

FLIGHT SAFETY TECHNOLOGIES INC  
Form 10QSB  
October 13, 2006

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 August 31, 2006

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

[REDACTED]  
(Issuer's telephone number)

[REDACTED]  
(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 October 13, 2006 was 8,215,210 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  
**August 31, 2006 and May 31, 2006**

Unaudited

	<u>August 31, 2006</u>	<u>May 31, 2006</u>
<b>Assets</b>		
Current assets:		
Cash and cash equivalents	\$ 3,840,265	\$ 145,572
Contract receivables	255,309	130,001
Investments available for sale	1,305,584	1,661,919
Investments held to maturity	500,002	4,337,907
Inventory	108,044	108,044
Other current assets	<u>338,517</u>	<u>264,750</u>
Total current assets	<u>6,347,721</u>	<u>6,648,193</u>
Property and equipment, net of accumulated depreciation of \$440,532 and \$418,656	<u>160,710</u>	<u>181,606</u>
Other Assets:		
Intangible assets, net of accumulated amortization of \$70,477 and \$65,330	243,395	230,750
Other receivables	<u>120,563</u>	<u>96,673</u>
Total other assets	<u>363,958</u>	<u>327,423</u>
Total Assets	\$ <u>6,872,389</u>	\$ <u>7,157,222</u>
Liabilities and Stockholders' Equity		
Current liabilities:		
Accounts payable	\$ 918,347	\$ 603,538

Accrued expenses	<u>189,139</u>	<u>228,427</u>
Total current liabilities	<u>1,107,486</u>	<u>831,965</u>
<b>Stockholders' equity:</b>		
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 and 8,215,210 shares outstanding	8,332	8,332
Additional paid-in-capital	13,070,192	13,070,192
Treasury Stock, 116,300 shares at cost	(199,827)	(199,827)
Accumulated other comprehensive income	18,665	--
Accumulated deficit	<u>(7,132,459)</u>	<u>(6,553,440)</u>
Total stockholders' equity	<u>5,764,903</u>	<u>6,325,257</u>
	\$ <u>6,872,389</u>	\$ <u>7,157,222</u>

**Total Liabilities and Stockholders' Equity**

The accompanying notes are an integral part of these financial statements

## FLIGHT SAFETY TECHNOLOGIES, INC.

Statements of Operations and Other Comprehensive Income (Loss)  
For the Three Months Ended August 31, 2006 and August 31, 2005  
Unaudited

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	<u>Months</u> <u>2006</u>	<u>Months</u> <u>2005</u>
Contract Revenues	\$ 605,360	\$ 1,218,460
<b>Cost of Revenues</b>	<b><u>379,465</u></b>	<b><u>781,930</u></b>
Gross Profit	<u>225,895</u>	<u>436,530</u>
<b>Operating Expenses:</b>		
Research and development	11,580	398,451
Selling, general and administrative	833,204	522,740
Depreciation and amortization	<u>27,023</u>	<u>31,405</u>
<b>Total operating expenses</b>	<b><u>871,807</u></b>	<b><u>952,596</u></b>
Loss from Operations	<u>(645,912)</u>	<u>(516,066)</u>
<b>Other Income (Expense)</b>		
Interest income	72,378	61,757
Loss on investments available for sale	<u>—</u>	<u>(170,875)</u>
Loss before provision for income taxes	<u>(573,534)</u>	<u>(625,184)</u>
Provision for income taxes	<u>5,485</u>	<u>6,200</u>
<b>Net Loss</b>	<b><u>(579,019)</u></b>	<b><u>(631,384)</u></b>
<b>Other Comprehensive Income (Loss)</b>		
Unrealized gains (loss) on investments	18,665	(6,852)
Less reclassified adjustments	<u>—</u>	<u>170,875</u>
<b>Comprehensive Loss</b>	<b><u>\$(560,354)</u></b>	<b><u>\$(467,361)</u></b>

Net Loss Per Share

Basic and diluted	\$	(.07)	\$	(.08)
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Weighted Average Number of Shares Outstanding

Basic and diluted	8,215,210	8,215,110
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The accompanying notes are an integral part of these financial statements

FLIGHT SAFETY TECHNOLOGIES, INC.

Statements of Changes in Stockholders' Equity  
For the Three Months Ended August 31, 2006 and August 31, 2005  
Unaudited

	Common Stock		Additional Paid - In Capital	Treasury Stock	Accumulated Other Comprehensive Income	Unearned Stock Compensation	Accumulated Deficit
	Shares	Amount					
Balance at May 31, 2005	8,331,410	\$ 8,331	13,069,863	(198,827)	(168,023)	\$ (4,769)	\$ (4,295,881)
Unearned stock comp.	--	--	--	--	--	4,769	-

Other comprehensive income (loss)	--	--	--	--	164,023	--	--	--
Net Loss	<u>--</u>	<u>--</u>	<u>--</u>	<u>--</u>	<u>--</u>	<u>--</u>	<u>--</u>	<u>(631,384)</u>
Balance at August 31, 2005	<u>8,331,410</u>	\$ <u>8,331</u>	\$ <u>13,069,863</u>	<u>(199,827)</u>	<u>\$ --</u>	\$ <u>--</u>	\$ <u>--</u>	\$ <u>(4,927,265)</u>
Balance at May 31, 2006	8,331,510	\$ 8,332	\$ 13,070,192	(199,827)	\$ --	\$ --	\$ --	\$ (6,553,440)
Other comprehensive income (loss)	--	--	--	--	18,665	--	--	--
Net loss	<u>--</u>	<u>--</u>	<u>--</u>	<u>--</u>	<u>--</u>	<u>--</u>	<u>--</u>	<u>(579,019)</u>
Balance at August 31, 2006	<u>8,331,510</u>	\$ <u>8,332</u>	\$ <u>13,070,192</u>	<u>(199,827)</u>	<u>\$8,665</u>	\$ <u>=</u>	\$ <u>=</u>	\$ <u>(7,132,459)</u>

The accompanying notes are an integral part of these financial statements



FLIGHT SAFETY TECHNOLOGIES, INC.

