

FLIGHT SAFETY TECHNOLOGIES INC
Form 10QSB
January 14, 2008

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549
FORM 10-QSB

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

For The Quarterly Period Ended November 30, 2007

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 No

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

Yes No

The number of shares of common stock outstanding as of January 14, 2008 was 8,295,210 shares.

Transitional Small Business Disclosure Format: Yes No

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PART I - FINANCIAL INFORMATION

Item 1. Financial Statements.

FLIGHT SAFETY TECHNOLOGIES, INC.

Balance Sheets

as of

November 30, 2007 and May 31, 2007

Unaudited

November 30, 2007

May 31, 2007

Assets

Current assets:

| | | | | |
|---------------------------|----|-----------|----|-----------|
| Cash and cash equivalents | \$ | 1,697,833 | \$ | 2,439,911 |
|---------------------------|----|-----------|----|-----------|

| | | | | |
|----------------------|--|---------|--|---------|
| Contract receivables | | 113,374 | | 105,538 |
|----------------------|--|---------|--|---------|

| | | | | |
|--------------------------------|--|---------|--|---------|
| Investments available for sale | | 400,000 | | 950,000 |
|--------------------------------|--|---------|--|---------|

| | | | | |
|-----------|--|---------|--|---------|
| Inventory | | 108,044 | | 108,044 |
|-----------|--|---------|--|---------|

| | | | | |
|----------------------|--|----------------|--|----------------|
| Other current assets | | <u>134,203</u> | | <u>183,027</u> |
|----------------------|--|----------------|--|----------------|

| | | | | |
|----------------------|--|------------------|--|------------------|
| Total current assets | | <u>2,453,454</u> | | <u>3,786,520</u> |
|----------------------|--|------------------|--|------------------|

| | | | | |
|--|--|---------------|--|----------------|
| Property and equipment, net of accumulated depreciation of \$530,745 and \$488,245 | | <u>84,349</u> | | <u>126,849</u> |
|--|--|---------------|--|----------------|

Other Assets:

| | | | | |
|---|--|---------|--|---------|
| Intangible assets, net of accumulated amortization of \$98,611 and \$86,611 | | 313,128 | | 275,173 |
|---|--|---------|--|---------|

| | | | | |
|-------------------|--|---------------|--|---------------|
| Other receivables | | <u>30,460</u> | | <u>30,693</u> |
|-------------------|--|---------------|--|---------------|

| | | | | |
|--------------------|--|----------------|--|----------------|
| Total other assets | | <u>343,588</u> | | <u>305,866</u> |
|--------------------|--|----------------|--|----------------|

| | | | | |
|--------------|----|------------------|----|------------------|
| Total Assets | \$ | <u>2,881,391</u> | \$ | <u>4,219,235</u> |
|--------------|----|------------------|----|------------------|

Liabilities and Stockholders' Equity

Current liabilities:

| | | | | |
|------------------|----|---------|----|---------|
| Accounts payable | \$ | 522,708 | \$ | 322,662 |
|------------------|----|---------|----|---------|

| | | | | |
|------------------|--|----------------|--|----------------|
| Accrued expenses | | <u>272,280</u> | | <u>270,075</u> |
|------------------|--|----------------|--|----------------|

| | | | | |
|---------------------------|--|----------------|--|----------------|
| Total current liabilities | | <u>794,988</u> | | <u>592,737</u> |
|---------------------------|--|----------------|--|----------------|

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,
8,331,510
shares issued at November 30,
2007 and

8,332

8,332

May 31, 2007

Additional paid-in-capital

13,174,333

13,125,455

Treasury Stock, 36,300 shares at
November 30, 2007, 96,300 shares
at May 31, 2007, at cost

(62,371)

(165,463)

Accumulated deficit

(11,033,891)

(9,341,826)

Total stockholders' equity

2,086,403

3,626,498

\$ 2,881,391

\$ 4,219,235

Total Liabilities and Stockholders' Equity

The accompanying notes are an integral part of these financial statements

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FLIGHT SAFETY TECHNOLOGIES, INC.

Statements of Operations and Other Comprehensive Loss
For the Three and Six Months Ended November 30, 2007 and November 30, 2006
Unaudited

| | <u>Three</u> | <u>Three</u> | <u>Six</u> | <u>Six</u> |
|-------------------|---------------|---------------|---------------|---------------|
| | <u>Months</u> | <u>Months</u> | <u>Months</u> | <u>Months</u> |
| | <u>2007</u> | <u>2006</u> | <u>2007</u> | <u>2006</u> |
| Contract Revenues | \$ 75,144 | \$ 654,667 | \$ 121,345 | \$ 1,260,027 |

| | | | | |
|---|--------------------|--------------------|----------------------|----------------------|
| Cost of Revenues | <u>35,265</u> | <u>468,635</u> | <u>78,016</u> | <u>848,100</u> |
| Gross Profit | <u>39,879</u> | <u>186,032</u> | <u>43,329</u> | <u>411,927</u> |
| Operating Expenses: | | | | |
| Research and development | 84,338 | 15,348 | 193,760 | 26,928 |
| Selling, general and administrative | 741,410 | 853,216 | 1,554,767 | 1,686,420 |
| Depreciation and amortization | <u>27,250</u> | <u>27,023</u> | <u>54,500</u> | <u>54,046</u> |
| Total operating expenses | <u>852,998</u> | <u>895,587</u> | <u>1,803,027</u> | <u>1,767,394</u> |
| Loss from Operations | <u>(813,119)</u> | <u>(709,555)</u> | <u>(1,759,698)</u> | <u>(1,355,467)</u> |
| Other Income | | | | |
| Interest income | 30,793 | 60,837 | 70,773 | 133,215 |
| Gain (loss) on investments available for sale | <u>--</u> | <u>12,025</u> | <u>--</u> | <u>12,025</u> |
| Loss before provision for income taxes | <u>(782,326)</u> | <u>(636,693)</u> | <u>(1,688,925)</u> | <u>(1,210,227)</u> |
| Provision for income taxes | <u>1,570</u> | <u>5,485</u> | <u>3,140</u> | <u>10,970</u> |
| Net Loss | <u>(783,896)</u> | <u>(642,178)</u> | <u>(1,692,065)</u> | <u>(1,221,197)</u> |
| Other Comprehensive Income | | | | |
| Unrealized gains (loss) on investments | -- | (6,640) | -- | 12,025 |
| Less reclassified adjustments | -- | <u>(12,025)</u> | -- | <u>(12,025)</u> |
| Comprehensive Loss | <u>\$(783,896)</u> | <u>\$(660,843)</u> | <u>\$(1,692,065)</u> | <u>\$(1,221,197)</u> |
| Net Loss Per Share | | | | |
| Basic and diluted | \$ (.09) | \$ (.08) | \$ (.21) | \$ (.15) |

Weighted Average Number of Shares

Outstanding

| | | | | |
|-------------------|-----------|-----------|-----------|-----------|
| Basic and diluted | 8,278,116 | 8,215,110 | 8,252,041 | 8,215,110 |
|-------------------|-----------|-----------|-----------|-----------|

The accompanying notes are an integral part of these financial statements

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FLIGHT SAFETY TECHNOLOGIES, INC.

Statements of Changes in Stockholders' Equity
For the Six Months Ended November 30, 2007 and November 30, 2006
Unaudited

| | Common Stock | | Additional Paid - In Capital | Treasury Stock | Accumulated Deficit | Stockholders' Equity |
|------------------------------|------------------|-----------------|------------------------------|-------------------|---------------------|----------------------|
| | Shares | Amount | | | | |
| Balance at May 31, 2006 | 8,331,510 | \$ 8,332 | 13,070,192 | (\$99,827) | (6\$553,440) | \$ 6,325,257 |
| Net Loss | -- | -- | -- | -- | (1,221,197) | (1,221,197) |
| Balance at November 30, 2006 | <u>8,331,510</u> | <u>\$ 8,332</u> | <u>\$ 13,070,192</u> | <u>(\$99,827)</u> | <u>(7\$774,637)</u> | <u>\$ 5,104,060</u> |
| Balance at May 31, 2007 | 8,331,510 | \$ 8,332 | \$ 13,125,455 | (\$65,463) | (9\$41,826) | \$ 3,626,498 |

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| | | | | | | |
|------------------------------|------------------|-----------------|----------------------|-----------------|---------------------|---------------------|
| Treasury Stock issued | -- | -- | 32,228 | 103,092 | -- | 135,320 |
| Share-based compensation | -- | -- | 16,650 | -- | -- | 16,650 |
| Net Loss | -- | -- | -- | -- | (1,692,065) | (1,692,065) |
| Balance at November 30, 2007 | <u>8,331,510</u> | \$ <u>8,332</u> | \$ <u>13,174,333</u> | <u>\$62,371</u> | <u>(11,033,891)</u> | \$ <u>2,086,403</u> |

The accompanying notes are an integral part of these financial statements

FLIGHT SAFETY TECHNOLOGIES, INC.

