FLIGHT SAFETY TECHNOLOGIES INC
Form 10QSB
April 14, 2008

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 29, 2008

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

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes o No x

The number of shares of common stock outstanding as of April 14, 2008 was 8,395,210 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 29, 2008 and May 31, 2007
Unaudited

	February 29, 2008	May 31, 2007
Assets		

Current assets:				
Cash and cash equivalents	$	986,061	$	2,439,911
Contract receivables		94,641		105,538
Investments available for sale		400,000		950,000
Inventory		108,044		108,044
Other current assets		87,664		183,027
Total current assets		1,676,410		3,786,520
Property and equipment, net of accumulated depreciation of $513,059 and $488,245		53,364		126,849
Other Assets:				
Intangible assets, net of accumulated amortization of $104,611 and $ 86,611		312,027		275,173
Other receivables		30,460		30,693
Total other assets		342,487		305,866
Total Assets	$	2,072,261	$	4,219,235
Liabilities and Stockholders' Equity				
Current liabilities:				
Accounts payable	$	282,197	$	322,662
Accrued expenses		276,975		270,075
Total current liabilities		559,172		592,737
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, 8,431,510 shares issued at February 29, 2008 and May 31, 2007	8,432	8,332
Additional paid-in-capital	13,349,487	13,125,455
Treasury Stock, 36,300 shares at February 29, 2008, 96,300 shares at May 31, 2007, at cost	(62,371)	(165,463)
Accumulated deficit	(11,782,459)	(9,341,826)
Total stockholders' equity	1,513,089	3,626,498
	$ 2,072,261	$ 4,219,235

Total Liabilities and Stockholders' Equity

The accompanying notes are an integral part of these financial statements

3

FLIGHT SAFETY TECHNOLOGIES, INC.

Statements of Operations and Other Comprehensive Loss
For the Three and Nine Months Ended February 29, 2008 and February 28, 2007
Unaudited

	Three Months 2008	Three Months 2007	Nine Months 2008	Nine Months 2007
Contract Revenues	$ 125,885	$ 182,712	$ 247,230	$1,442,739
Cost of Revenues	31,269	334,193	109,285	1,182,293
Gross Profit	94,616	(151,481)	137,945	260,446
Operating Expenses:				

Research and development	36,373	22,535	230,133	49,463
Selling, general and administrative	789,344	596,942	2,344,112	2,283,362
Depreciation and amortization	27,250	27,023	81,750	81,069
Total operating expenses	852,967	646,500	2,655,995	2,413,894
Loss from Operations	(758,351)	(797,981)	(2,518,050)	(2,153,448)
Other Income				
Interest income	12,217	59,093	82,990	192,308
Gain (loss) on investments available for sale	--	--	--	12,025
Loss before provision for income taxes	(746,134)	(738,888)	(2,435,060)	(1,949,115)
Provision for income taxes	2,433	(17,925)	5,573	(6,955)
Net Loss	(748,567)	(720,963)	(2,440,633)	(1,942,160)
Other Comprehensive Income				
Unrealized gains (loss) on investments	--	--	--	12,025
Less reclassified adjustments	--	--	--	(12,025)
Comprehensive Loss	$(748,567)	$(720,963)	$(2,440,633)	$(1,942,160)
Net Loss Per Share				
Basic and diluted	$ (.09)	$ (.09)	$ (.29)	$ (.24)
Weighted Average Number of Shares Outstanding				
Basic and diluted	8,372,133	8,215,210	8,300,465	8,215,210

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 29, 2008 and February 28, 2007
Unaudited

	Common Stock Shares	Common Stock Amount	Additional Paid - In Capital	Treasury Stock	Accumulated Deficit	Stockholders' Equity
Balance at May 31, 2006	8,331,510	$ 8,332	13,070,192	($99,827)	(6$553,440)	$ 6,325,257
Net Loss	--	--	--	--	(1,942,160)	(1,942,160)
Balance at February 28, 2007	8,331,510	$ 8,332	$ 13,070,192	($99,827)	(8$495,600)	$ 4,383,097
Balance at May 31, 2007	8,331,510	$ 8,332	$ 13,125,455	($65,463)	(9$341,826)	$ 3,626,498
Treasury Stock issued	--	--	11,942	103,092	--	115,034
Share-based compensation	--	--	27,190	--	--	27,190
Common Stock Issued	100,000	$ 100	$ 184,900	--	--	185,000
Net Loss	--	--	--	--	(2,440,633)	(2,440,633)

Balance at February 29, 2008	8,431,510	$ 8,432	$ 13,349,487	$ (62,371)	$ (11,782,459)	$ 1,513,089

The accompanying notes are an integral part of these financial statements

FLIGHT SAFETY TECHNOLOGIES, INC.