Statements of Cash Flow  
For the Three Months Ended August 31, 2006 and August 31, 2005  
Unaudited

	For the Three Months Ended August 31,	
	<u>2006</u>	<u>2005</u>
Cash flows from operating activities:		
Net loss	\$(579,019)	\$ (631,384)
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation and amortization	27,023	31,405
Non-cash compensation - common stock	--	4,769
Loss on investment available for sale	--	170,875
Accretion of investment discounts	(39,482)	(27,647)

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Changes in operating assets and liabilities:

(Increase) in contract receivables	(125,308)	(245,362)
(Increase) decrease in other receivables	(23,890)	(9,260)
(Increase) in other current assets and other assets	(73,767)	19,144
Increase (decrease) in accounts payable and accrued expense	<u>275,521</u>	<u>134,670</u>
Net cash used in operating activities	<u>(538,922)</u>	<u>(552,790)</u>

Cash flows from investing activities:

Purchase of held to maturity securities	(3,667,613)	(5,047,840)
Proceeds from maturity of held to maturity securities	7,545,000	5,105,000
Proceeds from available for sale securities	375,000	--
Purchase of available for sale securities	--	--
Purchases of property and equipment	(980)	(54,005)
Payments for patents	<u>(17,792)</u>	<u>(2,606)</u>
Net cash provided by investing activities	<u>4,233,615</u>	<u>549</u>
Net cash provided by (used in) financing activities	<u>--</u>	<u>--</u>
Net decrease in cash and cash equivalents	3,694,693	(552,241)
Cash and cash equivalents at beginning of period	<u>145,572</u>	<u>2,519,837</u>
Cash and cash equivalents at end of period	<u>\$3,840,265</u>	<u>\$ 1,967,596</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 Months Ended August 31, 2006 and August 31, 2005

Note 1. Summary of Significant Accounting Policies

:

Basis of Presentation

These interim financial statements for the three months ended August 31, 2006 and August 31, 2005, included herein, have been prepared, without audit, pursuant to the rules and regulations of the SEC. Results for the three months ended August 31, 2006 and August 31, 2005 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, 2006 and May 31, 2005 which are included in our annual report on Form 10-KSB filed on September 6, 2006.

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, and other receivables. Actual results could differ from those estimates.

Stock-Based Compensation

Prior to our current fiscal year which began June 1, 2006, the Company accounted for its stock-based compensation plans under Accounting Principles Board (APB) Opinion No. 25, "Accounting for Stock Issued to Employees". The following table illustrates the effect on net income and earnings per share as if the Company had applied the fair value recognition provisions of SFAS No. 123, "Accounting for Stock-based Compensation" to stock-based employee compensation for the three months ended August 31, 2005:

---

Net (loss) as reported	\$ (631,384)
Deduct total stock-based employee compensation expense determined under fair value method for all awards	4,769 <u>(33,131)</u>
Pro forma net income	<u>\$ (659,746)</u>
Basic shares outstanding	8,215,110
Diluted shares outstanding	8,215,110
Earnings per share as reported:	
Basic	\$0.08
Diluted	\$0.08
Earnings per share, pro forma	
Basic	\$0.08
Diluted	\$0.08

The fair value of each option grant is estimated as of the grant date using the Black-Scholes option pricing model. The following weighted average assumptions were used to value the options granted in the quarter ended August 31, 2005:

Risk-free interest rate	4.00%
Expected dividend yield	None

Expected life of options	10 years
Expected volatility	40%
Weighted-average grant-date fair value	\$.51

In December 2004, the Financial Accounting Standards Board issued SFAS No. 123(R), "Share-Based Payment, an Amendment of FASB Statements No. 123 and 95." SFAS No. 123(R) establishes standards for the accounting for transactions in which an entity exchanges its equity instruments for goods or services or incurs liabilities in exchange for goods or services that are based on the fair value of the entity's equity instruments. SFAS No. 123(R) requires public entities 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 (with limited exceptions) and recognize the cost over the period during which an employee is required to provide service in exchange for the award. Adoption requires a modified prospective application whereby compensation expense is recognized on or after the required effective date for the portion of the outstanding awards for which the requisite service has not yet been rendered, based on the grant-date fair value of those awards, calculated on a basis consistent with the SFAS No. 123 pro forma disclosures. The Company adopted SFAS No. 123 (R) on its effective date, commencing with the quarter beginning June 1, 2006.

Adoption of SFAS No. 123(R) did not have a material effect on our financial statements for the three month period ended August 31, 2006 as there were no unvested options outstanding and no options were granted in the three month period ended August 31, 2006.

#### Earnings Per Share

Basic loss per share is computed by dividing net loss by the weighted average number of shares of common stock outstanding during the period. For the three and nine month periods ended August 31, 2006 and August 31, 2005, 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 3,794,883 and 2,572,634 for the three months ended August 31, 2006 and August 31, 2005, respectively.

#### Cash and Cash Equivalents

Cash and cash equivalents as of August 31, 2006 represents cash on hand of \$368,483 in checking accounts, \$212,977 in money market accounts and an investment in a debt security with a carrying value of \$3,258,805 that had a maturity of less than 90 days at the date of purchase.