Statements of Cash Flow
For the Six Months Ended November 30, 2007 and November 30, 2006
Unaudited

| | For the Six Months Ended November 30, | |
|---|---|---------------|
| | <u>2007</u> | <u>2006</u> |
| Cash flows from operating activities: | | |
| Net loss | \$(1,692,065) | \$(1,221,197) |
| Adjustments to reconcile net loss to net cash used in operating activities: | | |
| Depreciation and amortization | 54,500 | 54,046 |
| Share-based compensation | 151,970 | -- |
| Gain (loss) on investments for sale | -- | (12,025) |
| Accretion of investment discounts | -- | (39,482) |
| Changes in operating assets and liabilities: | | |
| (Increase) in contract receivables | (7,836) | (300,176) |

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| | | |
|---|--------------------|---------------------|
| Decrease in other receivables | 233 | 70,982 |
| Decrease in other current assets and other assets | 48,824 | 109,052 |
| Increase in accounts payable and accrued expense | <u>202,251</u> | <u>195,438</u> |
| Net cash used in operating activities | <u>(1,242,123)</u> | <u>(1,143,362)</u> |
| 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 available from sale securities | 550,000 | 1,123,944 |
| Purchases of property and equipment | -- | (12,387) |
| Payments for patents | <u>(49,955)</u> | <u>(40,399)</u> |
| Net cash provided by investing activities | <u>500,045</u> | <u>4,748,547</u> |
| Net increase (decrease) in cash and cash equivalents | (742,078) | 3,605,185 |
| Cash and cash equivalents at beginning of period | <u>2,439,911</u> | <u>145,572</u> |
| Cash and cash equivalents at end of period | <u>\$1,697,833</u> | <u>\$ 3,750,757</u> |

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 Six Months Ended November 30, 2007 and November 30, 2006

Note 1. Summary of Significant Accounting Policies

:

Basis of Presentation

These interim financial statements for the six months ended November 30, 2007 and November 30, 2006, included herein, have been prepared, without audit, pursuant to the rules and regulations of the SEC. Results for the six months ended November 30, 2007 and November 30, 2006 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 \$151,970 and \$0 during the six months ended November 30, 2007 and 2006, respectively, as

expense related to share-based compensation.

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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 six month period ended November 30, 2007 and November 30, 2006, 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 six months ended November 30, 2007 and November 30, 2006, respectively.

Cash and Cash Equivalents

Cash and cash equivalents as of November 30, 2007 represents cash on hand of \$2,833 in checking and savings accounts and \$1,695,000 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.

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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 six months ended November 30, 2007 and November 30, 2006 was \$12,000 and \$10,294 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 November 30, 2007 is as follows:

| | <u>Amortized Cost</u> | <u>Gross Unrealized Gains</u> | <u>Gross Unrealized (Losses)</u> | <u>Fair Value</u> |
|--------------------|---------------------------|-----------------------------------|--------------------------------------|-----------------------|
| Available for Sale | | | | |
| Mutual bond funds | \$ <u>400,000</u> | \$ <u>--</u> | \$ <u>--</u> | \$ <u>400,000</u> |

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 November 30, 2007, and changes during the six month period then ended is presented below:

| <u>Options</u> | 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 | <u>(20,834)</u> | 6.00 | -- | = |
| Outstanding at November 30, 2007 | <u>2,034,015</u> | \$ 3.51 | 7.80 | <u>\$ 0</u> |
| Exercisable at November 30, 2007 | <u>1,921,515</u> | \$ 3.51 | 7.72 | <u>\$ 0</u> |

Note 4. Warrants:

We have 1,919,200 warrants outstanding as of November 30, 2007. 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 November 30, 2007 and May 31, 2007.

November 30, 2007

May 31, 2007

| | | |
|-------------------|------------------|------------------|
| Retained Fee | | |
| Phase IV Socrates | \$ 30,460 | \$ 30,460 |
| | <u> --</u> | <u> 233</u> |
| Other | \$ <u>30,460</u> | \$ <u>30,693</u> |
| Total | | |

Note 6. Other Current Assets

:

The summary below compares the balances for other current assets as of November 30, 2007 and May 31, 2007.

November 30, 2007

May 31, 2007

| | | |
|--------------------------|---------------|--------------|
| Prepaid insurance | \$20,470 | \$36,768 |
| Prepaid rent | 3,670 | 3,670 |
| Prepaid taxes | 21,407 | 21,407 |
| Prepaid legal fees | 33,858 | 36,027 |
| Insurance claims | 54,798 | 75,199 |
| Prepaid lobbying expense | -- | 7,000 |
| Prepaid other | <u> --</u> | <u>2,956</u> |

| | | |
|-------|------------------|------------------|
| Total | <u>\$134,203</u> | <u>\$183,027</u> |
|-------|------------------|------------------|

We expect to receive payments for the prepaid legal fees and insurance claim by February 29, 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 November 30, 2007, our cash and investments were \$2,097,833 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 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 are actively pursuing funding for our SOCRATES and AWSM Technologies from this current federal budget funding for wake turbulence and 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 and complete 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.

We are currently pursuing settlements to the two lawsuits pending against us. The class action suit has been arbitrated and a settlement in principle reached by all parties which would require us to pay \$135,000. Management believes the probability of settling the class action suit is high and accordingly we have expensed this cost for the three and six months ending November 30, 2007. The company admits no fault in this settlement agreement. The lawsuit with Analogic/SDI has been settled. In exchange for a transfer to us of intellectual property rights relating to TIICM™ technology, we will make a cash payment to Sanders Design International of \$100,000 and attorney fees and issue 100,000 shares of our common stock to Sander's Design International, Inc. and, depending if testing of an anti-shoulder fire missile technology we refer to as TIICM™ is successful, issue an additional 250,000 shares of our

common stock. The 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 six months ended November 30, 2007 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 resulting 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 is approximately \$28.1 million.

From these amounts, we have received four contracts aggregating approximately \$19.8 million in funding and as of November 30, 2007, we have recognized an aggregate of approximately \$19.8 million of contract revenue. Our current SOCRATES® government contract backlog as of November 30, 2007 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.

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.

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 June 1, 1997 To July 31, 1999 |
| II | DTRS-57-99-D-00074 | \$6,062,948 | From August 27, 1999 To December 31, 2003 |
| III | DTRS-57-03-D-30024 | \$7,617,165 | From November 1, 2003 To October 15, 2005 |
| IV | DTRT-57-05-D-30115 Task Order No: T0001 | \$1,695,029 | From September 15, 2005 To March 31, 2006 |
| | DTRT-57-05-D-30115 Task Order No: T0002 | <u>\$1,409,025</u> | From January 27, 2006 To December 31, 2006 |
| Total contract funding to date | | <u>\$19,803,522</u> | |

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 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, there is no assurance that we will 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 November 30, 2007, our direct cumulative research and development expenses for UNICORN™ total approximately \$1,415,000. 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. In November, 2006, we engaged a placement agent 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). In

support of this effort we have incurred cumulative expenses for legal fees, placement agent fees, market assessment and business planning expenses of approximately \$380,000. The original engaged placement agent agreement has been cancelled and we have engaged a new placement agent, to secure this financing. As of November 30, 2007 we have incurred approximately \$38,000 for expenses associated with this new effort to secure this financing. The market assessment currently in use was prepared by Charles River Associates based in Boston, Massachusetts. There can be no guarantee or assurance that we will complete a financing to fund our UNICORN™ technology research and development. If we do not complete such a financing, we will continue to pursue private and federal government funding to develop UNICORN™ UAV applications. On April 2, 2007, we received an Air Force contract to begin the research and development of UNICORN™ for UAV's. This contract is for approximately \$99,000 and has a period of performance which should be completed in February 2008. We have applied for a Phase II extension of this Air Force contract and are awaiting determination of continuance.

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 November 30, 2007 our cumulative direct independent research and development expense for TIICM™ technology is approximately \$703,000. 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. We have curtailed development activities on TIICM™ technology pending final resolution of the Analogic lawsuit and can make no assurance as to how, if or development of activities will resume.

We have experienced significant losses since our inception. The loss for the six months ended November 30, 2007 was approximately \$1,692,000. 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 six months ended November 30, 2007 were caused by (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.

Our Phase III and Phase IV government contracts do not include rate ceilings. If we obtain government funding, and 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 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. Subjective judgments may have a material impact on our financial statements, including recoverability of inventory and intangible assets and insurance claims receivable.

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 six months ended November 30, 2007. 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 six months ended November 30, 2007 unreasonable for a company our size. For rate setting purposes, we have excluded approximately \$970,000 for potential unrecoverable selling, general and administrative, research and development, and certain other expenses, i.e., unabsorbed operating expenses, for the six months ended November 30, 2007. 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 six months ended November 30, 2007, our primary revenue was \$58,000 and \$86,000, from hydrodynamic software development provided to companies in the maritime industry which compares to \$101,000 and \$164,000 of such revenue, respectively, for the same periods ended November 30, 2006. The current backlog for these services is approximately \$185,000. In addition, for the three and six months ended November 30, 2007, we had \$17,000 and \$35,000 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 six months ended November 30, 2007 was \$0 compared to \$554,000 and \$1,096,000 for the three and six months ended November 30, 2006. The decrease in revenue for the three and six months ended November 30, 2007 compared to the same period in the prior year was due to the completion of our contract work and revenue in December 2006.