Statements of Cash Flow
For the Nine Months Ended February 29, 2008 and February 28, 2007
Unaudited

	For the Nine Months Ended February 29,	
	2008	2007
Cash flows from operating activities:		
Net loss	$(2,440,633)	$(1,942,160)
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation and amortization	81,750	81,068
Common Stock issued in connection with legal settlement	185,000	--
Share-based compensation	142,224	--
Gain (loss) on investments for sale	--	(12,025)
Accretion of investment discounts	--	(39,482)
Changes in operating assets and liabilities:		
Decrease in contract receivables	10,897	(83,963)
Decrease in other receivables	233	65,789
Decrease in other current assets and other assets	95,363	86,983
Decrease in accounts payable and accrued expense	(23,830)	(245,518)

Net cash used in operating activities	(1,948,996)	(2,089,308)
Cash flows from investing activities:		
Purchase of held to maturity securities	--	(3,667,613)
Proceeds from maturity of held to maturity securities	--	8,045,002
Purchase of securities	--	(700,000)
Proceeds from sale of available for sale securities	550,000	1,123,944
Purchases of property and equipment	--	(13,311)
Payments for patents	(54,854)	(45,062)
Net cash provided by investing activities	495,146	4,742,960
Net (decrease) increase in cash and cash equivalents	(1,453,850)	2,653,652
Cash and cash equivalents at beginning of period	2,439,911	145,572
Cash and cash equivalents at end of period	$986,061	$ 2,799,224
Supplemental non-cash disclosures:		
Proceeds on sale of motor vehicle offset by reduction in amounts due	9,735	--

The accompanying notes are an integral part of these financial statements

FLIGHT SAFETY TECHNOLOGIES, INC.

Notes To The Financial Statements
(Unaudited)
For The Three and Nine Months Ended February 29, 2008 and February 28, 2007

Note 1. Summary of Significant Accounting Policies

:

Basis of Presentation

These interim financial statements for the nine months ended February 29, 2008 and February 28, 2007, included herein, have been prepared, without audit, pursuant to the rules and regulations of the SEC. Results for the nine months ended February 29, 2008 and February 28, 2007 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, 2007 and May 31, 2006 which are included in our annual report on Form 10-KSB filed on September 10, 2007.

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 investments, inventory, intangible assets, other receivables and the calculation of share-based compensation. Actual results could differ from those estimates.

Share-Based Compensation

Effective June 1, 2006, the Company adopted the provisions of Statement of Financial Accounting Standards ("SFAS") No. 123, "Share-Based Payments (revised 2004)," (SFAS No. 123R) which requires the Company to measure the cost of employee services received in exchange for an award of equity instruments based on the grant date fair value of the award. That cost is recognized over the period during which an employee is required to provide services in exchange for the award, the requisite service period (usually the vesting period). Under SFAS No. 123R, the Company provides an estimate of forfeitures at the initial grant date. The Company elected the modified prospective transition method under SFAS No. 123R and accordingly has not restated periods prior to adoption. The Company recognized $142,224 and $0 during the nine months ended February 29, 2008 and February 28, 2007, respectively, as expense related to share-based compensation.

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 nine month period ended February 29, 2008 and February 28, 2007, the effect of stock options and warrants was anti-dilutive; 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 anti-dilutive, were 3,953,215 and 3,774,049 for the nine months ended February 29, 2008 and February 28, 2007, respectively.

Cash and Cash Equivalents

Cash and cash equivalents as of February 29, 2008 represents cash on hand of $78,849 in checking and savings accounts and $907,212 in money market accounts.

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 and our maritime industry customers are cost-reimbursable contracts that provide for a fixed profit percentage (base fee), applied to our actual costs to complete the work. These contracts are subject to audit and adjustment by our customers, and are subject to cost limitations as provided by the contracts.

For these contracts, revenue is recorded at the time services are performed based upon actual project costs incurred including 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 subject to approval. 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. Project 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 chargeable costs and revenue recorded and are recognized in the period in which the revisions are determined. Revenue related to additional claims under the contract is recorded at the lesser of actual costs incurred or the amount expected to be realized.

The Company participates in teaming agreements where it is the primary contractor and participates with other organizations to provide services to our customers. The Company has managerial and oversight responsibility for team members as well as the responsibility for the ultimate acceptability of performance under the contract. Accordingly, the Company includes as revenues the amounts that it bills under the teaming arrangements and includes as direct costs amounts that are reimbursable or paid to team members.

Intangible Assets

Intangible assets consist of patent costs. Amortization expense for the nine months ended February 29, 2008 and February 28, 2007 was $18,000 and $15,441 respectively. Amortization expense for each of the next five years is currently expected to be approximately $24,000.