#### Inventory

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

#### Revenue and Cost Recognition

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

For these contracts, fee revenue is recorded at the time services are performed based upon actual project costs incurred and include a reimbursement for general, administrative, and overhead costs and the base fee. The general, administrative, and overhead costs are estimated periodically in accordance with government contract accounting regulations and may change based on actual costs incurred 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 Government audit process.

Contracting costs include all direct material, labor and subcontracting costs. General and administrative costs are charged to expense as incurred. Provisions for estimated losses on uncompleted contracts are made in the period in which such losses are determined. Changes in job performance, job conditions and estimated profitability and final contract settlements may result in revisions to costs and income and are recognized in the period in which the revisions are determined. Revenue related to claims is recorded at the lesser of actual costs incurred or the amount expected to realized.

#### Intangible Assets

Intangible assets consist of patent costs. Amortization expense for the three months ended August 31, 2006 and August 31, 2005 was \$5,147 and \$2,655 respectively. Amortization expense for each of the next five years is currently expected to be approximately \$22,000.

#### Note 2. Investments in Marketable Securities:

A summary of investments as of August 31, 2006 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>1,286,919</u>	\$ <u>18,665</u>	\$--	\$ <u>1,305,584</u>

## Held to Maturity

U.S. Government securities	\$ <u>500,002</u>	\$ <u>    --</u>	\$ <u>(2,187)</u>	\$ <u>497,815</u>
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Held-to-maturity securities at August 31, 2006 are due in one year or less.

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 stock options granted to date were vested and exercisable as of May 31, 2006. 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.

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A summary of option activity under the plan as of August 31, 2006, and changes during the three-month period then ended is presented below:

<u>Options</u>	<u>Shares (000)</u>	<u>Weighted- Average Exercise Price</u>	<u>Weighted- Average Remaining Contractual Term (years)</u>	<u>Aggregate Intrinsic Value (\$000)</u>
Outstanding at May 31, 2006	1,886,100	\$ 3.58	8.99	\$--
Granted	--	--	--	--
Exercised	--	--	--	--
Forfeited or expired	<20,834>	6.00	--	--
Outstanding at August 31, 2006	<u>1,865,266</u>	\$ 3.55	8.74	<u>\$0</u>
Exercisable at August 31, 2006	<u>1,865,266</u>	\$ 3.55	8.74	<u>\$0</u>

Note 4. Warrants:

We have 1,919,200 warrants outstanding as of August 31, 2006. 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 August 31, 2006 and May 31, 2006.

	<u>August 31, 2006</u>	<u>May 31, 2006</u>
Retained Fee		
Phase III Socrates	\$ 96,673	\$ 96,673
Phase IV Socrates	<u>23,890</u>	<u>--</u>
Total	<u>\$120,563</u>	<u>\$ 96,673</u>

Note 6. Other Current Assets

:

As of August 31, 2006, other current assets were \$338,517 compared to \$264,750 as of May 31, 2006. This net increase of \$73,767 is primarily due to prepaid expenses for refurbishment of our SOCRATES system at the Denver International Airport and is covered by our current insurance policy.

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 fiscal quarter ended August 31, 2006 or otherwise incorporated by reference into this document, contain "forward-looking statements" (as such term is defined in the Private Securities Litigation Reform Act of 1995). These statements are identified by the use of forward-looking terminology such as "believes", "plans", "intend", "scheduled", "potential", "continue", "estimates", "hopes", "goal", "objective", "expects", "may", "will", "should" or "anticipates" or the negative thereof or other variations thereon or comparable terminology, or by discussions of strategy that involve risks and uncertainties. The safe harbor provisions of Section 21E of the Securities



Exchange Act of 1934, as amended, and Section 27A of the Securities Act of 1933, as amended, apply to forward-looking statements made by us. We caution you that no statements contained in this Form 10-QSB should be construed as a guarantee or assurance of future performance or results. These forward-looking statements involve risks and uncertainties, which include risks and uncertainties associated with, among other things, the outcome of pending class action litigation alleging violations of federal securities laws, the outcome of Massachusetts federal district court litigation initiated by Analogic Corporation concerning our TIICM™ technology, whether the government will implement wake vortex advisory system at all or with the inclusion of a SOCRATES® wake vortex sensor, the impact of competitive products and pricing, limited visibility into future product demand, slower economic growth generally, difficulties inherent in the development of complex technology, new products sufficiency, availability of capital to fund operations, research and development, fluctuations in operating results, and these and other risks are discussed in the "Known Trends, Risks and Uncertainties" section 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 current operations 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 a wake vortex advisory system, sometimes referred to as WakeVAS, that National Aeronautics and Space Administration (NASA) has 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. As of August 31, 2006, we have recognized an aggregate of approximately \$19.1 million of contract revenue with \$0.2 million in contract receivable as of August 31, 2006. Our current SOCRATES® government contract backlog is approximately \$0.7 million. 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 WakeVAS system 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® technology. 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 federal budget for U.S. fiscal year ending September 30, 2007 does not contain any further stipulated earmarks for testing and development of SOCRATES®-based technology nor did the federal budget for U.S. in fiscal year ending September 30, 2006 specify any such funding. 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.

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	

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			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 Present
	DTRT-57-05-D-30115 Task Order No: T0002	<u>\$1,409,025</u>	From January 27, 2006 To Present
Total contract funding to date		<u>\$19,803,522</u>	

We expect the current task order funding of \$1,409,025 to support our current level of effort on SOCRATES® technology research and development through approximately November 30, 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. The Phase IV contract was awarded on September 25, 2005 for \$9,815,140 and if additional funding becomes available under this contract, the remaining amount of \$6,711,086 can be funded with new task orders which generally require less administrative effort than a new contract award.

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 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," expected to be implemented and tested in the U.S. fiscal years 2008-2011 timeframe.