Costs of Revenues

. Subcontractor, consultant and direct labor costs comprise our costs of revenues. Costs of revenue for the three and six months ended November 30, 2007 was \$35,000 and \$78,000, compared to \$469,000 and \$848,000 for the three and six months ended November 30, 2006. 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 six months ended November 30, 2006 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 six months ended November 30, 2007 was \$84,000 and \$194,000 compared to \$15,000 and \$27,000 for the three and six months ended November 30, 2006. The increase in research and development expenses of \$69,000 and \$167,000 for the three and six months ended November 30, 2007 was primarily due to the research and development expense for project UNICORN™ and AWSM™ technologies. During the six months ended November 30, 2007, the cumulative research and development expense for UNICORN™ technology was \$102,000, for AWSM™ technology was \$90,000, and for TIICM™ technology was \$2,000.

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 six month periods ending November 30, 2007 and 2006 are detailed as follows:

| | Three Months <u>2007</u> | Three Months <u>2006</u> | Six Months <u>2007</u> | Six Months <u>2006</u> |
|--|--------------------------------|--------------------------------|------------------------------|------------------------------|
| <u>Unallowable</u> | | | | |
| Selling, general & administrative expenses | \$ 67,000 | \$ -- | \$152,000 | \$ -- |
| Share-based compensation | (26,000) | 299,000 | 175,000 | 477,000 |
| Legal and professional | 36,000 | 44,000 | 67,000 | 87,000 |
| Lobbying | 24,000 | -- | 36,000 | -- |
| UNICORN private placement effort | 135,000 | -- | 135,000 | -- |
| Class action suit settlement | <u>38,000</u> | <u>39,000</u> | <u>71,000</u> | <u>70,000</u> |
| All other | <u>\$ 274,000</u> | <u>\$ 382,000</u> | <u>\$ 636,000</u> | <u>\$ 634,000</u> |
| Total | | | | |
| <u>Allowable</u> | | | | |
| Selling, general & administrative expenses | | | | |
| General and administrative | | | | |
| salaries and wages | \$ 118,000 | \$ 127,000 | \$ 246,000 | \$ 252,000 |
| Business development salaries | | | | |
| and wages | 60,000 | 55,000 | 123,000 | 123,000 |
| Business development travel | 18,000 | 77,000 | 38,000 | 116,000 |
| Employee benefits | 99,000 | 109,000 | 205,000 | 223,000 |
| Legal and professional | 51,000 | -- | 118,000 | 117,000 |
| Insurance | 34,000 | 1,000 | 74,000 | 40,000 |
| Investor Relations | 28,000 | 31,000 | 30,000 | 38,000 |
| Director's Fees | 15,000 | 45,000 | 19,000 | 83,000 |
| All other | <u>44,000</u> | <u>26,000</u> | <u>66,000</u> | <u>60,000</u> |
| Total | <u>\$ 467,000</u> | <u>\$ 471,000</u> | <u>\$ 919,000</u> | <u>\$ 1,052,000</u> |

| | | | | |
|--|--------------------------|--------------------------|----------------------------|----------------------------|
| Total selling, general and administrative expenses | <u>\$ 741,000</u> | <u>\$ 853,000</u> | <u>\$ 1,555,000</u> | <u>\$ 1,686,000</u> |
|--|--------------------------|--------------------------|----------------------------|----------------------------|

Below is an analysis of allowable selling, general & administrative expense accounts which have a significant difference for the three and six months ending November 30, 2007 compared to the same period in 2006.

Allowable General and Administrative and Business Development Salaries and Wages:

The small decrease of \$4,000 and \$6,000 for the three and six month period ended November 30, 2007 compared to November 30, 2006, respectively represents a steady staff level over the past eighteen months for these two categories of salaries and wages.

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Allowable Business Development Travel:

The decrease for business development travel of approximately \$59,000 and \$78,000 for the three and six months ended November 30, 2007 compared to November 30, 2006, respectively, was due to our efforts to reduce expenses in this category.

Allowable Employee Benefits:

Total payroll, which includes salaries and wages and direct labor, for the three and six months ended November 30, 2007 decreased by 13%, compared to the three and six months ended November 30, 2006. 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 \$51,000 for the three months ended November 30, 2007 compared to the three months ended November 30, 2006 due to legal and consulting fees which were reclassified to unallowable expense for work related to the UNICORN™ technology private placement efforts in 2006. The legal and professional fees for the six months ended November 30, 2007 compared to 2006 are primarily the same and include fees for legal and accounting reviews and audits of our required year end and quarter end filings.

Allowable Insurance:

For the three and six months ended November 30, 2007, insurance expense is approximately \$34,000 higher than the same periods in 2006 because the prepaid insurance account, part of other current assets, as of May 31, 2006 was understated by approximately \$23,000. The adjusted insurance expense for the three and six months ended November 30, 2007 would be approximately \$10,000 higher than the expense for the three and six months ended November 30, 2006 and is in line with expectations

Allowable Director Fees:

For the three and six months ended November 30, 2007 director fees were limited to fees for our outside lead director only. For the three and six months ended November 30, 2006 there were four outside directors who received director's fees.

The operating losses for the three and six months ended November 30, 2007 and November 30, 2006 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:

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| | Three Months <u>2007</u> | Three Months <u>2006</u> | Six Months <u>2007</u> | Six Months <u>2006</u> |
|--------------------------------------|--------------------------------|--------------------------------|------------------------------|------------------------------|
| 1. Unallowable, selling, general and | \$ 274,000 | \$ 382,000 | \$ 636,000 | \$ 634,000 |
| 2. administrative expenses | -- | 164,000 | -- | 299,000 |
| 3. Contract cost overruns | 444,000 | 122,000 | 970,000 | 467,000 |
| 4. Unabsorbed operating expenses | | | | |
| Corporate research and development | <u>41,000</u> | <u>5,000</u> | <u>91,000</u> | <u>11,000</u> |
| Total | <u>\$ 759,000</u> | <u>\$ 673,000</u> | <u>\$ 1,697,000</u> | <u>\$ 1,411,000</u> |

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 six months ended November 30, 2007 is a one time charge of \$135,000 for the settlement of the class action suit. Excluding this settlement expense the primary reasons for the decrease in unallowable expenses which would have been \$243,000 and \$133,000 for the three and six months ended November 30, 2007 compared to 2006 was that the legal fees for our defense of the Analogic lawsuit for the three and six months ending in 2007 have exceeded the retention level of our Director & Officer insurance policy, which was not the case in 2006, and 2006 unallowable legal fees includes a reclassification of previously recorded allowable legal fees in support of our UNICORN™ technology private placement. The negative \$26,000 for the three months ended November 30, 2007 represents billing adjustments from the law firm that represents us in the Analogic lawsuit.

(2) Contract Cost Overruns. Contract cost overruns for the three and six months ended November 30, 2006 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 six months ending November 30, 2007 compared to the same period in 2006 due to the lack of government funding for SOCRATES™. The table below details unabsorbed operating expenses for the three and six months ended November 30, 2007 compared to 2006.

| | Three Months <u>2007</u> | Three Months <u>2006</u> | Six Months <u>2007</u> | Six Months <u>2006</u> |
|---|--------------------------------|--------------------------------|------------------------------|------------------------------|
| Allowable selling, general and administrative expenses | \$ 468,000 | \$ 471,000 | \$ 919,000 | \$ 1,053,000 |
| Other recoverable operating expenses | \$ 8,000 | \$ 29,000 | \$ 101,000 | \$ 51,000 |
| Absorption/billings to customs | \$ <u>(32,000)</u> | \$ <u>(378,000)</u> | \$ <u>(50,000)</u> | \$ <u>(637,000)</u> |
| Unabsorbed operating expenses | \$ <u>444,000</u> | \$ <u>122,000</u> | \$ <u>970,000</u> | \$ <u>467,000</u> |

(4) Corporate Research and Development. The increase of \$36,000 and 80,000 for the three and six months ended November 30, 2007 compared to 2006 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 most recent contract, titled Phase IV SOCRATES®, is the fourth successive contract that we have received to continue work on our SOCRATES® wake vortex sensor. 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 November 30, 2006 was approximately \$77,000 and as of November 30, 2007 was \$0.

As of November 30, 2007 and May 31, 2007, our cash and investments were approximately \$2,098,000 and \$3,390,000, respectively. The decrease in cash on hand and investments of approximately \$1,292,000 was primarily attributable to the net loss of approximately \$1,557,000 and patent costs of approximately \$50,000, offset by the change in operating assets and liabilities of approximately \$109,000, depreciation and amortization expense of approximately \$54,000 and share based compensation of \$152,000 for the six months ended November 30, 2007.

