FLIGHT SAFETY TECHNOLOGIES INC
Form 10QSB
April 19, 2005

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 February 28, 2005

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 April 19, 2005 was 8,215,110 shares.

Transitional Small Business Disclosure Format: Yes o No x

FLIGHT SAFETY TECHNOLOGIES, INC.
INDEX

PART I - FINANCIAL INFORMATION

Item 1. Financial Statements.

FLIGHT SAFETY TECHNOLOGIES, INC.

Balance Sheets
as of
February 28, 2005 and May 31, 2004
Unaudited

	February 28, 2005	May 31, 2004

Assets				
Current assets:				
Cash	$	1,730,033	$	2,180,863
Contract receivables		277,044		532,043
Other receivables		---		194,479
Investments held to maturity		5,015,120		4,991,669
Investments available for sale at fair value		883,569		1,879,755
Inventory		108,044		---
Other current assets		32,020		28,840
Total current assets		8,045,830		9,807,649
Property and equipment, net of accumulated depreciation of $295,929 and $216,356		238,227		259,252
Other Assets:				
Intangible assets, net of accumulated amortization of $42,791 and $33,969		168,401		149,990
Investments held to maturity		500,002		500,002
Other receivables		429,674		---
Total Other Assets		1,098,077		649,992
Total Assets	$	9,382,134	$	10,716,893
Liabilities and Stockholders' Equity				
Current liabilities:				
Accounts payable	$	345,652	$	615,911
Accrued expenses		172,868		141,259
Total current liabilities		518,520		757,170

Stockholders' equity:		
Preferred Stock, $0.001 par value, 5,000,000 shares authorized, none issued and outstanding		---
Common stock, $0.001 par value, 50,000,000 shares authorized, 8,331,410 shares issued and outstanding	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	(115,687)	(119,501)
Unearned stock compensation	(103,510)	(150,733)
Accumulated deficit	(3,831,556)	(2,884,237)
Total stockholders' equity	8,863,614	9,959,723
	$ 9,382,134	$ 10,716,893

Total Liabilities and Stockholders' Equity

The accompanying notes are an integral part of these financial statements

1

FLIGHT SAFETY TECHNOLOGIES, INC.

Statements of Operations and Other Comprehensive Income (Loss)
For The Three and Nine Month Periods Ended February 28, 2005 and February 29, 2004
Unaudited

	Three Months 2005	Three Months 2004	Nine Months 2005	Nine Months 2004
Contract Revenues	$ 631,197	$ 1,008,923	$ 2,505,138	$ 2,303,390
Cost and expenses:				
Cost of revenues	370,154	621,909	1,673,542	1,533,721

Research and development	163,661	60,990	348,308	137,647
Selling, general and administrative	528,699	293,399	1,477,925	1,005,976
Depreciation and amortization	29,465	23,534	88,395	61,456
Total cost and expenses	1,091,979	999,832	3,588,170	2,738,800
Loss from operations	(460,782)	(1,083,032)	9,091	(435,410)
Other Income (Expense)				
Interest income	54,561	156,458	4,669	7,462
Loss before provision for income taxes	(406,221)	13,760	(926,574)	(427,948)
Provision for income taxes	6,915	7,349	20,745	8,003
Net Income (Loss)	(413,136)	6,411	(947,319)	(435,951)
Other Comprehensive Income (Loss)				
Unrealized gains on investments	26,783	--	3,814	--
Comprehensive Income (loss)	$(386,353)	$6,411	$(943,505)	$(435,951)
Net Loss Per Share				
Basic and diluted	$ (.05)	$ .00	$ (.12)	$ (.08)
Weighted Average Number of Shares Outstanding				
Basic and diluted	8,215,110	6,097,884	8,218,925	5,481,608

The accompanying notes are an integral part of these financial statements

FLIGHT SAFETY TECHNOLOGIES, INC.