Note 2. Investments in Marketable Securities:

A summary of investments as of February 29, 2008 is as follows:

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized (Losses)	Fair Value
Available for Sale				
Mutual bond funds	$ 400,000	$ --	$ --	$ 400,000

Note 3. 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 options are exercisable up to ten years from the date of vesting.

The fair value of each option award is estimated on the date of grant using the Black-Scholes option valuation model. Expected volatilities are based on the historical volatility of the Company's stock and other factors. The Company uses historical data to estimate option exercise and employee termination within the valuation model. The expected term of options granted represents the period of time that options granted are expected to be outstanding. The risk-free rate for periods within the contractual life of the option is based on the U.S. Treasury yield curve in effect at the time of grant.

A summary of option activity under the plan as of February 29, 2008, and changes during the nine month period then ended is presented below:

Options	Shares (000)	Weighted-Average Exercise Price	Weighted-Average Remaining Contractual Term (years)	Aggregate Intrinsic Value ($000)
Outstanding at May 31, 2007	2,054,849	$ 3.54	8.22	$ --
Granted	--	--	--	--
Exercised	--	--	--	--
Forfeited or expired	(20,834)	6.00	--	--
Outstanding at February 29, 2008	2,034,015	$ 3.51	7.55	$ 0
Exercisable at February 29, 2008	1,934,016	$ 3.51	7.48	$ 0

Note 4. Warrants:

We have 1,919,200 warrants outstanding as of February 29, 2008. These warrants are comprised of 1,514,200 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 which were issued as part of a public offering that expire January 29, 2009.

Note 5. Other Receivables:

Other receivables represent retained fees on government contracts which represent up to a 15% payment hold back against billable fees. 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 29, 2008 and May 31, 2007.

	February 29, 2008	May 31, 2007
Retained Fee		
Phase IV Socrates	$ 30,460	$ 30,460
	--	233

Other Total	$ 30,460	$ 30,693

-

Note 6. Other Current Assets

:

The summary below compares the balances for other current assets as of February 29, 2008 and May 31, 2007.

	February 29, 2008	May 31, 2007
Prepaid insurance	$ 33,848	$36,768
Prepaid rent	2,550	3,670
Prepaid taxes	16,616	21,407
Prepaid legal fees	31,721	36,027
Insurance claims	--	75,199
Prepaid lobbying expense	--	7,000
Prepaid other	2,929	2,956
Total	$ 87,664	$183,027

We expect to receive payments for the prepaid legal fees May 31, 2008.

Note 7: Contingency

Our liquidity to date has primarily been provided by revenue from our government contracts and proceeds from the sale of our equity securities. Our funded contract backlog for our Phase IV Contract has been $0 since December 31, 2006. As of February 29, 2008, our cash and investments were $1,386,061 and we anticipate that we will fund a substantial portion if not all of our operating expense and technology and development costs from our own cash and investments on hand through the end of our fiscal year May 31, 2008.

Our cash projections do not consider additional funding from our SOCRATES® research and development contract received September 15, 2005. In order to receive additional contract funding the government must request and we must submit a cost and technical proposal for review and approval of the government. As of the date of this report, we have not received a request for an additional task order and do not have a projection as to a date for additional task orders. Further task orders will require additional government funding for further research and development of SOCRATES® technology or Aircraft Wake Safety Management (AWSM).

The federal budget for US fiscal year ended September 30, 2008 has $15,813,000 funding specified for wake turbulence research, engineering and development. We have actively pursued funding for our SOCRATES and AWSM technologies from this current federal budget funding for wake turbulence but as of this date we have been unsuccessful. In addition, we are pursuing various other sources of funding but there can be no assurance as to whether or when we will obtain such funding. Lack of and further delays in obtaining additional government contract or

other outside funding will require us to internally fund our operation by drawing upon our cash and investments. Without such internal funding, we would be unable to carry on further research and development of SOCRATES® technology or AWSM, as well as our other technologies. However, our own resources are limited and are not sufficient to complete the research, development and testing that is necessary to commercialize any of our technologies. Our inability to obtain further government or private funding for research, development and testing of our technologies would have a material adverse affect upon our financial condition and our ability to maintain our operations.

The lawsuit with Analogic/SDI was settled in the quarter ended February 29, 2008. In exchange for a transfer to us of intellectual property rights relating to TIICM™ technology on December 21, 2007, we made a cash payment to Sanders Design International of $100,000 and attorney fees and issued 100,000 shares of our common stock to Sander's Design International, Inc. If testing of an anti-shoulder fire missile technology we refer to as TIICM™ had met certain success criteria, we would have issued an additional 250,000 shares of our common stock. As of this date, the test results have been analyzed and it has been determined that those success criteria were not met but were sufficiently promising that we are considering whether to continue the development of the TIICM technology. The settlement agreement also contains certain future royalty rights to Analogic and SDI.