As of November 30, 2007, our accounts receivable were \$113,000 compared to \$106,000 as of May 31, 2007. The balance as of November 30, 2007 reflects the decrease in revenue of approximately \$29,000 for the three months ended November 30, 2007 compared to the three months ended May 31, 2007 offset by \$35,000 of accounts receivable that were over 60 days as of November 30, 2007.

We had total current liabilities, including accounts payable, of \$795,000 as of November 30, 2007 compared to \$593,000 as of May 31, 2007. Accounts payable as of November 30, 2007 were \$523,000, compared to accounts payable as of May 31, 2007 of \$323,000. The increase of \$200,000 in accounts payable as of November 30, 2007 compared to May 31, 2007 is due primarily to increased legal fees we incurred in defending the Analogic lawsuit and an expense of \$135,000 for the class action suit settlement.

For the six month period from December 1, 2007 to May 31, 2008, we have estimated and expect to incur approximately \$1,050,000 in operating expenses and technology development cost primarily for the further development of our UNICORN® and AWSM™ technologies, patent costs of \$50,000, approximately \$125,000 for previous deferred payroll and vacation for recently retired employees, \$100,000 to purchase SDI intellectual property

and approximately \$135,000 to settle the class action lawsuit. During this period, we have estimated and expect to receive approximately \$200,000 from our contract billing for hydrodynamic software development, an estimated \$88,000 from an insurance claim for damages to our Denver International Airport test site, and approximately \$52,000 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 \$978,000 as of May 31, 2008. Increases in costs, 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.

Our cash projections do not consider any additional funding from our \$9.815 million 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® or AWSM™ technology, and no such funding is available as of this date. We are actively pursuing 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.

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.

On October 12, 2007, we received notice from the American Stock Exchange indicating that we are below certain of the Amex's continued listing standards as set forth in Section 1003 of the Amex Company Guide in that our shareholders' equity of \$3.626 million as of May 31, 2007 and \$2.803 million as of August 31, 2007 were below the Amex requirement of \$4 million, and we have incurred losses from continuing operations in our last four consecutive fiscal years. The Amex afforded us the opportunity to submit a plan of compliance that is intended to demonstrate our ability to regain compliance with these requirements by April 12, 2009. If the plan is not accepted by the Amex or we fail to perform the plan, we will be subject to delisting procedures as set forth in Section 1010 and part 12 of the Amex Company Guide. We submitted our plan of compliance to Amex on November 12, 2007, although we can make no assurance as to whether or when Amex will accept such plan or if Amex accepts such plan, we will succeed in performing the plan.

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

Known Trends, Risks and Uncertainties

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

Risks Related to Our Business

We need additional contract funding or need to raise additional capital.

Our present financial resources are limited and are not sufficient to complete research and development of or commercialize any of our technologies or continue operations significantly beyond our current fiscal year ending May 31, 2008. In addition, we need to raise equity in the amount of approximately \$4 million to meet certain requirements of the American Stock Exchange and avoid delisting of our securities from that exchange. We face many uncertainties with respect to research and development and the timing of commercialization of our SOCRATES®, AWSM™, UNICORN™ and TIICM™ based products, the availability and level of government funding, the FAA approvals required for our products, and the long sales cycle from initial customer contact to actual, if any, revenue generation.

Depending on the outcome of these uncertainties, we might not be able to generate sufficient, if any, revenue or investment capital to fund our research and development and operations over the period of years we believe are required to commercialize our products. In each of our prior fiscal years, we have incurred substantial operating losses which we have funded, in part, with equity capital that we raised from new investors.

We do not have any credit facilities in place and we may not be able to obtain sufficient, if any, additional capital or raise such capital on acceptable terms. We are actively exploring and discussing a possible capital infusion with potential sources, although there can be no assurance we will succeed in obtaining such capital. Obtaining additional debt or equity capital may require our entry into joint ventures or issuance of additional securities, which may cause dilution to our current capital structure and stockholders' ownership. Additional securities also could have a greater priority as to dividends, distributions and other rights than our common stock.

We will continue to incur significant expenses for research and development and testing of our SOCRATES®, AWSM™, UNICORN™ and TIICM™ technologies and may continue to experience such losses prior to commercialization and thereafter. In addition, future costs, including, without limitation, marketing, sales and installation and research and development costs of later generation SOCRATES®, AWSM™, UNICORN™ and TIICM™ based products also could require us to seek additional capital. If we were unable to generate sufficient working capital from revenue from government funding or private contracts for these purposes, we would need to seek and obtain additional capital.

For the life of our public warrants, and the underwriter's warrants issued pursuant to our February 2004 public offering, and our existing unregistered options, the holders thereof are given the opportunity to profit from a rise in the market for our common stock, with a resulting dilution in the interest of all other stockholders. So long as these warrants or options are outstanding, the terms on which we could obtain additional capital may be adversely affected. The holders of these warrants or options might be expected to exercise them at a time when we would, in all likelihood, be able to obtain any needed capital by a new offering of securities on terms more favorable than those provided by these warrants or options.

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

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

All of our contract funding to date has resulted from earmarks made by the U.S. Congress during its budget and appropriation process. There is no assurance that we will receive further contract funding in this manner. Rather, we expect our future contract funding, if any, will depend primarily upon and result from the decision of our sponsoring agencies, particularly the FAA, to approve contract funding for further research, development and testing of our SOCRATES® wake vortex sensor or the wake vortex avoidance system as part of their agency budget and make funds available for such purpose from amounts appropriated to them or mandated by Congress or other sources. The

FAA has not as yet included such funding in its budget and there can be no assurance that we will be successful in obtaining any such funding.

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

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

To date, we have incurred significant net losses, including net losses of approximately \$1,692,000 for the six months ended November 30, 2007, net loss of approximately \$2,788,000 for the fiscal year ended May 31, 2007; \$2,258,000 for the fiscal year ended May 31, 2006 and \$1,412,000 for the fiscal year ended May 31, 2005. We had an accumulated deficit of \$11,033,891 as of November 30, 2007. We anticipate we may continue to incur operating losses for at least the next several years. We may never generate material revenues or achieve or maintain profitability. Substantially all our revenues have been devoted to payment of costs incurred in the research, development, and testing of our SOCRATES®, AWSM™, UNICORN™ or TIICM™ technology. Our ability to achieve, maintain, and/or increase profitability will depend in large part upon the successful further development and testing of our SOCRATES®, AWSM™, UNICORN™-based, and TIICM™ products, Congressional appropriations and our ability to obtain additional federal research and development contracts for SOCRATES®, AWSM™, UNICORN™ and TIICM™ based products, approval of our SOCRATES®, AWSM™, UNICORN™-based, and TIICM™ products and systems by various agencies of the federal government, procurement of our products and systems by the FAA, airports and the aviation industry, and the availability of funding to finance such procurements.

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

The current federal budget for its fiscal year ending September 30, 2008 contains approximately \$15.813 million of FAA funding for wake turbulence research, engineering and development. However, there can be no assurance we will obtain any of such funds. We continue to explore and incur significant business development expenses to obtain government funding for research and development of our technologies, as well as other sources, but can make no assurance as to whether, when or in what amount we will be able to obtain any such funding. While we believe the federal government will continue to have a long-term interest in the development of a wake vortex advisory system

and our SOCRATES® wake vortex sensor and AWSM™ technology for inclusion in such a system, the U.S. government may terminate our government contract at any time if it determines such termination is in the best interests of the government or may terminate, reduce or modify it because of budgetary constraints or any change in the government's requirements. Furthermore, the federal government has in the past delayed or reduced and may in the future delay, reduce, or eliminate funding for research and development of our SOCRATES® wake vortex sensor and AWSM™ technology or the wake vortex advisory system as a result of, among other things, lack of progress or set-backs in technology development, a reduction in support or opposition from supervising agencies or the U.S. Congress, changes in budgetary priorities, fiscal constraints caused by federal budget deficits, or decisions to fund competing systems or components of systems. Any such event reduces our

resources available for research and development of our proprietary technologies, new products or enhancements to SOCRATES®, AWSM™, UNICORN™ or TIICM™ technologies and to market our products. Delay, termination or reduction of contract funding from the federal government prevents or delays achievement of or increases in profitability, if any, creates a substantial strain on our liquidity, resources and product development, and has a material adverse effect on the progress of our research and development and our financial condition.

Our success depends on our successful product development and testing.