Statements of Changes in Stockholders Equity
For The Nine Months Ended February 28, 2005 and February 29, 2004
Unaudited

	Common Stock Shares	Common Stock Amount	Accumulated Other Comprehensive loss	Treasury Stock	Additional Paid-In Capital	Unearned Stock Compensation	Accumulated Deficit	Stockholder Equity (Deficit)
Balance at May 31, 2003	14,757,104	$ 14,757	---	$ ---	3,687,623	$ (96,192)	$ (2,460,023)	$ 1,146
Amortization of unearned stock comp.	--	--	--	--	--	25,188	--	25
Net proceeds from issuance of common stock	3,878,600	3,878	--	--	9,290,440	--	--	9,294
Minority Interest	294,129	294	--	--	882	--	--	1
Reverse Stock Split	(10,598,423)	$ (10,598)	--	--	10,598	--	--	
Net Loss	--	--	--	--	--	--	(435,951)	(435,

Balance at February 29, 2004	8,331,410	$	8,331	$	--	$	--	12,989,543	(71,004)	(2,895,974)	$	10,030
Balance at May 31, 2004	8,331,410	$	8,331	$	(119,501)	$	--	13,105,863	(150,733)	(2,884,237)	$	9,959
Amortization of unearned stock comp.	--		--		--		--	--	47,223	--		47
Other Comprehensive Income (loss)	--		--		3,814		--	--	--	--		3
Purchase of Treasury stock	--		--		--		(199,827)	--	--	--		(199,
Net loss	--		--		--		--	--	--	(947,319)		(947,
Balance at February 28, 2005	8,331,410	$	8,331		(115,687)		(199,827)	13,105,863	(103,510)	(3,831,556)	$	8,863

The accompanying notes are an integral part of these financial statements

3

FLIGHT SAFETY TECHNOLOGIES, INC.

Statements of Cash Flow
For The Nine Months Ended February 28, 2005 and February 29, 2004
Unaudited

	Nine Months Ended February 28,	
	2005	2004
Cash flows from operating activities:		
Net loss	$ (947,319)	$ (435,951)
Adjustments to reconcile net loss to net cash provided by operating activities:		
Depreciation and amortization	88,395	61,456
Non-cash compensation - common stock	47,223	25,188
Changes in operating assets and liabilities:		
(Increase) decrease in contract receivables	254,999	(183,188)
(Increase) decrease in other receivables	(235,195)	(112,078)
(Increase) decrease in other current assets and other assets	(3,180)	(20,284)
	(108,044)	--

(Increase) decrease in inventory		
Increase (decrease) in accounts payable and accrued expense	(238,650)	397,491
Net cash used in operating activities	(1,141,769)	(267,366)
Cash flows from investing activities:		
Proceeds from sale and maturity of investments	976,549	--
Purchases of property and equipment	(58,548)	(209,626)
Payments for patents and other costs	(27,233)	(27,308)
Net cash (used for) provided by investing activities	890,768	(236,934)
Cash flows from financing activities:		
Purchase of treasury stock	(199,827)	--
Proceeds from issuance of common stock	--	9,294,318
Net cash provided by (used for) financing activities	(199,827)	9,294,318
Net increase (decrease) in cash and cash equivalents	(450,830)	8,790,018
Cash and cash equivalents at beginning of period	2,180,863	1,039,693
Cash and cash equivalents at end of period	$ 1,730,033	$ 9,829,711

The accompanying notes are an integral part of these financial statements

FLIGHT SAFETY TECHNOLOGIES, INC.

Notes To The Financial Statements
(Unaudited)
For The Nine Months Ended February 28, 2005 and February 29, 2004

Note 1. Summary of Significant Accounting Policies

:

Basis of Presentation

These interim financial statements for the three and nine months ended February 28, 2005 and February 29, 2004, included herein, have been prepared, without audit, pursuant to the rules and regulations of the SEC. Results for the three months and nine months ended February 28, 2005 and February 29, 2004 are not necessarily indicative of results for the entire year. In the opinion of management, all adjustments, consisting of normal recurring adjustments, which are necessary for a fair statement of operating results for the interim period have been made. These financial statements do not include all disclosures associated with annual financial statements and, accordingly, 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.

Certain reclassifications have been made to the prior period financial statements to conform to current period presentation with no effect to the Company's reported net loss or financial position.

Use of Estimates

In preparing financial statements in conformity with generally accepted accounting principles, management is required to make estimates and assumptions that affect the reported amounts of assets and liabilities as of the balance sheet date and the reported amounts of revenue and expenses during the reporting period. Material estimates that are particularly susceptible to significant change in the near term relate to the carrying values of other receivables. Actual results could differ from those estimates.

