,884 for the three month period ending August 31, 2003. The three month results principally reflect the 170% increase in contract revenue and a 162% increase in subcontractor cost for the three months ended August 31, 2004 compared to the three months ended August 31, 2003.

When our government contract is funded, charges to direct costs do not generally impact our operating income because each contract covers its own direct costs. However, during periods when our government contract is not funded or the actual direct cost of a specific task order exceeds its budgeted funding and the government is not willing to reallocate direct costs between task orders, any such costs we may incur are not reimbursable and must be funded from our own resources. Total direct and indirect expenses during August 2004 that could not be billed on our contract totaled $73,910.

Operating Expenses. Government contractors are required to categorize operating expenses as overhead expenses or general and administrative expenses. These two indirect "cost pools" are then divided by their appropriate "direct cost base" combinations of direct contract cost, which determines the contractors overhead and general and administrative rates. These rates, for our first two government contracts, were subject to ceilings, which were set at 70% for overhead and 20% for general and administrative. Our third contract is not limited by rate ceilings. Instead, we submitted provisional billing rates of 83% for overhead and 29% for general and administrative for our fiscal year ending May 31, 2005 which are based on forecasted direct and indirect costs and were audited by the Defense Contract Audit Agency and approved by Volpe on September 13, 2004. Under our present government contract for SOCRATES, our actual rates will be based on actual allowable costs incurred which we will submit to the government for audit at the end of our fiscal year. When our actual rates have been audited, we will adjust our government contract billings higher or lower to reflect the audited actual rates versus the previous estimated provisional billing rates. Our historical rates are shown below.

	For Year Ended 5-31-03	For Year Ended 5-31-04	For Three Months Ended 08-31-04
Overhead Rates	89%	80%	81%
General and Admin. Rates	67%	35%	29%

The above rates for each of the previous periods include only allowable operating expenses and have been lower over the last three years due to increased contract funding and the increase in our direct cost base. We believe these rates will remain approximately equal to our current provisional billing rates of 83% for overhead and 29% for general administration during our fiscal year ending May 31, 2005, although we can make no assurance in this regard.

Unreimbursable non-contract costs include: 1) expenses considered unallowable per Federal Acquisition Regulations (FAR), such as lobbying and financing costs, 2) over ceiling expenses, and/or 3) operating expenses and direct costs incurred during unfunded periods or attributable to specific tasks that have reached funding limits set in the statement of work. These non-contract costs are not reimbursable under our U.S. government contracts and must be paid from other sources. To date, these sources consist primarily of proceeds from the public and private sales of our equity securities. Non-contract costs have been the primary use of this source of liquidity and have had a significant impact on our operating loss to date. Non-contract costs are detailed below:

	For the 3 Months Ending (Unaudited)	
	08-31-04	08-31-03
1. Unallowable expenses (1) & (2)	$89,990	$ 131,721
2. Over-ceiling expenses	0	99,735
3. Expenses during unfunded period	73,910	0
Total	$163,900	$231,456

Notes:

(1) Includes $15,741 of stock based compensation expense for the 3 months-ended 08-31-04.
(2) Includes $8,396 of stock based compensation expense for the 3 months-ended 08-31-03.

Our total selling, general and administrative expense consist of unallowable and allowable expenses and for the three month period ending August 31, 2004 was $410,437 compared to $353,711 for the same periods in 2003.

Unallowable selling, general and administrative expenses for the three month period ending August 31, 2004 were $89,990 and decreased by $41,731 over the three month period ended in 2003 primarily due to less expense for lobbying and marketing for the three months ending August 31, 2004.

Allowable selling, general, and administrative expenses for the three month period ended August 31, 2004 totaled $320,447 compared to $221,990 for the three month period ended August 31, 2003. The increase of $98,457 for the three months ended August 31, 2004 over the three months ended August 31, 2003 was primarily due to an increase in expenses associated with having three additional full time employees and one additional office.