Our future success will depend upon our ability to successfully complete the development, testing, and commercialization of our technologies and our ability to develop and introduce new products and services to meet industry, government, and client requirements. We are planning to eventually develop a number of products, based on our SOCRATES®, AWSM™, UNICORN™ and TIICM™ technologies. The process of developing such products contains significant technological and engineering hurdles and is extremely complex and expensive. In 2001, Volpe and associated federally funded research centers prepared reports which concluded it was unlikely SOCRATES® technology would result in a sensor that could be used for any operational procedure and associated federally funded research centers prepared reports which concluded it was unlikely SOCRATES® technology would result in a sensor that could be used for any operational procedure and even for research because of technical unknowns relating to an understanding of wake vortices and the need to obtain acceptance of WVAS by controllers and pilots. We believe this conclusion was premature and based on an incomplete understanding of SOCRATES® technology and its operational potential. In our opinion, the testing and analysis we have conducted has increasingly supported this potential and resulted in the continuation of funding for our government contracts for research, development and testing of our SOCRATES® technology. However, there still are technical, engineering and program integration hurdles we must meet to develop SOCRATES® technology into an operational sensor, including, but not limited to, expanding the sensor to at least sixteen and as many as thirty-two laser beams, integrating the sensor into and with the other components of an AWSM™ system to make it suitable and effective for a WVAS, and developing operating protocols for AWSM™ technology that define how it would be used by air traffic controllers and pilots. In a long term mission needs statement approved by the FAA in 2003, it assigned an overall moderate to high risk rating to implementation of a WVAS due to technical unknowns and risks associated with getting controllers and pilots to accept a ground or flight deck based system. In the case of UNICORN™ technology, we must successfully overcome development, engineering and testing hurdles to produce an operational product and obtain FAA approval of this product.

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

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

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

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

In the past, our business has relied on a strategic alliance with Lockheed Martin Corporation.

In May 1997, we signed a teaming agreement with Lockheed Martin Corporation to jointly develop and market SOCRATES® based products. This agreement expired in May 2007 and our relationship with Lockheed Martin has terminated. The agreement stipulated that we serve as prime contractor and Lockheed Martin Corporation as subcontractor in the development and any deployment of our SOCRATES® wake vortex sensor. We have been increasing our capability to continue without Lockheed Martin. This may require the hiring of additional personnel, and/or consultants with subject matter expertise. We are also exploring possible strategic partnering relationships. There can be no assurance that these efforts to replace our past reliance on Lockheed Martin will be successful.

On April 26, 2004, in conjunction with the renewal of a nondisclosure agreement, we were advised by Lockheed Martin Corporation that it owns a certain patent which predates our SOCRATES® patent and, according to Lockheed Martin Corporation, contains some intellectual property related to our SOCRATES® patent. Lockheed Martin Corporation has told us that it was prevented from previously disclosing the patent to us because of a government secrecy order. After consultation with counsel, including our patent counsel, we strongly believe that the Lockheed Martin Corporation patent will not impair the value of our SOCRATES® patent

because our SOCRATES® patent is aimed at improving air traffic safety, by detection of atmospheric turbulence, a use not contemplated by the Lockheed Martin Corporation patent. Furthermore, it is our position that Lockheed Martin Corporation acknowledged and accepted our invention of the SOCRATES® technology in the May 1997 teaming agreement. We have met several times with Lockheed Martin Corporation to discuss the matter and potential opportunities relating to our SOCRATES® patent. However, Lockheed Martin Corporation continues to disagree with our position.

In our discussions with Lockheed Martin Corporation concerning our respective intellectual property claims, Lockheed Martin has asserted that essentially all of its work product, which results from its research and development on SOCRATES® technology pursuant to work orders from us, is its property. We have informed Lockheed Martin that we believe that we own or have rights to use such work product, subject to any rights of the government.

We can make no assurance as to whether or when these issues will be completely resolved with Lockheed Martin in a satisfactory manner. It is too early for us to assess how this situation will impact us and whether discussions between us and Lockheed Martin will resume, continue or resolve the issue. Termination of work by Lockheed Martin could have a material adverse effect upon our ability to obtain further government funding for and carryout research, development of our SOCRATES® technology, as well as on our operations, finances and prospects for successful completion and commercialization of SOCRATES® technology.

Loss of key personnel could adversely affect our business.

Our future success depends to a significant degree on the skills, experience and efforts of our executive officers, William B. Cotton, Chief Executive Officer and Director, David D. Cryer, Chief Financial Officer and Treasurer, C. Robert Knight, General Counsel, Vice President of Administration and Secretary, and Dr. Neal Fine, Senior Vice President for Technology and Director. The sustained unavailability of any one or more of those individuals for any reason could have a material adverse impact on our operations and prospects.

We anticipate hiring additional executive officers in the future. In view of our present financial condition and limited liquidity, we may not be able to complete the hiring of these additional officers in a timely manner or at all. We also depend on the ability of our executive officers and other members of senior management to continue to work effectively as a team.

Government regulation could adversely affect our business.

As a result of receiving contract funding from the federal government and our involvement in the field of aviation, our business and operations are subject to numerous government laws and regulations. In the near term, and for so long as we receive funding from the federal government, we will be subject to many procurement and accounting rules and regulations of the federal government. We are also subject to periodic audits by the Defense Contract Audit Agency, or DCAA. To date, we are current on all D.C.A.A. required audits and our last audits were completed and reports distributed by D.C.A.A. on November 14, 2006 and November 21, 2006. The subject audits covered an audit of the government accounting system which was approved and the final annual indirect cost rates for our fiscal year ended May 31, 2006 were approved and submitted. Reports have been issued by the D.C.A.A. to our government customer which have stated that we are performing in accordance with Federal Acquisitions Regulations. There is no assurance that any of the results or contents of any future audits will portray us favorably.

These rules and regulations are complex in nature and sometimes difficult to interpret or apply. Adherence to these rules is reviewed by participating agencies of the federal government. If such agencies suspect or believe that violations of procurement or accounting rules and regulations have occurred, they may refer such matters to other enforcement divisions of the federal government, such as the U.S. Attorney's Office or the Inspector General's office. If we violate these rules and regulations, even if unintentionally, we may have to pay fines and penalties or could be terminated from receiving further funding from the federal government. If we market, sell and install our products in foreign countries, the laws, rules and regulations of those countries, as well as certain laws of the United States, will apply to us. Existing as well as new laws and regulations of the United States and foreign countries which regulate aviation and airports could also adversely affect our business.

Our success depends on our ability to protect our proprietary technology.

Any failure by us to protect our intellectual property could harm our business and competitive position. For example, although we have sought patent protection for our technologies, the steps we have taken or intend to take with regard to protecting our technologies may not be adequate to defend and prevent misappropriation of our technology, including the possibility of reverse engineering and the possibility that potential competitors will independently develop technologies that are substantially equivalent or superior to our technology. Furthermore, any patent we have obtained or may obtain may subsequently be invalidated for any of a variety of reasons. In addition, even if we are issued a patent, we may not be able to gain any commercial advantage from such patent. Existing United States laws afford only limited intellectual property protection.

We intend to use a combination of patent, trade secret, copyright and trademark law, nondisclosure agreements, and technical measures to protect our proprietary technology. We intend to enter into confidentiality agreements with and obtain assignments of intellectual property from all of our employees, as well as with our clients and potential clients, and intend to limit access to and distribution of our technology, documentation and other proprietary information. However, the steps we take in this regard may not be adequate to deter misappropriation or independent third-party development of our technology. In addition, the laws of some foreign countries do not protect proprietary technology rights to the same extent as do the laws of the United States. If we resort to legal proceedings to enforce our intellectual property rights, the proceedings could be burdensome and expensive and could involve a high degree of risk to our proprietary rights if we are unsuccessful in such proceedings. Moreover, our financial resources may not be adequate to enforce or defend our rights in our technology. Additionally, any patents that we apply for or obtain may not be broad enough to protect all of the technology important to our business, and our ownership of patents does not in itself prevent others from securing patents that may block us from engaging in actions necessary to our business, products, or services.

Other companies may claim that we infringe their intellectual property or proprietary rights.

If our proprietary technology violates or is alleged to violate third party proprietary rights, we may be required to reengineer our technology or seek to obtain licenses from third parties to continue offering our technology without substantial reengineering. Any such efforts may not be successful or if successful could require payments that could have a material adverse effect on our profitability and financial condition. Any litigation involving infringement claims against us would be expensive and time-consuming, and an adverse outcome may result in payment of damages or injunctive relief that could materially and adversely affect our business.

Under certain circumstances, the federal government may be able to use our SOCRATES®-related technologies or other technologies developed with government funding without payment to us.

We have taken certain steps to preserve our rights in our SOCRATES®-related technologies under our contracts with the federal government. However, as is the case with all research and development contracts funded by the federal government, the Federal Acquisition Regulations provide that, under certain circumstances, the federal government may have paid-up rights to use, or have used on its behalf, our SOCRATES®-related technologies or other technologies developed with government funding. We do not expect that the federal government will attempt to use our SOCRATES®-related technologies without compensating us. Nevertheless, if the federal government attempts to exercise these rights, it is difficult to predict what effect, if any, it may have on us. If the federal government succeeds in exercising these rights, it may have a material adverse effect on our business operations and financial performance, which could negatively affect the value of our stock.

Our future customers, including the FAA, may not accept the price of or be able to finance our products.