Stock-Based Compensation

The Company accounts for its stock-based compensation using the intrinsic value method provided for under Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees" ("APB 25") and related interpretations for stock options issued to employees and directors. Under APB 25, compensation expense is recognized over the vesting period to the extent that the fair market value of the underlying stock exceeds the exercise price of the employee stock award on the date of grant. Stock options issued under our stock option plans generally have no intrinsic value at the grant date, and under APB 25 no compensation cost is recognized for them. Statement of Financial Accounting Standards ("SFAS") No. 123, Accounting for Stock-Based Compensation, establishes a fair-value-based method of accounting for stock-based compensation plans. The Company has adopted the disclosure-only alternative under SFAS No. 123, which requires the disclosure of the pro forma effects on net loss and net loss per share as if the fair value accounting prescribed by SFAS No. 123 had been adopted.

All options granted had an exercise price greater than the market value of the underlying common stock on the date of grant. The following table illustrates the effect on net income (loss) and net income (loss) per share if the Company had applied the fair value recognition provisions of SFAS No. 123 to stock-based employee compensation:

	Three months ended		Nine months ended	
	February 28, 2005	February 29, 2004	February 28, 2005	February 29, 2004
Net income (loss) as reported	$<413,136>	$6,411	$<947,319>	$<435,951>
Add: stock-based employee compensation expense included in net income	$15,741	$8,396	$47,223	$25,188

Deduct: Total stock-based employee compensation expense determined under the fair value based method for all awards	$<35,798>	$<12,298>	$<71,988>	$<43,346>
Pro forma net income (loss)	$<433,193>	$2,509	$<972,084>	$<454,109>
Earnings per share:				
Basic and diluted - as reported	$ <.05>	$<.00>	$<.12>	$<.08>
Basic and diluted - pro forma	$ <.05>	$<.00>	$<.12>	$<.08>

Earnings Per Share

Basic loss per share is computed by dividing net loss by the weighted average number of shares of common stock outstanding during the period. For the three and nine month periods ended February 28, 2004 and February 29, 2004, the effect of stock options and warrants was antidilutive; therefore, they were not included in the computation of diluted loss per share. The number of shares issuable upon the exercise of outstanding stock options and warrants that were excluded from the computation as their effect would be antidilutive were 3,073,327 and 2,653,327 for the three months ended February 28, 2005 and February 29, 2004, respectively, and 3,073,327 and 2,653,327 for the nine months ended February 28, 2005 and February 29, 2004, respectively.

Cash

Cash represents cash on hand of $189,995 in checking accounts and $1,540,038 in money market accounts as of February 28, 2005. Money market accounts earn interest at approximately 2.64% (per annum).

Research and Development

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

Inventory

Inventory represents purchasing of long lead SOCRATES™ system components to further expand to a thirty-two beam system. Inventory is accounted for at lower of cost or market and on the first-in first-out basis.

Revenue and Cost Recognition

Our contracts with the United States government are cost-reimbursable contracts that provide for a fixed profit percentage applied to our actual costs to complete the work. These contracts are subject to audit and adjustment by our customer, and are subject to cost limitations as provided by the contract.

For these contracts, fee revenue is recorded at the time services are performed based upon actual project costs incurred and include a reimbursement for general, administrative, and overhead costs and the base fee. The general, administrative, and overhead costs are estimated periodically in accordance with government contract accounting regulations and may change based on actual costs incurred. Revenue may be adjusted for our estimate of costs that may be categorized as disputed or unallowable as a result of cost overruns or the audit process.

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. Amortization expense for the nine months ended February 28, 2005 and February 29, 2004 was $8,823 and $6,190, respectively. Amortization expense for each of the next five years is currently expected to be approximately $11,760.

SFAS No. 142, Goodwill and Other Intangible Assets (SFAS No. 142), stipulates that we are required to perform goodwill and other intangible asset impairment tests on at least an annual basis and more frequently in certain circumstances. We will perform our annual impairment testing for fiscal year 2005 during our fourth fiscal quarter. Currently, we are not aware of any event that occurred since our last impairment testing date that would have caused our intangible assets to become impaired.