Expenses during unfunded period of $73,910 for the three month period ending August 31, 2004 represents direct and indirect expenses on several tasks that reached their funding limit under our government contract and therefore could not be billed. These tasks are ongoing and we have committed to continue to pay the costs of these tasks until we receive the next funding, which we expect will cover these tasks going forward.

Over-ceiling expenses and expenses during unfunded periods fluctuate from period to period due to the timing of unfunded periods. We expect to receive additional funding by the end of our second quarter, i.e., November 30, 2005, which should eliminate the expenses during unfunded period category for the third and fourth quarter of our fiscal year 2005. We are no longer subject to rate ceilings which eliminated the over-ceiling expense category during the second quarter of our fiscal year 2004 and we believe will eliminate the over-ceiling category for all of our fiscal year 2005.

Profit or Loss

Our net loss for the three month period ended August 31, 2004 was $49,327. We also have reported an unrealized holding loss of $15,253, and consequently our comprehensive loss for these three months is $64,580, compared to a net loss of $226,641 for the same period in 2003. In our previous two quarters ended February 29, 2004 and May 31, 2004, we were fully funded under our government contracts and earned a profit of $6,411 and $11,737, respectively. The loss for the three month period ended August 31, 2004 was caused by: (1) unallowable expenses under our government contract and (2) expenses during unfunded periods.

Liquidity and Capital Resources

Our sources of liquidity, which we define as our ability to generate cash to fund our operations, are primarily provided by revenue from our government contracts and proceeds from the sale of our equity securities.

Our funded contract backlog on our third contract as of August 31, 2004 is $97,085 compared to $604,796 for our fiscal quarter ended August 31, 2003 and $1,514,315 at the end of our fiscal year ended May 31, 2004.

Our aggregate cash and investments were $9,103,177 as of August 31, 2004 compared to $2,261,736 on August 31, 2003 and $9,552,289 as of May 31, 2004. The increase as of August 31, 2004 over August 31, 2003 was attributable to the sale of 3,028,600 shares of common stock with net proceeds of $7,594,138, less the operating losses for the period from September 1, 2003 to August 31, 2004, capital additions during the twelve month period ending August 31, 2004 of $127,709 and our purchase of our common stock at an aggregate cost of $199,827 in June 2004. The capital addition consisted primarily of the purchase of one company car and computers and software for our new office and for other computers and software that needed to be replaced or upgraded. The decrease as of August 31, 2004 compared to May 31, 2004 was primarily due to a reduction in accounts payable of $243,858, capital additions of $56,510 and purchase of common stock.

As of August 31, 2004, we had other receivables of $257,108 compared to $55,649 as of August 31, 2003 and $194,479 as of May 31, 2004. The increase relative to August 31, 2003 was primarily due to $155,497 of unbilled government contract receivables. The $155,497 increase represents the difference between overhead and general administrative rates billed using provisional rates of 73% and 28%, respectively, and the actual rates of 80% and 35%, for fiscal year 2004 and 81% and 29% for the three months ended August 31, 2004, applied to our direct costs incurred in our Phase III SOCRATES contract to date. At the end of each year, after our rates have been audited by the D.C.A.A., our final government billing for the period is adjusted to reflect the actual allowable overhead and general administrative cost incurred.

As of August 31, 2004, we had total current liabilities, including accounts payable, of $513,312 compared to $391,411 of current liabilities as of August 31, 2003 and $757,170 as of May 31, 2004. Accounts payable as of August 31, 2004 were $377,872, which included approximately $265,000 to our subcontractor, Lockheed Martin Corporation, $48,000 for legal expenses and $65,000 in other expenses, compared to accounts payable as of August 31, 2003 of $288,597, which included approximately $131,000 to Lockheed Martin, $22,000 for legal fees and $135,000 in other expenses.