At present, we cannot precisely fix a price for the sale and installation of an initial SOCRATES® wake vortex sensor at airports or UNICORN™-based collision avoidance systems in small aircraft or TIICM™ in commercial airliners. We estimate that the cost of our SOCRATES® wake vortex sensor will be roughly \$10 million to \$20 million per airport installation, depending on, among other things, the number and configuration of runways. Due to developments in the market for general aviation collision warning and avoidance products and information we have obtained from our ongoing research, development and engineering of UNICORN™, we now expect the UNICORN™-based system could be more complex than we originally envisioned. As a result, we anticipate the wholesale price of this product could be approximately \$25,000 which is substantially greater than the \$10,000 price we have previously estimated. As we develop further information on the configuration and components of a UNICORN™-based system for general aviation, related production costs, and rapidly evolving competitive technologies, we will reassess the potential market for a commercial UNICORN™-based collision avoidance system for general aviation. Our current goal is to use, build on, and complete the UNICORN™ research and development we have conducted to date through a tax advantaged joint venture with private investors that we presently are pursuing. In addition, we have been pursuing the application of UNICORN™ technology to unmanned air vehicles (UAV's). On April 2, 2007, we received an Air Force contract to begin the research and development of UNICORN™ for UAV's. This contract is for \$99,316 and has a nine month period of performance. Because we have not completed the research, development, and testing of either product or received final approvals for them from the federal government, we have not commenced production or marketing efforts. We currently do not anticipate having these products ready for commercial sale for at least several years. We therefore are not yet in a position to gauge the reaction of potential customers to the pricing of these products or future products and whether such potential customers will be able to afford and finance our products.

We believe that the increase in efficiency and safety to airports, airlines, and private aircraft resulting from our products will justify the substantial anticipated cost of sales and installation of these products. However, our customers' ability to afford such costs will depend, in part, on the health of the overall economy, the financial condition and budget priorities of the federal government, particularly the FAA and NASA, profitability of airports, airlines, and aircraft manufacturers, and the availability of private and government sources of funding to finance the sales and acquisition of our products. While a variety of potential funding sources exist, inability of the FAA, airlines or airports to access or obtain funding for purchase and installation of our products could have a material adverse impact on sales of our SOCRATES®, AWSM™, UNICORN™ or TIICM™ based products.

We may experience long sales cycles.

We expect to experience long time periods between initial sales contacts and the execution of formal contracts for our products and completion of product installations. The cycle from first contact to revenue generation in our business

involves, among other things, selling the concept of our technology and products; developing and implementing a pilot program to demonstrate the capabilities and accuracy of our products; negotiating prices and other contract terms; and, finally, installing and implementing our products on a full-scale basis. We anticipate this cycle will entail a substantial period of time, on average between seven to twelve months, and the lack of revenue experienced during this cycle and the expenses involved in bringing new sales to the point of revenue generation would put a substantial strain on our resources.

Our success will depend on our ability to create effective sales, marketing, production and installation forces.

At present and for the near future, we will depend upon a relatively small number of employees and subcontractors to complete the research and development of our SOCRATES® wake vortex sensor and pursue research and development of other SOCRATES®, AWSM™, UNICORN™ and TIICM™ based products. The marketing and sales of these products will require us to find additional capable employees or subcontractors who can understand, explain, market, and sell our technology and products to airports, airlines, and airplane manufacturers. We also will need to assemble new personnel and/or contractors for production and installation of our products. Upon successful completion of research and development, these demands will require us to rapidly increase the number of our employees, vendors, and subcontractors. There is intense competition for capable personnel in all of these areas, and we may not be successful in attracting, integrating, motivating, or retaining new personnel, vendors, or subcontractors for these required functions.

Our business could be adversely affected if our products fail to perform properly.

Products and systems as complex as ours may contain undetected errors or "bugs," which result in system failures, or failure to perform in accordance with industry expectations. Despite our plans for quality control and testing measures, our products including any enhancements may contain such bugs or exhibit performance degradation, particularly during the early stages of installation, and deployment. Product or system performance problems could result in loss of or delay in revenue, loss of market share, failure to achieve market acceptance, adverse publicity, injury to our reputation, diversion of development resources and claims against us by governments, airlines, airline customers, and others.

We could be subject to liability claims relating to malfunction of our technology.

Sale of our products will depend on their ability to improve airport, airline, and airplane safety and efficiency. We will take great care to test our products and systems after installation and before actual operation to insure accuracy and

reliability. The FAA acquires air traffic control equipment for U.S. airports, and typically assumes the principal product liability risk for such equipment. However, unforeseen problems, misuse, or changing conditions could cause our products and systems to malfunction or exhibit other operational problems. Such problems could cause, or be perceived to cause, airplane accidents, including passenger fatalities. We may receive significant liability claims if governments, airlines, airports, passengers and other parties believe that our systems have failed to perform their intended functions. Liability claims could require us to spend significant time and money in litigation, pay substantial damages, and incur increased insurance premiums, regardless of our responsibility for such failure. Although we plan to maintain product liability insurance, such coverage may not continue to be available on reasonable terms or be available in amounts sufficient to cover one or more large claims, and the insurer may disclaim coverage as to any claim.

We face significant competition from other companies.

The air safety systems and air traffic control industries are already highly competitive. Other industry participants could develop or improve their own systems to achieve the cost efficiencies and value that we believe our products will provide upon successful completion of research and development. Additional companies may enter the market with competing systems as the size and visibility of the market opportunity increases. In addition, the government could cause us to compete against other companies for research and development or production and deployment of our technologies, when and if we successfully complete any of their development. Many of our potential competitors have longer operating histories, greater name recognition, substantially greater financial, technical, marketing, management, service, support, and other resources than we do. Therefore, they may be able to respond more quickly than we can to new or changing opportunities, technologies, standards, or customer requirements. Competition could reduce our revenues and margins and have a material adverse effect on our operations.

New products or technologies will likely increase the competitive pressures that we face. Increased competition could result in pricing pressures, reduced margins, or the failure of our products to achieve or maintain market acceptance. The development of competing products or technologies by market participants or the emergence of new industry or government standards may adversely affect our competitive position. As a result of these and other factors, we may be unable to compete effectively with current or future competitors. Such inability would likely have a material adverse effect on our business, financial condition, or results of operations.

Rapid technological change could render our systems obsolete.

Our business in general is characterized by rapid technological change, frequent new product and service introductions and enhancements, uncertain product life cycles, changes in customer requirements, and evolving industry standards which make us susceptible to technological obsolescence. The introduction of new products embodying new

technologies, the emergence of new industry standards, or improvements to existing technologies could render our products and systems obsolete or relatively less competitive. Our future success will depend upon our ability to continue to develop and introduce a variety of new products and to address the increasingly sophisticated needs of our customers. We may experience delays in releasing new products and systems or enhancements in the future. Material delays in introducing new products and systems or enhancements may cause customers to forego purchases of our products and systems and purchase products and systems of competitors instead.

Failure to properly manage growth could adversely affect our business.

To implement our strategy, we believe that we will have to grow rapidly. Rapid growth may strain our management, financial, and other resources. To manage any future growth effectively, we must expand our sales, marketing, production, installation, and customer support organizations, invest in research and development of new products or enhancements to existing systems that meet changing customer needs, enhance our financial and accounting systems and controls, integrate new personnel or contractors, and successfully manage expanded operations. We may not be able to effectively manage and coordinate our growth so as to achieve or maximize future profitability.

We must hire and retain skilled personnel.

Our success depends in large part upon our ability to attract, train, motivate, and retain highly skilled employees, particularly sales and marketing personnel, scientists, engineers, and other technical support personnel. Our failure to attract and retain the highly trained technical personnel that are integral to our direct sales, product development, installation, support, and professional services may limit the rate at which we can generate sales or develop new products or system enhancements, which could have a material adverse effect on our business, financial condition, or results of operations.

Any acquisition we make could disrupt our business and harm our financial condition.

We may attempt to acquire businesses or technologies that we believe are a strategic fit with our business. We currently have no commitments for any acquisition. Any future acquisition may result in unforeseen operating difficulties and expenditures, and may absorb significant management attention that would otherwise be available for ongoing development of our business. Since we may not be able to accurately predict these difficulties and expenditures, these costs may outweigh the value we realize from a future acquisition. Future acquisitions could result in issuances of equity securities that would reduce our stockholders' ownership interest, the incurrence of debt, contingent liabilities, amortization of expenses related to other intangible assets and the incurrence of large, immediate write-offs.

You should carefully read and evaluate this entire Form 10-QSB and our current SEC filings including the risks it describes and not consider or rely upon any statement, information or opinion about us that is not contained in this Form 10-QSB and our current SEC filings.

Certain statements, information and opinions about us have appeared and may continue to appear in published news reports, analysts' reports, other media sources and our web site. Some of the information contained in these reports or sources may not be material to understanding our business or may be out of date, erroneous or inconsistent with that disclosed in this Form 10-QSB and our current SEC filings. In making a decision to invest in our securities, you should not rely upon any of these statements, information or opinions and should only rely upon, consider and carefully evaluate the information and risks contained in this Form 10-QSB and our current SEC filings.

We may suffer losses from various investments that we make and related market risks.