Note 2. Equity Transactions:

During the nine months ended February 29, 2004, 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 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 these issuances 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 issued - February 5, 2004	2,700,000
Common stock issued - February 13, 2004	328,600
Total common stock issued as of February 28, 2005	8,331,410

Note 3. Investments in Marketable Securities:

We classify our debt and marketable equity securities into held-to-maturity, trading, or available-for-sale categories according to the provisions of SFAS 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:

February 28, 2005			
Available for Sale	Amortized Cost	Fair Value	Unrealized Gain/(Losses)
Mutual bond funds	$999,256	$883,569	$(115,687)
Held to Maturity			
Corporate bonds	$5,015,120	$5,020,052	$ 4,932
U.S. Government Securities	500,002	490,780	(9,222)
	$5,515,122	$5,510,832	$(4,290)

Contractual maturities of held-to-maturity securities at February 28, 2005 are as follows:

Carrying Amount

Due in one year or less	$5,015,120
Due in 2-5 years	500,002
	$5,515,122

Note 4. Treasury Stock

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

-

Note 5. Stock Options

Options may be granted from time to time for shares of common stock as determined by the Board of Directors, subject to any applicable shareholder approval requirements. The stock options granted to date vest over a period of 36 months. The options are exercisable up to three years from the date of vesting. The Company granted 632,955 options prior to the year ended May 31, 2004, with an exercise price of $6.00. As of May 31, 2004 601,706 options were vested and no options had been exercised or forfeited.

On December 1, 2004, 420,000 options were granted to employees with an exercise price of $3.50, vesting over a 36 month period and are exercisable up to ten years from the date of grant.

A summary of the status of our outstanding stock options at May 31, 2004 and February 28, 2005 is as follows:

	Options Outstanding	Weighted Average Exercise Price
Balance, May 31, 2004	632,955	$ 6.00
Cancelled	--	--
Granted	420,000	$ 3.50
Exercised	--	--
Balance, February 28, 2005	1,052,955	$ 5.00

The estimated grant date fair value per option of options granted during the nine months ended February 28, 2005 was $.55.

The following table summarized information regarding options outstanding and options exercisable at February 28, 2005:

	Options Outstanding			Options Exercisable	
Exercise	Number of	Weighted Average Remaining Contractual	Weight Average Exercise	Number of Options	Weighted Average Exercise

Price	Options	Life	Price	Exercisable	Price
$6.00	632,955	.55	$6.00	622,539	$6.00
$3.50	420,000	9.75	$3.50	35,000	$3.50
	1,052,955	4.23	$5.00	657,539	$5.86

-

Note 6. Warrants

We have outstanding warrants of 2,020,372 as of February 28, 2005 and May 31, 2004. These warrants are comprised of 101,072 warrants issued pursuant to a private placement of preferred stock which have an exercise price of $6.00 that expire August 31, 2005; and 1,514,300 warrants with an exercise price of $3.30, 270,000 with an exercise price of $3.60, and 135,000 warrants with an exercise price of $5.40 issued as part of a public offering that expire January 31, 2014.

Note 7. Other Receivable

Other receivables include retained fees on Government contracts which represent up to a 15% payment hold back against billable fees, amounts representing differences in actual and provisional overhead and general administrative rates which we expect are recoverable and will be paid by the Government and other miscellaneous receivables. We do not expect to receive payments for these other receivables in the next year and consider this account a long term asset. The summary below compares the balances for other receivables as of February 28, 2005 and May 31, 2004.

	February 28, 2005	May 31, 2004
Retained Fee		
Phase II Socrates	$ --	$ 56,392
Phase III Socrates	31,794	4,583
Recoverable Rate difference		
Phase III Socrates	393,000	133,000
Miscellaneous	4,880	504
Total	$429,674	$194,479

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

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 February 28, 2005 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", 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. These forward-looking statements involve risks and uncertainties, which include risks and uncertainties associated with, among other things, 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 these and other risks are discussed in the "Known Trends, Risks and Uncertainties" section of this Form 10-QSB. The actual results that we achieve may differ materially from any forward-looking statements due to such risks and uncertainties. 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 ending September 30, 1997 through September 30, 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 $18.5 million in U.S. fiscal years ending September 30, 2001 through September 30, 2004. From these amounts, we have received three contracts aggregating approximately $16.3 million. As of February 28, 2005, we have recognized an aggregate of approximately $13.7 million of contract revenue with $0.3 million in contract receivable as of February 28, 2005. Our current SOCRATES™ government contract backlog is approximately $2.6 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, costs incurred while our contracts are not funded, or costs deemed unreasonable by the government are not reimbursable under our government contracts and have been funded primarily by proceeds of our equity offerings. All of our government contracts and funding are subject to the requirements of the Federal Acquisition Regulations.