To our knowledge, the FAA has no plans to apply sufficient resources to the development of a WVAS 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.

We believe that the WakeVAS system we are assisting to develop, which may incorporate the SOCRATES® wake vortex sensor, will be the only system that could include both wake vortex prediction and detection. However, there is currently no funding for further research and development of SOCRATES® technology or WakeVAS in the current FAA budget for its fiscal year ending September 30, 2007 and we received no such funding in the federal budget for its fiscal year ended September 30, 2006. We are pursuing other sources of government and private funding for research and development of SOCRATES® technology, 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/or WakeVAS technology from the federal government could eliminate or delay achievement of profitability, if any, create a substantial strain on our liquidity, resources and product development, and have a material adverse effect on the progress of our SOCRATES® technology research and development and our financial condition.

From June 1, 1997, to the present we have advanced the SOCRATES® concept through various research and development milestones and now have a 16 beam SOCRATES® sensor installed at Denver International Airport where we anticipate the sensor will undergo further testing in our fiscal year ending May 31, 2007. Our current contract Task Order No. T0002 statement of work includes system engineering and development of a concept of operations for a functional emulation of a WakeVAS and preparation for additional field testing.

During the 2006 New Years Eve holiday period, there was a break-in and vandalism at our SOCRATES® sensor test site at Denver International Airport. A number of items were stolen from the SOCRATES® sensor van as well as from the U.S. Department of Transportation Volpe trailer on site. Damage to SOCRATES® sensor optoelectronics also occurred as a result of fire retardant chemicals being sprayed by the perpetrators. As of August 31, 2006, the SOCRATES™ sensor has not been fully restored but we believe the sensor will be ready for additional testing commencing October 2006. There can be no guarantee or assurance of a complete restoration. We have insurance coverage for the damage to the SOCRATES™ sensor.

We also are pursuing development of an airborne collision 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 August 31, 2006, our direct cumulative research and development expenses for UNICORN™ total approximately \$1,286,000. 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. We have 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 legal and consultant expenses of approximately \$250,000 for the preparation of a market assessment and business plan. The market assessment 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™ 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.

During 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™ 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 August 31, 2006 our cumulative independent research and development expense for TIICM™ is approximately \$690,000. We have entered into additional arrangements with SDI pursuant to which we have applied for a new patent on TIICM™ 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 expects to receive \$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™ research and development. This funding is expected to come half from the U.S. Air Force and half from the Department of Homeland Security. FST expects to participate in a subcontract from SDI to support this further development, test and maturation of TIICM™ technology, although there can be no assurance of whether or when we will receive such contract or the amount of such subcontract. There can be no assurance that any new patents on TIICM™ will be issued, or that we will derive any revenue or profit from TIICM™, nor any expectation that we will receive any government or commercial funding for TIICM™. Prospects for development of TIICM™ may be adversely influenced by pending litigation that Analogic Corporation, which previously had supported development of TIICM™, brought against us and SDI.

We have experienced significant losses since our inception. The loss for the three months ended August 31, 2006 was \$579,019. Losses for the fiscal years ending May 31, 2006, 2005, and 2004 were \$2,257,559, \$1,411,644 and \$424,214, respectively. The net loss for our fiscal year ended May 31, 2004 was caused primarily by two factors: (1) rate ceilings during the first six months, and (2) unallowable expenses under our government contract. The loss for the fiscal year ending May 31, 2005 was caused by: (1) unallowable expenses, (2) expenses during a partially unfunded period, and (3) unrecoverable and/or unabsorbed operating expenses. The loss for the fiscal year ended May 31, 2006 and the three months ended August 31, 2006 was caused by (1) unallowable expenses, (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 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.

In addition, 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 three months ended August 31, 2006. 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 three months ended August 31, 2006 unreasonable for a company our size. For rate setting purposes, we have excluded approximately \$350,000 for potential unrecoverable selling, general and administrative, research and development, and certain other expenses, i.e., unabsorbed operating



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For the Three Months Ended August 31, 2006 and August 31, 2005

	August 31, <u>2006</u>	August 31, <u>2005</u>
Contract Revenues	\$ 605,360	\$ 1,218,460
Cost of Revenues	<u>379,465</u>	<u>781,930</u>
Gross Profit	225,895	436,530
Operating Expenses		
Research and development	11,580	398,451
Selling, general and administrative	833,204	522,740
Depreciation and amortization	<u>27,023</u>	<u>31,405</u>
Total Operating Expenses	<u>871,807</u>	<u>952,596</u>
Loss From Operations	(645,912)	(516,066)
Other Income (Expense)		
Interest income	72,378	61,757
Loss on investments available for sale	<u>---</u>	<u>(170,875)</u>
Loss before provision for income taxes	(573,534)	(625,184)
Provision for income taxes	<u>5,485</u>	<u>6,200</u>
Net Income (Loss)	(579,019)	(631,384)
Other Comprehensive Income (Loss)		
Unrealized gains (loss) on investments	18,665	(6,852)
Less reclassification adjustment for loss included in net income	<u>---</u>	<u>170,875</u>
Comprehensive Income (Loss)	<u>\$(560,354)</u>	<u>\$(467,361)</u>
Net Loss Per Share		
Basic and diluted	\$ (.07)	\$ (.08)
Weighted Average Number of Shares Outstanding		



Basic and diluted	8,215,210	8,215,110
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## Revenues

. To date, the majority of our revenues have consisted of revenues earned from our four successive SOCRATES® wake vortex sensor research and development contracts with the federal government. In addition, during the three months ended August 31, 2006 and 2005 we had revenue of \$63,057 and \$4,933 respectively generated for engineering services provided to companies conducting research and development in the maritime industry. The current backlog for these services is approximately \$395,000.