Item 2. Management's Discussion and Analysis of Financial Condition and Results 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 nine months ended February 29, 2008 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, whether the government will implement wake vortex advisory system at all or with the AWSM design and 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 Management's Discussion and Analysis of Financial Conditions and Results of Operations 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 operations to date have been funded substantially by U.S. Congressional appropriations that resulted in four 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 our version of a wake vortex advisory system, WVAS (WakeVas), that National Aeronautics and Space Administration (NASA) had been developing. We estimate the appropriations to the Federal Aviation Administration (FAA) totaled approximately $9.6 million in U.S. fiscal years ended September 30, 1997 through September 30, 2000 for research and development of our SOCRATES® wake vortex sensor; and appropriations to NASA for research and development of our SOCRATES® wake vortex sensor totaled approximately $18.5 million in U.S. fiscal years ended September 30, 2001 through September 30, 2005. To date the total government appropriations for SOCRATES® and WakeVAS were approximately $28.1 million. From these amounts, we received four contracts aggregating approximately $19.8 million in funding and as of February 29, 2008, we recognized an aggregate of approximately $19.8 million of contract revenue. Our current SOCRATES® government contract backlog as of February 29, 2008 is $0. The balance of the government appropriations from 1997 to 2005 of approximately $8.3 million has funded the FAA and NASA program management and technical participation in the development of our SOCRATES® wake vortex sensor and AWSM™ technology.

13

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, research and development 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, and hence unrecoverable, 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.

On September 25, 2005, we received our fourth successive contract from Volpe in the aggregate amount of approximately $9.8 million to continue research, development and testing of our SOCRATES® and AWSM™ technologies. The initial task order funding under this new contract provided approximately $1.7 million of contract funding to us and was dated September 25, 2005. On January 27, 2006 we received our second task order under this new contract which provided approximately $1.4 million of additional funding.

The second task order funding was completely expended as of December 31, 2006. Our ability to generate additional revenue under our Phase IV contract is subject to further U.S. government funding and the issuance of additional task orders of which there can be no assurance. If additional funding becomes available under the Phase IV contract, the remaining amount of $6.7 million can be funded with new task orders which generally require less administrative effort than a new contract award. No such task orders have been requested or are being processed at the present time. We did not undertake significant research or development on SOCRATES® or AWSM™ technology during our fiscal quarter ended February 29, 2008 and have no plans to do so unless and until we are able to procure additional government, private or equity funding, of which there can be no assurance.

The table below represents the U.S. Government funding to date for our four SOCRATES® contracts.

SOCRATES® Phase	Contract Number	Contract Funding	Period of Performance	
I	DTRS-57-97-C-00042	$3,019,355	From To	June 1, 1997 July 31, 1999
II	DTRS-57-99-D-00074	$6,062,948	From To	August 27, 1999 December 31, 2003
III	DTRS-57-03-D-30024	$7,617,165	From To	November 1, 2003 October 15, 2005
IV	DTRT-57-05-D-30115 Task Order No: T0001	$1,695,029	From To	September 15, 2005 March 31, 2006
	DTRT-57-05-D-30115 Task Order No: T0002	$1,409,025	From To	January 27, 2006 December 31, 2006
Total contract funding to date		$19,803,522		

We believe that the federal government has indicated a long-term interest in the development of a wake vortex avoidance system and our SOCRATES® wake vortex sensor for potential inclusion in such a system. In 2003, the federal government began an initiative to develop the Next Generation Air Traffic System (NGATS). NGATS is intended to be a more flexible and automated air traffic system "capable of meeting up to two or three times the current capacity demand by the year 2025". The federal government's Joint Planning and Development Office (JPDO) oversees a coalition of government agencies which are involved in developing NGATS, including the U.S. Departments of Transportation, Defense, Homeland Security and Commerce and the FAA, NASA and White House Office of Science and Technology Policy. These organizations have developed a "roadmap" that defines the technologies that must be developed and implemented in order to achieve the goals of NGATS. Among those technologies are systems which allow for enhanced safety as well as increased throughput of air traffic at airports through reduction of the applied spacing between aircraft. This reduction will be accomplished, in part, "based on ground-based wake vortex detection and prediction," which we expect to be tested and implemented in the U.S. fiscal years 2008-2011 timeframe substantially as stated in the NGATS road map.

To our knowledge, the FAA has no plans to apply sufficient resources to the development of a WakeVAS incorporating both prediction and detection in time for implementation and testing in the timeframe called for by the NGATS roadmap. This disparity between the roadmap and FAA budgeting has been noted in Congressional communications to the FAA and we expect will be the subject of future discussions between the FAA and Congress, although there can be no assurances as to the pace or outcome of any such discussions.