From time to time, we may make various types of investments which include, but may not be limited to, acquisitions of other companies, strategic transactions and joint ventures, repurchase of our shares, and general investment of our available cash in various types of debt and equity securities. Some of these investments, such as acquisitions or joint ventures, may involve a high degree of risk and we could lose the entire amount of our investment. Other investments are intended to be conservative, e.g., investment of cash reserves in high quality bonds or equity funds, but are subject to judgments about many factors beyond our control which can adversely affect these types of investments. For example, a rise in such interest rates will adversely affect the value of fixed income securities we hold and we may incur a loss of principal if we have to sell under such conditions. A decline in interest rates may reduce our investment income. We

attempt to be prudent in making any of the foregoing investments, which are reviewed and approved by management and our board of directors. These types of transactions are necessary and important for the success of our overall business and our efforts to create value for our shareholders. However, we have suffered losses on certain of these investments and can make no assurance that we will not suffer losses in the future. Any such losses could have a

material adverse impact on our results of operations and cash available to support our operations and investment in research and development.

Risks Related to Investment in Our Securities

The American Stock Exchange has notified us that our securities will be delisted from the AMEX if we do not submit and perform an acceptable compliance plan.

On October 12, 2007, we received notice from the American Stock Exchange indicating that we are below certain of the Amex's continued listing standards as set forth in Section 1003 of the Amex Company Guide in that our shareholders' equity of \$3.626 million as of May 31, 2007 and \$2.803 million as of August 31, 2007 were below the Amex requirement of \$4 million, and we have incurred losses from continuing operations in our last four consecutive fiscal years. The Amex afforded us the opportunity to submit a plan of compliance that is intended to demonstrate our ability to regain compliance with these requirements by April 12, 2009. If the plan is not accepted by the Amex or we fail to perform the plan, we will be subject to delisting procedures as set forth in Section 1010 and part 12 of the Amex Company Guide. We submitted our plan of compliance to Amex on November 12, 2007, although we can make no assurance as to whether or when Amex will accept such plan or if Amex accepts such plan, we will succeed in performing the plan.

If any of our securities are delisted from the American Stock Exchange, we may be subject to the risks relating to penny stocks.

If any of our securities were to be delisted from trading on the American Stock Exchange and the trading price of such security remains below \$5.00 per share on the date such security was delisted, trading in such security would also be subject to the requirements of certain rules promulgated under the Securities Exchange Act of 1934. These rules require additional disclosure by broker-dealers in connection with any trades involving a security defined as a penny stock and impose various sales practice requirements on broker-dealers who sell penny stocks to persons other than established customers and accredited investors, generally institutions. The additional burdens imposed upon broker-dealers by such requirements may discourage broker-dealers from effecting transactions in our securities, which could severely limit the market price and liquidity of such securities and the ability of purchasers to sell our securities in the secondary market. A penny stock is defined generally as any non-exchange listed equity security that has a market price of less than \$5.00 per share, subject to certain exceptions.

The price of our securities could be volatile and subject to wide fluctuations.

The market price of the securities of a pre-commercial, research and development stage aviation technology company, such as ours, can be especially volatile. Thus, the market price of our securities could be subject to wide fluctuations. In fact, the trading volume and price of our shares have fluctuated greatly. Subject to the information set forth in this Form 10-QSB, we are unaware of any specific reasons for this volatility and cannot predict whether or for how long it will continue.

If our revenues do not grow or grow more slowly than we anticipate, we are unable to procure federal contracts for our SOCRATES® wake vortex sensor, AWSM™, UNICORN™ or TIICM™ technology research and development, we encounter technical or engineering obstacles to the successful commercial development of SOCRATES®, AWSM™, UNICORN™ or TIICM™ technology, our operating or capital expenditures exceed our expectations and cannot be adjusted accordingly, or if some other event adversely affects us, the market price of our securities could decline. In addition, if the market for aviation technology stocks or the stock market in general experiences a loss in investor confidence or otherwise fails, the market price of our securities could fall for reasons unrelated to our business, results of operations, and financial condition. The market price of our securities also might decline in reaction to events that affect other companies in our industry even if these events do not directly affect us. Furthermore, the sale in the open market of recently sold securities or newly issued securities, which we may sell from time to time to raise funds for various purposes, and securities issuable upon the exercise of purchase rights under existing options and warrants may place downward pressure on the market price of our securities. Speculative traders may anticipate a decline in the market price of our securities and engage in short sales of our securities. Such short sales could further negatively affect the market price of our securities.

Litigation could adversely affect our operating results and financial condition.

Companies that have experienced volatility in the market price of their stock have been the subject of securities class action litigation. We and our former chairman and chief executive officer and president are defendants in pending class action litigation that alleges violations of federal securities laws and breach of fiduciary duties. This case has been settled in principle but still must be approved by the plaintiff class and the court. A second case against us and our chief executive officer, which alleges contractual interference relating to the development of TIICM™ technology, was recently settled. Defending against existing and potential litigation requires significant attention and resources and, regardless of the outcome, results in significant legal expenses, which adversely affect our results unless covered by insurance or recovered from third parties. If our defenses are ultimately unsuccessful, or if we are unable to achieve a favorable resolution, we could be liable for damage awards that could materially adversely affect our results of operations and financial condition.

An active trading market for our securities may not be developed or sustained which could limit the liquidity of an investment in our securities.

There is a limited trading market for our securities which are currently trading on the American Stock Exchange. There is no assurance that we will be able to continue to meet the listing requirements and that our securities will remain listed on the American Stock Exchange. If we are delisted from the American Stock Exchange, an investor could find it more difficult to dispose of, or to obtain accurate quotations as to the market value of, our securities. Additionally, regardless of which exchange our securities may trade on, an active and liquid trading market may not develop or, if developed, may not be sustained, which could limit security holders' ability to sell our securities at a desired price.

A large number of shares may be sold in the market following our February 2004 public offering which may cause the price of our securities to decline.

Sales of a substantial number of shares of our common stock or other securities in the public markets, or the perception that these sales may occur, could cause the market price of our common stock or other securities to decline and could materially impair our ability to raise capital through the sale of additional securities. We have 8,295,210 shares of our common stock outstanding. Of our outstanding shares, 6,469,972 are eligible for public trading.

Certain events could result in a dilution of your ownership of our common stock.

As of November 30, 2007, we have 8,295,210 shares of common stock and an aggregate of 3,953,215 warrants and options outstanding. The exercise price of all of our common stock equivalents ranges from \$3.30 to \$6.00 per share of common stock. Some of these warrants and options may provide anti-dilution protection to their holders which would result in our issuance of shares in addition to those under the warrant or option, upon the occurrence of sales of our common stock below certain prices, stock splits, redemptions, mergers, and other similar transactions. Furthermore, from time to time we may issue additional shares of common stock in private or public transactions to raise funds for working capital, research and development, acquisitions, or other purposes. If one or more of these events occurs, the number of outstanding shares of our common stock would increase and dilute your percentage ownership of our common stock.

If we do not maintain an effective registration statement or comply with applicable state securities laws, you may not be able to exercise our public warrants.

For any holder to be able to exercise our public warrants, the shares of our common stock underlying the public warrants must be covered by an effective and current registration statement and qualify or be exempt under the securities laws of the state or other jurisdiction in which you live. We cannot assure you that we will continue to

maintain a current registration statement relating to the shares of our common stock underlying our public warrants or that an exemption from registration or qualification will be available throughout their term. This may have an adverse effect on demand for our public warrants and the prices that can be obtained from reselling them.

Our public warrants may be redeemed on short notice. This may have an adverse impact on their price.

We may redeem our public warrants for \$0.25 per warrant, subject to adjustment in the event of a stock split, dividend or the like, upon 30 days' notice so long as the last reported sale price per share of our common stock as reported by the principal exchange or trading market on which our common stock trades equals or exceeds \$10.00 (subject to adjustment) for twenty consecutive trading days ending on the tenth day prior to the date we give notice of redemption. If we give notice of redemption, holders of our public warrants will be forced to sell or exercise the public warrants they hold or accept the redemption price. The notice of redemption could come at a time when, under specific circumstances or generally, it is not advisable or possible to sell or exercise our public warrants.

Our officers, directors and major stockholders will exercise significant control over us.

Our current officers, directors and other major stockholders, in the aggregate, control approximately 47.09% of our outstanding common stock (including common stock issuable to such person or group within 60 days after November 30, 2007). As a result, these stockholders acting together will be able to exert significant control over matters requiring stockholder approval, including the election of directors, approval of mergers, and other significant corporate transactions. This concentration of ownership could delay, prevent, or deter a change in control, and could deprive our stockholders of an opportunity to receive a premium for their stock as part of a sale of us and could affect the market price of our stock.

We do not intend to pay cash dividends.

We have never paid cash dividends on our stock and do not anticipate paying any cash dividends in the foreseeable future.

We may spend our funds in ways with which our stockholders may not agree.

The use of proceeds description from our recent public offering reflected our then-current planning and was only an estimate that is subject to change in our discretion. Furthermore, a substantial portion of the net proceeds from our recent public offering was not allocated for specific uses. Consequently, our management can spend our funds in ways with which our stockholders may not agree. We cannot predict that our funds will be invested or otherwise utilized to yield a favorable return.