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 million 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 $1.230 million for the first phase of this proposal and in March 2003, a second work order was approved and funded in the amount of $0.991 million. 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 a four beam configuration (which was tested at the Denver International Airport in September 2003) to eight beams and began further expansion to sixteen beams. This contract was 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 ended September 30, 2004, an additional $5 million NASA appropriation specifically for continued work on project SOCRATES™ has been enacted into law. On November 30, 2004, after a three month period without contract funding, our sponsoring agencies approved a modification and extension of our contract. As and when set forth in the contract modification, statement of work and appropriate work orders, Volpe has advanced funds to us to complete the expansion of our SOCRATES™ wake vortex sensor from a four beam configuration to a sixteen beam configuration and to conduct a limited "shakedown" test of the expanded sixteen beam SOCRATES™ wake vortex sensor, which we expect to occur at Denver International Airport in September 2005. Although we are cautiously optimistic, there can be no assurance that this test will be successful. Failure to achieve the desired results could limit or delay our prospects for deployment of a SOCRATES™ wake vortex sensor. The funding for this contract modification was $3.237 million and we anticipate that this will provide the necessary funding for project SOCRATES™ through September 2005, although we can make no assurance in this regard.

For U.S. fiscal year ended September 30, 2005, Congress recently enacted, and the President signed into law, the Omnibus Appropriations Bill which contained a further $5 million specifically designated for SOCRATES™. While we expect to obtain a contract modification for a substantial portion of these funds, we have not begun negotiation of a new contract or the statement of work that we expect Volpe will require and must approve together with our government sponsors. There can be no assurance as to the timing for release or amount of funds, if any, which we ultimately may receive from the U.S. fiscal year 2005 appropriation. If these funds are made available to us, we would plan to further expand the SOCRATES™ wake vortex sensor to a thirty two beam configuration and conduct another test of the expanded sensor.

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 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, lack of progress or setbacks in our SOCRATES™ research and development, changes in budgetary priorities, fiscal constraints caused by federal budget deficits, or decisions to fund competing systems or components of systems. If any such delays or reduction occur, 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 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 approximately $0.443 million for different aspects of this project.

We have experienced significant losses since our inception. The net loss for fiscal year ended May 31, 2004 of $424,214 compared favorably to the net loss of $943,974 in fiscal year ended May 31, 2003. Net losses for the three and nine months period ended February 28, 2005 of $413,136 and $947,319, respectively, compared unfavorably to net income of $6,411 and a net loss of $435,951 for the same periods in our fiscal year ended May 31, 2004. The net 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 in November 2002, 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. The loss for the first nine months of fiscal year ending May 31, 2005 was caused by: (1) unallowable expenses, (2) expenses during a partially unfunded period, and (3) unreasonable expenses. The unreasonable expense category represents general and administrative expenses, primarily legal expenses and independent research and development expense for our UNICORN™ technology which we believe are necessary but are significantly higher compared to prior years and may be considered unreasonable by the Defense Contract Audit Agency.

Our third consecutive and current government contract that we initially received on September 30, 2003 does not include rate ceilings. If the government deems our allowable expenses to be reasonable, of which there can be no assurance, the absence of rate ceilings should eliminate or reduce a second significant source of losses in previous years. We will continue to incur certain unallowable expenses or allowable expenses the government deems unreasonable. We also 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 judgments 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 judgments 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 judgments do not have a material impact on our financial statements except as discussed in the next paragraph.