There were no stipulated earmarks or other sources of funding in the U.S. fiscal year 2006 and fiscal year 2007 budget for further testing and development of SOCRATES®-based technology. In the FAA budget request submitted to the U.S. Congress and signed by the President for U.S. fiscal year 2008, which commenced October 1, 2007, a total of $15.8 million is specified for wake turbulence research, engineering and development. Although this represents a threefold increase over previous FAA budget modifications for wake turbulence research, we do not expect to receive any of these funds. We are continuing to explore additional funding opportunities from potential sources in the NASA and/or U.S. Department of Transportation (DOT) budgets and from the private sector for research and development of SOCRATES® and AWSM™ technologies, but can make no assurances of whether or when we will obtain such additional funding. Our inability to obtain or any delay in such contract funding for research and development of SOCRATES® and AWSM™ technologies from the federal government or other sources has delayed and could continue to delay further research, development and testing; could eliminate or continue to delay achievement of profitability, if any; has created a substantial strain on our liquidity, resources and product development; and has had a material adverse effect on the progress of our technology research and development and our financial condition.

We also are pursuing development of an airborne collision alerting and ground proximity warning system for aircraft that we refer to as UNICORN™. We believe that UNICORN™ may have application to manned and unmanned air vehicles operated for a variety of private and governmental purposes. As of February 29, 2008, our direct cumulative research and development expenses for UNICORN™ total approximately $1,418,000. During August 2005 we tested a UNICORN™ prototype antenna in a proof-of-principle test. The data collected from this test has been analyzed and the results were favorable. Since that time, our research, testing and development activities on UNICORN™ activity have been limited, while we evaluated the market for this technology and pursued financing for it. Since November, 2006, we have engaged two placement agents to assist us in pursuing a tax advantaged joint venture financing to complete the research and development of our UNICORN™ technology for general aviation aircraft and unmanned aerial vehicles (UAV's). As of February 29, 2008, we have incurred cumulative expenses for legal fees, placement agent fees, market assessment and business planning expenses of approximately $440,000 in support of this effort. In February 2008, we discontinued efforts to complete a financing to fund our UNICORN™ technology research and development. On April 2, 2007, we received an Air Force contract to begin the research and development of UNICORN™ for UAV's. This contract was for approximately $99,000 and was completed in February 2008. We applied for a Phase II extension of this Air Force contract, but our proposal was rejected. We continue to limit our UNICORN™ research and development until we procure financing to support such effort. We intend to continue to pursue private and federal government funding to develop UNICORN™ UAV applications.

16

During our fiscal year 2005, we also began the exploratory development of a third major technology initiative called TIICM™ (Tactical Integrated Illuminating Countermeasure) in conjunction with Sanders Design International (SDI), a New Hampshire company. TIICM™ technology is intended to provide a low cost yet highly effective shield of protection for airliners against the threat of certain terrorist-launched missiles. In April 2004, we executed a ten year Teaming Agreement with SDI under which we would be the prime contractor on development of countermeasure technologies to protect aircraft from shoulder-fired missiles. As of February 29, 2008 our cumulative direct independent research and development expense for TIICM™ technology is approximately $712,000. We have entered into additional arrangements with SDI pursuant to which we have applied for a new patent on TIICM™ technology with SDI and would have joint ownership of any resulting patent. In the Department of Homeland Security budget for U.S. fiscal year 2006, Congress added $10 million for the investigation of emerging technology for the protection of civil aircraft against terrorist missile threats. SDI received $1 million in funding from an extension to their Phase II Small Business Innovative Research (SBIR) contract with the U.S. Air Force for further TIICM™ technology research and development. This funding came half from the U.S. Air Force and half from the Department of Homeland Security. There can be no assurance that any new patents on TIICM™ technology will be issued, or that we will derive any revenue or profit from TIICM™ technology, nor any expectation that we will receive any government or commercial funding for TIICM™ technology. A series of tests conducted on TIICM™ under the supervision of the U.S. Air Force were concluded in February, 2008 and these tests did not meet the criteria for success that we established with SDI. We have curtailed development activities on TIICM™ technology pending further review of our options, including, but not limited to, further analysis of test data, potential changes to implementation of TIICM™ technology and availability of funding for further research and development.