We anticipate that our funded contract balance for our third contract of $97,085 as of August 31, 2004 will only partially fund our direct and indirect costs for September 2004 and that the government will not fund us in October and November 2004. For the quarter ending November 30, 2004, we have budgeted and expect to incur approximately $550,000 in direct and indirect costs for SOCRATES research and development that will not be funded by our government contract, and approximately $100,000 in unallowable expenses. Assuming we operate within budget, as to which we can make no guaranty or assurance, at the end of our fiscal quarter ending November 30, 2004, we estimate our available cash and investments should be approximately $8,450,000. We have budgeted and expect to incur a total of $250,000 of unallowable expenses in the third and fourth quarters of our fiscal year ending May 31, 2005, and assuming we operate within budget, as to which we can make no guaranty or assurance, at the end of our fiscal year ending May 31, 2005, we estimate our available cash and investments should be approximately $8,200,000.

We expect to receive approximately $3,200,000 of additional contract funding from a $5 million appropriation to NASA for project SOCRATES contained in the recently enacted U.S. Fiscal Year 2004 Consolidated Appropriations Bill, if and when our sponsoring agencies extend our Phase III SOCRATES contract by issuing a contract modification which will include work orders to us. As of this date, we have received, from our sponsoring agency, the planned statement of work for the $3.2 million and are waiting for their formal request to submit a cost and technical proposals for review and approval of the government. The timing for release of such request is not clear. However, we expect to receive the contract modification for additional funding of approximately $3.2 million by November 30, 2004. Any delay in obtaining a contract extension also might require us to draw upon our cash during the third quarter of our current fiscal year to fund our operations.

From time to time, we may consider and execute strategic investments, acquisitions, or other transactions that we believe could benefit us and could require use of some or all of our liquidity. To facilitate such transactions and enhance our liquidity position for these and other purposes, such as working capital for research and development, we also may conduct from time to time various types of equity offerings, including, but not limited to, public or private offerings of common or preferred stock based on a negotiated fixed share value, or floating market price of our publicly traded shares. If we encounter delays in, or are unable to procure, contract funding from the U.S. government for further research development and testing of our SOCRATES wake vortex sensor, incur costs over budget, or make a strategic investment, our cash resources will be reduced more rapidly than we presently anticipate. In such event, we may need to obtain additional capital to maintain operations. There can be no guaranty or assurance of our future ability to obtain capital for any of the foregoing purposes and, if obtained, the terms and conditions of such capital may dilute our present shareholders' ownership.

Known Trends, Risks and Uncertainties

Our business and future success are subject to many risks. The following describes some of the general and specific trends, risks, and uncertainties to which our business is subject and should be read with care.

Risks Related to Our Business

Our limited operating history and lack of commercial operations make it difficult to evaluate our prospects.

Since we began operations in 1997, we have generated limited revenues solely from three SOCRATES technology research and development contracts with agencies of the federal government that fund, administer, and oversee these contracts. The federal government has funded these contracts from earmarked U.S. Congressional appropriations to agencies that have awarded these contracts to us on a sole source basis without competitive bidding. Under these contracts, we are reimbursed for certain allowable research and development costs and are paid a fee calculated as a percentage of costs.

We have not as yet received any revenue from the sale of any products. We do not anticipate receiving any such revenue unless and until our SOCRATES or UNICORN-based products become operational, which could take several years. Our estimates of the market size for the products we are developing are based on many assumptions and uncertainties. These estimates have not been evaluated by an independent party. The actual markets and price we can charge for our products, if and when we successfully complete their development, could be substantially less and our costs could be greater than our estimates. It therefore is difficult to assess our prospects for commercial sales, revenues and profitability.

We have incurred and, for the next several years, can be expected to incur operating losses.