Federal Acquisitions Regulations require that, among other things, our reimbursable costs are reasonable. We have analyzed our actual overhead rate of 73% and general administrative rate of 60% for the nine months ended February 28, 2005. We believe all component costs have been ordinary and necessary but that government auditors may consider our legal expenses, independent research and development expense for UNICORN™ technology, and certain other general and administrative expenses as of the nine months ended February 28, 2005 unreasonable for a company our size. For rate setting purposes, we have reserved $240,000 for potential unreasonable expenses, which reduced the general and administrative rate to 48% for the nine months ended February 28, 2005. Since there is a 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.

Our financial statements and notes thereto include an item for "Other Receivables" that is described therein. Other Receivables includes recoverable rate differences resulting from the difference between the current adjusted general and administrative rate of 48% compared to our provisional rate of 29%, which has created a $260,000 difference for the nine months ended February 28, 2005. In addition, $133,000 was the difference for FY 2004 which brings the total to $393,000 as of February 28, 2005 for recoverable rate difference. We believe this amount will be recoverable along with other contract cost differences, some higher and others lower, when our sponsoring government agency has reviewed our request for contract cost growth which in total is approximately $218,000. Under our government contract, we are entitled to receive this amount as long as it is allowable and reasonable and the contracting officer approves the cost growth due to rate adjustments. The portion of Other Receivables represented by recoverable rate difference also reflects our judgment that we expect the government will have a funding source available to pay us the recoverable rate difference. This source may result from a reallocation of items within our existing contract to reflect actual expenditures, from use of funds available to our next contract, or from reserve sources otherwise available to the government.

We have assessed our prospects for payment and based on the experience of our management under these procedures, we believe that we will receive these amounts upon final government review and audit of our contract. We therefore have recognized them as revenue, although ultimate collection will depend upon availability of one or more of the foregoing sources for payment, of which we can make no assurance.

Results of Operations

For the periods ended February 28, 2005 and February 29, 2004

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.

Contract revenue for the three and nine month periods ended February 28, 2005 was $631,197 and $2,505,138, respectively, compared to $1,008,923 and $2,303,390 for the same periods ended February 29, 2004.

The decrease for the three month period ended February 28, 2005 compared to the same period of the prior year was due to a lower amount of scheduled contract work completed by us and our subcontractor, in accordance with the current statement of work, during the current period. The small increase for the nine month period ended February 28, 2005 compared to the same period of the prior year was due to an increase in contract work completed for the first quarter ended August 31, 2005 compared to the same period in 2004. As of February 28, 2005, our contract receivable against our government contract was $277,044 as compared to $339,021 as of February 29, 2004.

Costs of Revenues

. Subcontractor, consultant and direct labor expenses comprise our costs of revenues. Direct contract costs for the three and nine month periods ended February 28, 2005 were $370,154 and $1,673,542, respectively, compared to $621,909 and $1,533,721 for the same periods ended February 29, 2004.

The three month results principally reflect the decrease in contract revenue for the three month period ended February 28, 2005. The small increase for the nine month results reflects an increased amount of contract work during the quarter ending August 31, 2004.

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 if 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.

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 the DOT/Volpe Center on December 4, 2003. Starting with the end of our fiscal year ended May 31, 2004, our actual rates, based on actual allowable costs incurred, were submitted to the government for audit on September 16, 2004. 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. As long as actual costs are reasonable, of which there can be no assurance, we can include them in our actual rate and receive reimbursement for them. However, if the government will not approve an increase in contract funding to cover a billing adjustment that is higher than our provisional rates, we may not be able to obtain reimbursement for the increase. Our historical rates are shown below.

	For Year Ended 5-31-03	For Year Ended 5-31-04	Nine Months Ended 02-29-04	Nine Months Ended 2-28-05
Overhead Rates				
General and Admin. Rates	89%	80%	73%	73%
	67%	35%	43%	48%

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 the overhead rate will remain approximately equal to our current provisional billing rate of 83%. We expect that our general and administrative rate which was 48% as of February 28, 2005, will be approximately 40% by the end of our fiscal year ending May 31, 2005, compared to our provisional rate of 29%. We believe government auditors will consider a 40% rate reasonable, although we can make no assurance in this regard.

Un-reimbursable non-contract costs include: 1) expenses considered unallowable per Federal Acquisition Regulations (FAR), such as lobbying, stock based compensation and company car expense, 2) over ceiling expen