We have experienced significant losses since our inception. The loss for the nine months ended February 29, 2008 was approximately $2,441,000. The loss for the fiscal year ended May 31, 2007 was approximately $2,788,000. Losses for the fiscal year ended May 31, 2006, was approximately $2,258,000. The loss for the fiscal year ended May 31, 2006 and the fiscal year ended May 31, 2007, as well as for the nine months ended February 29, 2008 included the following (1) unallowable expenses under our contracts, (2) contract cost overruns, (3) unrecoverable and unabsorbed operating expenses, and (4) corporate research and development expenses. The unrecoverable expense category represents general and administrative expenses, primarily legal expenses and independent research and development expense which we believe are necessary but are significantly higher compared to prior years and may be considered unreasonable by the Defense Contract Audit Agency for a company our size.

17

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. Subjective judgments may have a material impact on our financial statements, including recoverability of inventory and intangible assets.

Federal Acquisitions Regulations require that, among other things, our reimbursable costs are reasonable. We have analyzed our actual overhead rate and general administrative rate for the nine months ended February 29, 2008. We believe all component costs have been ordinary and necessary but that government auditors may consider some of our selling, general and administrative expenses for the nine months ended February 29, 2008 unreasonable for a company our size. For rate setting purposes, we have excluded $1,463,000 for potential unrecoverable selling, general and administrative, research and development, and certain other expenses, i.e., unabsorbed operating expenses, for the nine months ended February 29, 2008. 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.

Results of Operations

Revenues

. Through December 31, 2006, the majority of our revenues consisted of revenues earned from our four successive SOCRATES® wake vortex sensor research and development contracts with the federal government. However, during the three and nine months ended February 29, 2008, our primary revenue was $62,000 and $148,000, from hydrodynamic software development provided to companies in the maritime industry which compares to $107,000 and $271,000 of such revenue, respectively, for the same periods ended February 28, 2007. The current backlog for these services is approximately $155,000. In addition, for the three and nine months ended February 29, 2008, we had $64,000 and $99,000 in revenue from our Air Force SBIR Contract for development planning for our UNICORN™ technology. Our SOCRATES® and AWSM™ technology government contract revenue for the three and nine months ended February 29, 2008 was $0 compared to $75,000 and $989,000 for the three and nine months ended February 28, 2007. The decrease in revenue for the three and nine months ended February 29, 2008 compared to the same period in the prior year was due to the completion of our contract task orders and revenue in December 2006.

18

Costs of Revenues

. Subcontractor, consultant and direct labor costs comprise our costs of revenues. Costs of revenue for the three and nine months ended February 29, 2008 was $31,000 and $109,000, compared to $334,000 and $1,182,000 for the three and nine months ended February 28, 2007. The decrease in cost of revenues is primarily due to the decrease in costs of revenue that were associated with development of the SOCRATES® 16 beam system during the three and nine months ended February 28, 2007 which was completed in December 2006.

When our SOCRATES® and AWSM™ government contract is funded, charges to direct costs do not generally negatively impact our operating results 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 cost overruns, which are not reimbursable and must be funded from our own resources.

Research and Development

. Our research and development expense for the three and nine months ended February 29, 2008 was $36,000 and $230,000 compared to $23,000 and $49,000 for the three and nine months ended February 28, 2007. The increase in research and development expenses of $13,000 and $181,000 for the three and nine months ended February 29, 2008 was primarily due to the research and development expense for project UNICORN™ and AWSM™ technologies. During the nine months ended February 29, 2008, the research and development expense for UNICORN™ technology was $113,000, for AWSM™ technology was $106,000, and for TIICM™ technology was $11,000.

Selling, General and Administrative Expenses

. As a federal government contractor we are required to categorize selling, general and administrative expenses as allowable or unallowable. Unallowable expenses are defined in the Federal Acquisition Regulations (FAR) and include lobbying expense, stock based compensation, certain investor relations expenses, legal and professional expenses for defense of lawsuits and intellectual property issues, company car expense, advertising, and travel expense over the government per-diem rates. Unallowable expenses are not reimbursable by the federal government. Allowable and unallowable selling general and administrative expenses for the three and nine month periods ending February 29, 2008 and February 28, 2007 are detailed as follows:

	Three Months 2008	Three Months 2007	Nine Months 2008	Nine Months 2007
Unallowable				
Selling, general & administrative expenses				
Share-based compensation and legal	$ 175,000	$ --	$ 327,000	$ --
settlement	15,000	8,000	190,000	464,000
Legal and professional	--	50,000	67,000	137,000
Lobbying	21,000	--	57,000	--
UNICORN private placement effort	--	--	135,000	--
Class action suit settlement	100,000	--	100,000	--
Analogic Lawsuit Settlement	5,000	30,000	76,000	121,000
All other	**$316,000**	**$ 88,000**	**$ 952,000**	**$ 722,000**
Total				
Allowable				
Selling, general & administrative expenses				
General and administrative salaries and wages	$ 71,000	$ 111,000	$ 317,000	$ 364,000
Business development salaries and wages	61,000	52,000	184,000	174,000
Business development travel	22,000	18,000	60,000	134,000
Employee benefits	125,000	141,000	330,000	363,000
Legal and professional	44,000	36,000	162,000	154,000
Insurance	21,000	52,000	95,000	92,000
Investor Relations	40,000	31,000	70,000	60,000
Director's Fees	17,000	35,000	36,000	90,000
All other	72,000	33,000	138,000	130,000
Total	**$ 473,000**	**$ 509,000**	**$ 1,392,000**	**$ 1,561,000**