Government contract revenue for the three months ended August 31, 2006 was \$542,303 compared to \$1,213,527 for the three months ended August 31, 2005. The \$671,224 decrease in revenue for the three months ended August 31, 2006 compared to the same period in the prior year was due primarily to the significant effort we undertook in the prior year period to prepare a 16 beam SOCRATES system for testing.

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## Costs of Revenues

. Subcontractor, consultant and direct labor expenses comprise our costs of revenues. Costs of revenue for the three months ended August 31, 2006 was \$379,465 or 62.7% of revenue, compared to \$781,930 or 64.2% of revenue for the three months ended August 31, 2005. The decrease in cost of revenues is primarily due to the decrease in subcontractor, and consultant costs that were associated with development of the 16 beam system during the three months ended August 31, 2005.

When our 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 months ended August 31, 2006 was \$11,580 compared to \$398,451 for the three months ended August 31, 2005. The decrease in research and development expenses of \$386,871 for the three months ended August 31, 2006 was primarily due to the decrease of approximately \$100,000 of research and development expense for project TIICM™ (Tactical Integrated Illumination Countermeasure) for three months end of August 31, 2006 compared to August 31, 2005 and a decrease of \$286,000 in the cost of research and development of our UNICORN™ technology for three months ended August 31, 2006. We are waiting to see if we will be able to raise funding for UNICORN™ through a joint venture between us and private investors before we determine whether to continue the project and incur further research and development expenses for UNICORN™.

## 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 fiscal quarters ending August 31, 2006 and 2005 are detailed as follows:

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	August 31, <u>2006</u>	August 31, <u>2005</u>	Increase / <u>(Decrease)</u>
<b><u>Unallowable</u></b>			
	\$ --	\$4,769	
Selling, general & administrative expenses	--	22,250	\$(4,769)
Stock based compensation	178,559	46,260	(22,250)
Director and officer insurance	42,803	36,980	132,299
Legal and professional	<u>30,512</u>	<u>41,235</u>	5,823
Lobbying	<u>\$251,874</u>	<u>\$151,494</u>	<u>(10,723)</u>
All other			<u>\$100,380</u>
<b>Total</b>			
<b><u>Allowable</u></b>			
Selling, general & administrative expenses	\$ 125,545	\$ 86,609	\$ 38,936
General and administrative salaries and wages	67,991	28,805	
Business development salaries and wages	39,414	1,534	39,186
	113,730	86,616	37,880
	117,196	82,178	27,114

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Business development travel	38,122	12,148	35,018
Employee benefits	<u>79,332</u>	<u>73,356</u>	25,974
Legal and professional	<u>\$ 581,330</u>	<u>\$ 371,246</u>	<u>5,976</u>
Insurance			<u>\$ 210,084</u>
All other	<u>\$ 833,204</u>	<u>\$ 522,740</u>	
<b>Total</b>			<u>\$ 310,464</u>

Total selling, general and administrative expenses

Allowable General and Administrative Salaries and Wages: The increase for the three month period ended August 31, 2006 in general and administrative salary and wages is primarily due to the addition of an office manager for our Austin, Texas office, increased requirements for our Mystic, Connecticut office manager and accounting staff and a full three months of expense for our General Counsel, Vice President of Administration and Corporate Secretary compared to two months of such expense for the same period in our fiscal year 2005.

Allowable Business Development Salaries and Wages and Travel: The combined increase for business development of approximately \$77,000 was due to our efforts to secure additional funding for our three technologies, SOCRATES, UNICORN, and TIICM, and included presentations to industry and government agencies in Boston, Massachusetts, Washington, D.C., Memphis, Tennessee, and Anchorage, Alaska, as well as trade shows in Oshkosh, Wisconsin, and Farnborough International Air Show in England and initial expenses for business development trips to Dubai and Singapore. The business development costs for the three months ended August 31, 2005 primarily related to our SOCRATES technology.

Allowable Employee Benefits: Total payroll for the three months ended August 31, 2006 increased by two full time employees, compared to the three months ended August 31, 2005, which increased payroll tax, health insurance and 401K plan matched expenses.

Allowable Legal and Professional: Allowable legal and professional fees increased for the three months ended August 31, 2006 compared to the three months ended August 31, 2005 due to consulting expense from a consulting firm for a UNICORN™ market assessment, legal fees due to the efforts of our outside counsel in securing a Federal Communication Commission experimental license for UNICORN™ technology and preparing and filing our various SEC filings.

Allowable Insurance: For the three months ended August 31, 2005, our interpretation of the Federal Acquisition Regulations considered our Directors and Officers (D&O) insurance an unallowable expense. During a Defense Contract Audit Agency audit in October, 2005, we received a favorable opinion as to the allowability of D&O insurance expense. For the three months ended August 31, 2006, D&O insurance is therefore an allowable expense and primarily accounts for the increase in insurance expense.

The operating losses for three months ended August 31, 2006 and August 31, 2005 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 TIICM™. 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:

	For the Three Months Ended	
	<u>8-31-06</u>	<u>8-31-05</u>
1. Unallowable, selling, general and administrative expenses (1)	\$251,874	\$151,494
2. Contract cost overruns	135,725	--
3. Unabsorbed operating expenses	344,725	321,161
4. Corporate research and development	<u>5,168</u>	<u>106,738</u>
Total	<u>\$737,492</u>	<u>\$579,393</u>

Notes:

(1) Includes \$0 and \$4,769 of stock based compensation expense for the three months ended August 31, 2006 and 2005, respectively.