To date, we have incurred significant net losses, including net losses of $424,214 for our fiscal year ended May 31, 2003 and $49,327 for the three months ended August 31, 2004 (compared to net income of $6,411 for the three months ended February 29, 2004 and net income of $11,737 for the three months ended May 31, 2004). On August 31, 2004, we had an accumulated deficit of $2,933,564. We anticipate we may continue to incur operating losses for at least the next several years. We may never generate material revenues or achieve or maintain profitability. Substantially all our revenues have been devoted to payment of costs incurred in the research, development, and testing of our SOCRATES or UNICORN technology. Our ability to achieve, maintain, and/or increase profitability will depend in large part upon the successful further development and testing of our SOCRATES or UNICORN-based products, the continuation of Congressional appropriations and our ability to obtain additional federal research and development contracts for SOCRATES, our ability to obtain additional financing, approval of our SOCRATES or UNICORN-based products and systems by various agencies of the federal government, procurement of our products and systems by the FAA, airports and the aviation industry, and the availability of funding to finance such procurements.

Lack of future funding from the federal government to complete research and development of our SOCRATES wake vortex sensor could adversely affect our business.

Without notice to, or opportunity for prior review by us, the John A. Volpe National Transportation Systems Center of the U. S. Department of Transportation's Research and Special Programs Administration, or Volpe, circulated a report in October 2001 which recommended curtailing further government expenditure on our SOCRATES wake vortex sensor due to a high risk assessment of achieving operational feasibility. Because of this report and the events of September 11, 2001, the government did not fund our SOCRATES research and development contract from December 15, 2001 to November 19, 2002. Together with our major subcontractor, Lockheed Martin Corporation, we vigorously disputed and extensively discussed its assertions with Volpe and NASA. Subsequently, Volpe and NASA requested and we submitted a proposal for approximately $2.2 million of additional SOCRATES technology research, development and testing with an immediate objective of better characterizing the wake acoustics and background noise. We received contract funding for this proposal and subsequent proposals and we believe the federal government will continue to have a long-term interest in the development of a wake vortex advisory system and our SOCRATES wake vortex sensor for inclusion in such a system. However, the U.S. government may terminate our government contract at any time if it determines such termination is in the best interests of the government or may terminate, reduce or modify it because of budgetary constraints or any change in the government's requirements. Furthermore, the federal government has in the past delayed or reduced and may in the future delay, reduce, or eliminate funding for research and development of our SOCRATES wake vortex sensor or the wake vortex advisory system as a result of, among

other things, a reduction in support or opposition from supervising agencies or the U.S. Congress, changes in budgetary priorities, fiscal constraints caused by federal budget deficits, or decisions to fund competing systems or components of systems. If this occurs, it will reduce our resources available for research and development of our proprietary technologies, new products or enhancements to SOCRATES or UNICORN technologies and to market our products. Reduction of contract funding from the federal government could delay achievement of or increases in profitability, if any, create a substantial strain on our liquidity, resources and product development, and have a material adverse effect on the progress of our research and development and our financial condition.

The government will not pay us for SOCRATES research and development if we do not perform on our contract.

We perform our government contracts pursuant to specific work orders from the government. Such work orders include, but are not limited to, analysis of data, research, development of our SOCRATES technology, planning and conduct of testing, and preparation of various reports. If we do not perform the contracts in accordance with their terms, the government may withhold payment on our invoices that we submit monthly. Furthermore, if at any point the government considers a test to be a failure, it may cease to approve further work orders or fund further contracts. Loss of funding on our SOCRATES contract would have a material adverse effect on our business, financial condition, and results of operations.

Our success depends on our successful product development and testing.