Total selling, general and

administrative expenses	**$ 789,000**	**$ 597,000**	**$ 2,344,000**	**$ 2,283,000**

Below is an analysis of allowable selling, general & administrative expense accounts which have a significant difference for the three and nine months ending February 29, 2008 compared to the same period in 2007.

Allowable General and Administrative Salaries and Wages:

the decrease of $40,000 and $47,000 for the three and nine months ending February 29, 2008 reflects the company's ongoing effort to reduce staff hours.

Allowable Business Development Salaries and Wages:

The small increase of $9,000 and $10,000 for the three and nine month period ended February 29, 2008 compared to February 28, 2007, respectively represents an effort over the past two fiscal years to secure funding for our technology development.

Allowable Business Development Travel:

The decrease for business development travel of approximately $74,000 for the nine months ended February 29, 2008 compared to February 28, 2007, respectively, was due to our efforts to reduce expenses in this category by spending significantly more time on conference calls and less time on travel and less outside expense for consultants.

Allowable Employee Benefits:

Total payroll, which includes salaries and wages and direct labor, for the three and nine months ended February 29, 2008 decreased by approximately 10%, compared to the three and nine months ended February 28, 2007. The decrease in total payroll proportionately decreased payroll tax, health insurance and 401K plan expenses.

Allowable Legal and Professional:

Allowable legal and professional fees increased by $8,000 for the three and nine months ended February 29, 2008 compared to the three and nine months ended February 28, 2007 and include fees for legal and accounting reviews and audits of our required year end and quarter end filings.

Allowable Director Fees:

For the three and nine months ended February 29, 2008 director fees were limited to fees for our outside lead director only. For the three and nine months ended February 28, 2007 there were four outside directors who received director's fees.

The operating losses for the three and nine months ended February 29, 2008 and February 28, 2007 are primarily due to four unreimbursable non-contract costs: 1) Unallowable expenses, 2) contract cost overruns, 3) unrecoverable and unabsorbed operating expenses, and 4) corporate research and development primarily for our AWSM™ technology.

These non-contract costs are not reimbursable under our U.S. government contracts and must be paid from other sources, primarily 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. Our non-contract costs are detailed below:

		Three Months 2008	Three Months 2007	Nine Months 2008	Nine Months 2007
1.	Unallowable, selling, general				
	and	$ 316,000	$ 88,000	$ 952,000	$ 722,000
2.	administrative expenses	--	294,000	--	593,000
3.	Contract cost overruns	486,000	403,000	1,466,000	870,000
4.	Unabsorbed operating expenses				
	Corporate research and development	33,000	8,000	124,000	19,000
		$ 835,000	$ 793,000	$2,542,000	$ 2,204,000
	Total				

Below is a discussion and analysis of the non-contract cost categories listed above.

(1) Unallowable, Selling, General and Administrative Expenses. Included in this expense category for the three and nine months ended February 29, 2008 are charges of $285,000 for the settlement of our Analogic/SDI lawsuit, $135,000 for the settlement of the class action suit and related legal fees of $148,000. Excluding these settlement expenses the primary reasons for the decrease in unallowable expenses which would have been $57,000 and $190,000 for the three and nine months ended February 29, 2008 compared to 2007 were that the legal fees for our defense of the Analogic lawsuit for the three and nine months ending in 2008 have exceeded the retention level of our Director & Officer insurance policy, which was not the case in 2007, and 2007 unallowable legal fees includes a reclassification of previously recorded allowable legal fees in support of our UNICORN™ technology private placement.

(2) Contract Cost Overruns. Contract cost overruns for the three and nine months ended February 28, 2007 represented direct labor, overhead, subcontractor and consulting expense, that we incurred in excess of the contract funding to complete tasks for program management, concept of operations and technical remediation as part of Task Order No T0001 and T0002 of our government contract for development of SOCRATES® and AWSM™ technology.