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

(1) Unallowable, Selling, General and Administrative Expenses. The primary reasons for the increase in unallowable expenses of \$100,380 for the three months ending August 31, 2006 compared to that ending August 31, 2005 were increased legal fees of approximately \$135,000 due to the defense of the lawsuit Analogic Corporation brought against us on June 16, 2006 and of approximately \$25,000 for preparation of a tax advantaged joint venture to complete development of our UNICORN™ technology, offset by decreased unallowable D&O insurance of approximately \$22,000 and decreased other unallowable expenses of approximately \$37,000.

(2) Contract Cost Overruns. Contract cost overruns for the three months ended August 31, 2006 represent direct labor, overhead, subcontractor and consulting expense, 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 current government contract. There were no contract cost overrun for the three months ended August 31, 2005.

(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. The table below details the increase of \$23,564 for the three months ended August 31, 2006 compared to 2005.

	<u>August 31,</u> <u>2006</u>	<u>August 31,</u> <u>2005</u>	<u>Increase /</u> <u>(Decrease)</u>
Allowable selling, general and administrative expenses		\$ 371,246	
Other recoverable operating expenses	\$ 581,330		\$ 210,084
Absorption / billings to government	\$ 22,687	\$ 315,313	\$(292,626)
Increase in unabsorbed operating expenses	<u>\$(259,292)</u>	<u>\$(365,398)</u>	<u>\$ 106,106</u>
	<u>\$ 344,725</u>	<u>\$ 321,161</u>	<u>\$ 23,564</u>

(4) Corporate Research and Development. The decrease of \$101,570 for the three months ending August 31, 2006 compared to 2005 was due primarily to the decision to significantly reduce expenses for the research and development of our TIICM™ technology as we determine the impact the Analogic Corporation lawsuit has on our TIICM™ research and development project.

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**Liquidity and Capital Resources**

Our liquidity is primarily provided by revenue from our government contracts and proceeds from the sale of our equity 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 \$1,695,029 and a second task order provided additional funding of \$1,409,025. Our funded contract backlog for our Phase IV contract as of August 31, 2006 was \$659,658 and this backlog will fund most of our subcontractor and

consulting expenses and our allowable operating expenses to approximately November 30, 2006.

As of August 31, 2006 and May 31, 2006, our cash and investments were \$5,645,851 and \$6,145,398, respectively. The decrease in cash on hand and investments of approximately \$500,000 was primarily attributable to the net loss of approximately \$579,000 and purchases of equipment and patent costs of approximately \$19,000, offset by the change in operating assets and liabilities of approximately \$52,000, and depreciation and amortization expense of approximately \$27,000 for the three months ended August 31, 2006.

As of August 31, 2006, we had other receivables of \$120,563 compared to \$96,673 as of May 31, 2006. The increase is due to the addition of approximately \$24,000 for retained fees on our Phase IV SOCRATES® contract for the three months ended August 31, 2006.

As of August 31, 2006, our accounts receivable were \$255,309 compared to \$130,001 as of May 31, 2006. The balance as of August 31, 2006 reflects the increase in contract revenue of approximately \$125,000 for the month ended August 31, 2006 compared to the month ended May 31, 2006. The increase in revenue was due primarily to an increase in billings to the government for subcontractor activity and related costs for the month ending August 31, 2006. As of August 31, 2006, our current assets were \$338,517 compared to \$264,750 as of May 31, 2006. This increase of \$73,767 is due to reimbursable legal fees we incurred for the preparation of a motion to dismiss a class action suit and expenses for the refurbishment of the DIA Test site, both of which are covered by insurance policies.

We had total current liabilities, including accounts payable, of \$1,107,486 as of August 31, 2006 compared to \$831,965 as of May 31, 2006. Accounts payable as of August 31, 2006 were \$918,347, which included \$201,174 to our subcontractor, Lockheed Martin Corporation, \$311,173 to four law firms, \$123,020 to consultants for our UNICORN™ market study, and \$282,980 in other expenses compared to accounts payable as of May 31, 2006 of \$603,538, which included \$80,164 to Lockheed Martin, \$202,716 in legal fees; \$101,235 to consultants for our UNICORN™ market study, and \$219,423 in other expenses. The majority of the legal fees payable are included in other current assets and will be paid when we are reimbursed by our insurance company.

We anticipate that our funded contract balance for Task Orders 0001 and 0002 of our Phase IV contract of approximately \$660,000 as of August 31, 2006 will fund our allowable contract costs for SOCRATES® research and development until approximately November 30, 2006. During this period, we anticipate that we will fund a substantial portion of our other operating costs from our own cash and investments on hand.

For the three month period from September 1, 2006 to November 30, 2006, we have estimated and expect to incur approximately \$150,000 in non-contract unallowable expenses, \$250,000 in unabsorbed operating expenses and \$175,000 in contract cost overruns. During this period, we have estimated and expect to receive approximately \$25,000 in fees from our contract billing, and approximately \$70,000 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 \$5,200,000 as of November 30, 2006. Any acceleration or delays in the performance of these contracts by us or our subcontractors could, respectively, exhaust or extend our contract funding prior to or after November 30, 2006. In either event, we might be required to draw upon our cash before we anticipate which would reduce the foregoing estimate of cash and investments. However, we believe that we will be able to adjust our

operations to cover expenses through May 31, 2007 and based on current expectations and assumptions as to levels of activity and costs incurred, have estimated our cash and investments balance would be approximately \$4,500,000 at the end of our fiscal year ending May 31, 2007. Increases in costs, lack of government funding and many other factors could reduce our cash and investments faster than we expect and we can provide no assurance our actual cash and investments will be as estimated at any given date. These estimates also do not include any equity contribution or assurance of performance we expect to make if we proceed with a joint venture to develop our UNICORN™ technology.