Item 3. Controls and Procedures.

(a) The Company's Chief Executive Officer and Chief Financial Officer have evaluated the effectiveness of the Company's disclosure controls and procedures (as such term is defined in Rules 13a-14(c) and 15d-14(c) under the Securities Exchange Act of 1934, as amended (the "Exchange Act") as of the end of the period covered by this Form 10-QSB (the "Evaluation Date"). Based on such evaluation, such officer has concluded that, as of the Evaluation Date, 1) the Company's disclosure controls and procedures are effective to ensure that information required to be disclosed by the Company in reports the Company files under the Securities Exchange Act is recorded, processed, summarized and reported within the time periods specified in the rules and forms of the SEC and 2) the Company's disclosure controls and procedures are effective to ensure that information required to be disclosed in the reports that the Company files or submits under the Exchange Act is accumulated and communicated to our management, including our chief executive officer and chief financial officer, to allow timely decisions regarding required disclosure.

(b) Changes in Internal Controls. There has been no change in our internal control over financial reporting that occurred during our most recent fiscal quarter that has materially affected or is reasonably likely to materially affect our internal control over financial reporting.

Limitations on the Effectiveness of Controls

Our management, including our Chief Executive Officer and Chief Financial Officer, does not expect that our disclosure controls will prevent or detect all errors and all fraud. A control system, no matter how well designed and operated, can provide only reasonable, not absolute, assurance that the control system's objectives will be met. Further, the design of a control system must reflect the fact that there are resource constraints, and the benefit of controls must be considered relative to their costs. Because of the inherent limitations in all control systems, no evaluation of controls can provide absolute assurance that all control issues and instances of fraud, if any, within our company have been detected. These inherent limitations include the realities that judgments in decision-making can be faulty, and that breakdowns can occur because of simple error or mistake. Controls can also be circumvented by the individual acts of some

persons, by collusion of two or more people, or by management override of the controls. The design of any system of controls is based in part upon certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions. Over time, controls may become inadequate because of changes in conditions or deterioration in the degree of compliance with associated policies or procedures. Because of the inherent limitations in a cost-effective control system, misstatements due to error or fraud may occur and not be detected.

PART II - OTHER INFORMATION

Item 1. Legal Proceedings

We reached a settlement in principle with the plaintiffs in the securities law class action litigation pending in the U.S. District Court for the District of Connecticut, In Re Flight Safety Technologies, Inc. Securities Litigation, Civil Action

No. 3:04-CV-1175 (CFD). Under the terms of the agreement in principle, all claims against all of the defendants will be dismissed without presumption or admission of liability or wrongdoing. A one time settlement payment of \$1.2 million will be made to the plaintiff class by or on behalf of the defendants. We have agreed to contribute \$135,000 of the \$1.2 million settlement. The settlement is subject to a number of conditions, including negotiation and execution of appropriate settlement documents between the parties, preliminary and final court approval and other factors. At this time there can be no assurance that those conditions will be met or that the settlement in principle will receive final court approval.

We reached a settlement in the litigation pending in the U.S. District Court for the District of Massachusetts entitled *Analogic Corporation v. Flight Safety Technologies, Inc., et al*, No. 06-11288 (JLT). Under the terms of the settlement, Analogic assigned to us its license rights in the SICM MANPADS Countermeasure technology, which is intended to defend against certain shoulder fired missiles aimed at aircraft, but retained certain related manufacturing rights or, alternatively, certain royalty rights which range from 10% to 5% of gross revenue from the sale of related products depending on the gross margin realized by us. We will issue 100,000 shares of common stock and pay \$100,000 in cash to Sanders Design International (SDI) and SDI's legal fees associated with the lawsuit. Upon completion of a successful live fire test, we will issue SDI another 250,000 shares of common stock and hire three SDI employees for one year terms in exchange for ownership of all intellectual property associated with the SICM and TIICM™ MANPADS countermeasure technologies. SDI also would receive a royalty of 1% of gross revenue from sales of products based on these technologies. There can be no assurance whether or when any funding would be available for such further development, or that we eventually will realize revenue from any such products.

Item 5. Other Information

NONE

Item 6. Exhibits and Reports on Form 8-K

(a) Exhibits

The following is a list of exhibits filed as part of the quarterly report on Form 10-QSB. Where so indicated by footnote, exhibits which were previously filed are incorporated by reference. For exhibits incorporated by reference, the location of the exhibit in the previous filing is indicated.

| Exhibit <u>No.</u> | <u>Description</u> |
|-----------------------|---|
| 3.1 | Amended and Restated Articles of Incorporation (1) |
| 3.2 | By-Laws (2) |
| 10.1 | Employment Agreement effective as of November 4, 2003, between Flight Safety Technologies, Inc. |
| 10.2 | and Samuel A. Kovnat (3) |
| 10.3 | Employment Agreement effective as of November 4, 2003, between Flight Safety Technologies, Inc. |
| | and William B. Cotton (4) |
| 10.4 | Employment Agreement effective as of November 4, 2003, between Flight Safety Technologies, |

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- Inc.
- 10.5 and David D. Cryer (5)
- 10.6 Employment Agreement effective as of November 4, 2003, between Flight Safety Technologies, Inc.
- 10.7 and Frank L. Rees (6)
- 10.8 Teaming Agreement dated May 1, 1997, by and between FSTO and Lockheed Martin Corporation (7)
- 10.9 Share Exchange Agreement between Reel Staff, Inc. and Flight Safety Technologies, Inc., dated June 24, 2002, as amended July 15, 2002 (8)
- 10.10 Cost Reimbursement Research Project Agreement between Flight Safety Technologies, Inc. and Georgia Tech Applied Research Corporation (9)
- 10.11 Phase III Contract issued by U.S. Department of Transportation/RSPA/Volpe Center, dated September 30, 2003 (10)
- 31.1 Agreement between Flight Safety Technologies, Inc. and Advanced Acoustics Concepts, Inc., dated January 14, 2000 (11)
- 31.2 Employment Agreement effective as of June 23, 2005, between Flight Safety Technologies, Inc. and C. Robert Knight (12)
- 32.1 Phase IV Contract issued by U.S. Department of Transportation/RITA/Volpe Center, dated September 1, 2005 (13)
- *Chief Executive Officer Certification as Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 (18 U.S.C. Section 1350).
- *Chief Financial Officer Certification as Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 (18 U.S.C. Section 1350).
- *Certification of Chief Executive Officer and Chief Financial Officer as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 (18 U.S.C. Section 1350).

*Submitted herewith

- (1) Incorporated by reference to Exhibit 3.1 on our Form 10-QSB, which was filed on April 6, 2004.
- (2) Incorporated by reference to Exhibit 3.2 on our Form SB-2, which was filed on August 9, 2001.
- (3) Incorporated by reference to Exhibit 10.1 on our Form SB-2/A, which was filed on January 29, 2004.
- (4) Incorporated by reference to Exhibit 10.2 on our Form SB-2/A, which was filed on January 29, 2004.
- (5) Incorporated by reference to Exhibit 10.3 on our Form SB-2/A, which was filed on January 29, 2004.
- (6) Incorporated by reference to Exhibit 10.4 on our Form 10-QSB, which was filed on April 6, 2004.
- (7) Incorporated by reference to Exhibit 10.7 on our 8-KA, which was filed on November 6, 2002.
- (8) Incorporated by reference to Exhibit 10.1 on our Form 8-K, which was filed on July 18, 2002.
- (9) Incorporated by reference to Exhibit 10.7 on our Form SB-2/A, which was filed on November 26, 2003.
- (10) Incorporated by reference to Exhibit 10.8 on our Form SB-2/A, which was filed on November 26, 2003.
- (11) Incorporated by reference to Exhibit 10.9 on our Form SB-2/A, which was filed on November 26, 2003.
- (12) Incorporated by reference to Exhibit 10.10 on our Form 10-KSB, which was filed on September

7, 2006.

Incorporated by reference to Exhibit 10.11 on our Form 10-KSB, which was filed on September 7, 2006.

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(b) Reports on Form 8-K

On July 5, 2007, we filed a Current Report on Form 8-K. The report contained an Item 8.01 disclosure announcing certain recent developments of the company.

On October 15, 2007, we filed a Current Report on Form 8K. The report contained an item 8.01 disclosure announcing that we had received a notice from AMEX of noncompliance with AMEX listing requirements.

On November 12, 2007, we filed a Current Report on Form 8K. The report contained an item 8.01 disclosure announcing the new Board of Directors and Officers.

On November 15, 2007, we filed a Current Report on Form 8K. The report contained an item 8.01 disclosure announcing a settlement in principle of a class action suit.

SIGNATURES

In accordance with Section 13 or 15(d) of the Exchange Act, the registrant caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

Flight Safety Technologies, Inc.
a Nevada corporation

By: /s/ William B. Cotton



William B. Cotton
Chief Executive Officer

By: /s/ David D. Cryer



David D. Cryer
Chief Financial Officer