(3) Unabsorbed Operating Expenses. Unabsorbed operating expenses are primarily allowable selling, general and administrative expenses plus other recoverable operating expenses, such as depreciation, state income taxes and UNICORN™ technology research and development less the absorbed expense which we bill to the government pursuant to the terms of our government contracts which are significantly lower for the three and nine months ending February 29, 2008 compared to the same period in 2007 due to the lack of government funding for SOCRATES™. The table below details unabsorbed operating expenses for the three and nine months ended February 29, 2008 compared to 2007.

	Three Months 2008	Three Months 2007	Nine Months 2008	Nine Months 2007
Allowable selling, general and administrative expenses	$ 473,000	$ 509,000	$ 1,392,000	$ 1,561,000
Other recoverable operating expenses	$ 58,000	$ 11,000	$ 169,000	$ 63,000
Absorption/billings to customs	$ (45,000)	$ (117,000)	$ (95,000)	$ (754,000)
Unabsorbed operating expenses	$ 486,000	$ 403,000	$ 1,466,000	$ 870,000

(4) Corporate Research and Development. The increase of $25,000 and $105,000 for the three and nine months ended February 29, 2008 compared to 2007 was due primarily to the decision to increase funding for the research and development of our AWSM™ technology.

Liquidity and Capital Resources

Our liquidity to date has primarily been provided by revenue from our government contracts and proceeds from the sale of our equity securities. We are actively exploring and discussing a possible capital infusion with potential sources, although there can be no assurance we will complete any such financing or the impact any such financing would have on us or the price of our securities.

Our Phase IV SOCRATES® contract was initially funded at approximately $1,695,000 and a second task order provided additional funding of approximately $1,409,000. Our funded contract backlog for our Phase IV contract as of February 29, 2008 and as of February 28, 2007 was $0. In order to conserve our resources, we have substantially suspended research and development on our technologies while we seek to obtain additional government, private or equity funding, of which we can make no assurance. In conjunction with these financing efforts, we also are evaluating various strategic initiatives, including the acquisition of revenue generating companies with product lines that are unrelated to our current technologies.

As of February 29, 2008 and May 31, 2007, our cash and investments were approximately $1,386,000 and $3,390,000, respectively. The decrease in cash on hand and investments of approximately $2,004,000 was primarily attributable to the net loss of approximately $2,441,000 and patent costs of approximately $55,000, offset by the change in operating assets and liabilities of approximately $83,000, depreciation and amortization expense of approximately $82,000 and share based compensation and common shares issued in connection with settlement of lawsuit of $327,000 for the nine months ended February 29, 2008.

As of February 29, 2008, our accounts receivable were $95,000 compared to $106,000 as of May 31, 2007. The balance as of February 29, 2008 reflects the decrease in revenue for the three months ended February 29, 2008 compared to the three months ended May 31, 2007.

We had total current liabilities, including accounts payable, of $559,000 as of February 29, 2008 compared to $593,000 as of May 31, 2007. Accounts payable as of February 29, 2008 were $282,000, compared to accounts payable as of May 31, 2007 of $323,000. The decrease of $41,000 in accounts payable as of February 29, 2008 compared to May 31, 2007 is due primarily to decreased legal fees.

For the three month period from March 1, 2008 to May 31, 2008, we have estimated and expect to incur approximately $450,000 in operating expenses and technology development cost primarily for the further development of our UNICORN® and AWSM™ technologies, patent costs of $20,000, and pay approximately $122,000 for previous deferred payroll and vacation for recently retired employees. During this period, we have estimated and expect to receive approximately $70,000 from our contract billing for hydrodynamic software development, and approximately $15,000 of interest income. Assuming we achieve these estimates, as to which we can make no guaranty or assurance, we estimate our available cash and investments would be approximately $879,000 as of May 31, 2008. Increases in costs, continued lack of government funding, which currently is $0, and many other factors could reduce our cash and investments faster than we expect and we can provide no assurance that our actual cash and investments will be as estimated at any given date.

In order to receive additional contract funding the government must request and we must submit a cost and technical proposal for review and approval of the government. As of the date of this report, we have not received a request for an additional task order and do not have a projection as to a date for additional task orders. Further task orders will require additional government funding for further research and development of SOCRATES® or AWSM™ technology, and no such funding is available as of this date. We are seeking various sources of funding including funding from the FAA Budget for federal government fiscal year end September 30, 2008 which includes $15.8 million for wake turbulence research, engineering and development, although we do not expect to receive any portion of these funds. There can be no assurance as to whether or when we will obtain such funding. Lack of and further delays in obtaining additional government contract or other outside funding requires us to internally fund our operations by drawing upon our cash and investments. However, our own resources are limited and are not sufficient to complete the research, development and testing that is necessary to commercialize any of our technologies. Our inability to obtain further government or private funding for research, development and testing of our technologies has had and, if prolonged, will continue to have a material adverse affect upon our financial condition and our ability to maintain our operations.