Our cash projections do not consider additional funding from our \$9.815 million SOCRATES® research and development contract received September 15, 2005 beyond the current task order funding of \$3.104 million. 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 WakeVAS, of which there is no funding specified in the current federal budget for its fiscal year ending September 30, 2006 and \$0 in the FAA budget for fiscal year ending September 30, 2007. We are actively pursuing various 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 WakeVAS, as well as our other technologies. However, our own resources are limited and may not be sufficient to complete the research, development and testing that is necessary to commercialize any of our technologies. Our inability to obtain further government funding for research, development and testing of our technologies would have a material adverse affect upon our financial condition and prospects for success and profitability.

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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

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, including the current and next anticipated task order, has resulted from earmarks made by the U.S. Congress during its budget and appropriation process. We do not expect to 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 research and development 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 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®, 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 \$579,019 for the three months ended August 31, 2006, \$2,257,599 for the fiscal year ended May 31, 2006 and \$1,411,699 for the fiscal year ended May 31, 2005. We had an accumulated deficit of \$7,132,459 as of August 31, 2006. 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®, 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®, UNICORN™-based, and TIICM™ products, Congressional appropriations and our ability to obtain additional federal research and development contracts for SOCRATES®, UNICORN™ and TIICM™ based products, approval of our SOCRATES®, 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, 2006 did not contain contract funding for further research and development of our SOCRATES® technology and, neither the FAA nor any other U.S. government agency has proposed such funding in the federal budget for U.S. fiscal year 2007 that commenced October 1, 2006. We continue to explore and incur significant business development expenses for government funding for research and development of our SOCRATES® technology and our other 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 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 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. If this occurs, it will reduce our resources available for research and development of our proprietary technologies, new products or enhancements to SOCRATES®, UNICORN™ or TIICM™ technologies and to market our products. Termination or reduction of contract funding from the federal government could prevent or delay achievement of or increases in profitability, if any, create a substantial strain on our liquidity, resources and product development, and have a material adverse effect on the progress of our research and development and our financial condition.

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

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

Our success depends on our successful product development and testing.

Our future success will depend upon our ability to successfully complete the development, testing, and commercialization of our technologies and our ability to develop and introduce new products and services to meet industry, government, and client requirements. We are planning to eventually develop a number of products, based on our SOCRATES®, 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® 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 WakeVAS by controllers and pilots. We believe this conclusion was premature and based on an incomplete understanding of SOCRATES® and its operational potential. In our opinion, the testing and analysis we have conducted has increasingly supported this potential and resulted in the continuation of funding for our government contracts for research, development and testing of our SOCRATES® technology. However, there still are technical, engineering and program integration hurdles we must meet to develop SOCRATES® into an operational sensor, including, but not limited to, expanding the sensor to at least sixteen and as many as thirty-two laser beams, integrating the sensor into and with the other components of WakeVAS, and developing operating protocols for WakeVAS that define how it would be used by air traffic controllers and pilots. In the case of UNICORN™, we must successfully overcome development, engineering and testing hurdles to produce an operational product and obtain FAA approval of this product. Furthermore, we will need to extend the term of the experimental license the FCC has granted us and, ultimately, obtain a permanent license from the FCC for the operation of UNICORN™. We might not successfully complete the development of our SOCRATES®, 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®, 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 would be part of a multi-component wake vortex advisory system that also will require government approvals before it can be deployed. Any factor that delays or adversely affects this approval process, including delays in development or inability to obtain necessary government approvals, could have a material adverse effect on our business, financial condition, and results of operations, and we can make no assurance when or if all such approvals will be obtained.

Our business 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 will expire in May 2007, unless certain earlier termination provisions occur or the agreement is extended by mutual agreement. The agreement stipulates that we serve as prime contractor and Lockheed Martin Corporation as subcontractor in the development and any deployment of our SOCRATES® wake vortex sensor. Although to date we have generally worked in close cooperation with Lockheed Martin Corporation, we do not expect that this relationship will be sustained. Future disagreements as to work scope, revenue share, profit margins, ownership of intellectual property, or technical, marketing, or management philosophy, could adversely impact the relationship. Since we view our strategic relationship with Lockheed Martin Corporation as an important element of our business plan, any erosion of this relationship could have a negative impact on our business and future value.

On April 26, 2004, in conjunction with the renewal of a nondisclosure agreement, we were advised by Lockheed Martin Corporation that it owns a certain patent which predates our SOCRATES® patent and, according to Lockheed Martin Corporation, contains some intellectual property related to our SOCRATES® patent. Lockheed Martin Corporation has told us that it was prevented from previously disclosing the patent to us because of a government secrecy order. After consultation with counsel, including our patent counsel, we strongly believe that the Lockheed Martin Corporation patent will not impair the value of our SOCRATES® patent because our SOCRATES® patent is aimed at improving air traffic safety, 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. Although these discussions are continuing, to date, Lockheed Martin Corporation continues to disagree with our position.

In our continuing discussion 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. While we continued discussions on these and other issues, Lockheed informed us in February 2006 that it would temporarily suspend its contract effort on task order No. T0001 of our Phase IV contract for SOCRATES®

technology and related matters until these issues are resolved. We continued to work on task order No. T0001 and T0002 and believe the task orders were minimally impacted by the absence of Lockheed Martin. During May 2006, Lockheed Martin agreed to language concerning SOCRATES® intellectual property that we proposed and lifted its suspension of work and started working on T0001 in June 2006. However, Lockheed Martin has declined to participate and proceed on task order T0002 as it believes that task order is beyond the scope of the teaming agreement.

In order to complete our contractual commitments to the government under T0002, we are working with Intergraph Corporation as our principal support subcontractor for the emulation of an operational wake vortex system with demonstrations planned at Denver International Airport in early 2007.