Our future success will depend upon our ability to successfully complete the development, testing, and commercialization of our technologies and our ability to develop and introduce new products and services to meet industry, government, and client requirements. We are planning to eventually develop a number of products, based on our SOCRATES and UNICORN technologies. The process of developing such products contains significant technological and engineering hurdles and is extremely complex and expensive. In 2001, Volpe and associated federally funded research centers prepared reports which concluded it was unlikely SOCRATES would result in a sensor that could be used for any operational procedure and even for research because of technical unknowns relating to an understanding of wake vortices and the need to obtain acceptance of WVAS by controllers and pilots. We believe this conclusion was premature and based on an incomplete understanding of SOCRATES and its operational potential. In our opinion, the testing and analysis we have conducted has increasingly supported this potential and resulted in the continuation of funding for our government contracts for research, development and testing of our SOCRATES technology. However, there still are technical, engineering and program integration hurdles we must meet to develop SOCRATES into an operational sensor, including, but not limited to, expanding the sensor to at least 16 and as many as 32 laser beams, integrating the sensor into and with the other components of WVAS, and developing operating protocols for WVAS that define how it would be used by air traffic controllers and pilots. In the case of UNICORN, we must successfully overcome development,

engineering and testing hurdles to produce an operational product and obtain FAA approval of this product. Furthermore, we will need to extend the term of the experimental license the FCC has granted us and, ultimately, obtain a permanent license from the FCC for the operation of UNICORN. We might not successfully complete the development of our SOCRATES or UNICORN technologies into operational products and our products may not be commercially viable. Our failure to complete development of any such products and achieve market acceptance would have a material adverse effect on our business, financial condition, and results of operations.

In addition, certain of our products will require customized installation to address unique characteristics of their environments. Customization could place an additional burden on our resources or delay the delivery or installation of products which, in turn, could have a material adverse effect on our relationship with clients, our business, financial condition, and results of operations.

Our success depends on federal government approval of our products and related systems.

The airport and aviation industry is subject to extensive government oversight and regulation. To introduce our SOCRATES and UNICORN-based products for commercial sale, we must successfully complete research, development, and testing and obtain necessary governmental approvals for their installation. Upon approval by the Federal Aviation Administration, or FAA, our SOCRATES wake vortex sensor would be part of a multi-component wake vortex advisory system that also will require government approvals before it can be deployed. Any factor that delays or adversely affects this approval process, including delays in development or inability to obtain necessary government approvals, could have a material adverse effect on our business, financial condition, and results of operations, and we can make no assurance when or if all such approvals will be obtained.

Our business relies on a strategic alliance with Lockheed Martin Corporation.

In May 1997, we signed a Teaming Agreement with Lockheed Martin Corporation to jointly develop and market SOCRATES-based products. This agreement will expire in May 2007, unless certain earlier termination provisions occur or the agreement is extended by mutual agreement. The agreement stipulates that we serve as prime contractor and Lockheed Martin Corporation as subcontractor in the development and any deployment of our SOCRATES wake vortex sensor. Although to date we have generally worked in close cooperation with Lockheed Martin Corporation, there is no assurance that this relationship will be sustained. Future disagreements as to work scope, revenue share, profit margins, ownership of intellectual property, or technical, marketing, or management philosophy, could adversely impact the relationship. Since we view our strategic relationship with Lockheed Martin Corporation as a vital element of our business plan, any erosion of this relationship could have a negative impact on our business and future value.

On April 26, 2004, in conjunction with the renewal of a nondisclosure agreement, we were advised by Lockheed Martin Corporation that it owns a certain patent which predates our SOCRATES patent and, according to Lockheed Martin Corporation, contains some intellectual property related to our SOCRATES patent. Lockheed Martin Corporation has told us that it was prevented from previously disclosing the patent to us because of a government secrecy order. After consultation with counsel, including our patent counsel, we strongly believe that the Lockheed Martin Corporation patent will not impair the value of our SOCRATES patent because our SOCRATES patent is aimed at improving air traffic safety, a use not contemplated by the Lockheed Martin Corporation patent. Furthermore, it is our position that Lockheed Martin Corporation acknowledged and accepted our invention of the SOCRATES technology in the Teaming Agreement between us in May 1997. We have met with Lockheed Martin Corporation to discuss the matter and potential opportunities relating to