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 discussions between us and Lockheed Martin are ongoing. Any further suspension 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. We cannot predict or provide any assurance on the outcome of these discussions and whether any outcome will be satisfactory to us.

We may need to raise additional capital.

We cannot be certain that our present financial resources will be adequate or sufficient for our future needs. We face many uncertainties with respect to research and development and the timing of commercialization of our SOCRATES®, 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 last three fiscal years, we have incurred substantial operating losses which we have funded, in part, with equity capital that we raised from new investors.

We will continue to incur significant expenses for research and development and testing of our SOCRATES®, UNICORN™ and TIICM™ technology and may continue to experience such losses prior to commercialization and thereafter. Our current financial resources are limited and are not sufficient to achieve commercialization of our SOCRATES®, UNICORN™ and TIICM™ technologies. If we are unable to generate sufficient working capital from revenue from government funding or private contracts for these purposes, we would need to seek additional capital. In addition, other unforeseen costs, including, without limitation, marketing, sales and installation and research and development costs of later generation SOCRATES®, UNICORN™ and TIICM™ based products also could require us to seek additional capital. We do not have any credit facilities in place and, should the need for additional capital arise, we may not be able to obtain sufficient, if any, additional capital or raise such capital on acceptable terms. If we need to obtain additional debt or equity capital, it may include 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.

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.

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, Samuel A. Kovnat, Chairman of the Board and Chief Executive Officer, William B. Cotton, Vice Chairman of the Board and President, Frank L. Rees, Executive Vice President 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. 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.

At a recent meeting of our Board of Directors, Mr. Kovnat and Mr. Rees announced their intention to retire on November 30, 2007. The Board intends to develop an orderly plan of succession to appropriately carry the Company forward.

We anticipate hiring additional executive officers in the future. 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 audit for fiscal year 2006 provisional rates was completed on October 31, 2005 and accepted as 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.

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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

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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. If we do not enter such a joint venture, we intend to pursue the application of UNICORN™ technology to unmanned air vehicles, if we can obtain government funding for this purpose. While we have had discussions with the federal government in this regard, it is still too early to assess our prospects for obtaining such funding. 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®, 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®, 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 SOCRATES® wake vortex sensor, when and if we successfully complete its 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 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 UNICORN™ or TIICM™ research and development, we encounter technical or engineering obstacles to the successful commercial development of SOCRATES®, UNICORN™ or TIICM™, 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 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. A second case alleges contractual interference relating to the development of TIICM™. We firmly believe that the claims contained in both complaints are without merit and intend to conduct a vigorous defense in these matters. However, defending against existing and potential litigation will likely require significant attention and resources and, regardless of the outcome, result in significant legal expenses, which will 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.

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.

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 8,215,210 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 August 31, 2006, we have 8,215,210 shares of common stock and an aggregate of 3,784,466 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 5% stockholders will exercise significant control over us.

Our current officers, directors and 5% stockholders, in the aggregate, control approximately 38.40% of our outstanding common stock (including common stock issuable to such person or group within 60 days after August 31, 2006). 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 3A. 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

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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.

Item 3B. 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.

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<u>Exhibit 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.
10.4	and William B. Cotton (4)
10.5	Employment Agreement effective as of November 4, 2003, between Flight Safety Technologies, Inc.
10.6	and David D. Cryer (5)
10.7	Employment Agreement effective as of November 4, 2003, between Flight Safety Technologies, Inc.
10.8	and Frank L. Rees (6)
10.9	Teaming Agreement dated May 1, 1997, by and between FSTO and Lockheed Martin Corporation (7)
10.10	Share Exchange Agreement between Reel Staff, Inc. and Flight Safety Technologies, Inc., dated June 24, 2002, as amended July 15, 2002 (8)
10.11	Cost Reimbursement Research Project Agreement between Flight Safety Technologies, Inc. and Georgia Tech Applied Research Corporation (9)
31.1	Phase III Contract issued by U.S. Department of Transportation/RSPA/Volpe Center, dated September 30, 2003 (10)
	Agreement between Flight Safety Technologies, Inc. and Advanced Acoustics Concepts, Inc., dated January 14, 2000 (11)
	Employment Agreement effective as of June 23, 2005, between Flight Safety Technologies, Inc.



- 31.2 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.
- (13) Incorporated by reference to Exhibit 10.11 on our Form 10-KSB, which was filed on September 7, 2006.

(b) Reports on Form 8-K

On June 22, 2006, we filed a Current Report on Form 8-K. The report contained an Item 8.01 disclosure announcing that the Registrant posted its Year End Letter to Shareholders on its website.

On June 30, 2006, we filed a Current Report on Form 8-K. The report contained an Item 8.01 disclosure announcing that Analogic Corporation has filed a lawsuit against FST based on its alleged interference of a license agreement between Analogic and SDI and relating to development of TIICM™ countermanpads technology on which SDI and FST have filed a joint patent application.

On July 13, 2006, we filed a Current Report on Form 8-K. The report contained an Item 8.01 disclosure announcing that it will be participating in the Farnborough International Air Show to be held in England July 17th through July 21st.

On July 14, 2006, we filed a Current Report on Form 8-K. The report contained an Item 8.01 disclosure announcing that the U.S. Government is expected to provide \$1M in new funding to Sanders Design International for further research and development on SICM/TIICM™ technology in which the Registrant will participate.

On July 26, 2006, we filed a Current Report on Form 8-K. The report contained an Item 8.01 disclosure announcing that an article about us appeared July 17, 2006 on Dow Jones Newswire.

On July 28, 2006, we filed a Current Report on Form 8-K. The report contained an Item 8.01 disclosure announcing that a story about us appeared in the New London Day Newspaper on July 28, 2006.

On August 23, 2006, we filed a Current Report on Form 8-K. The report contained an Item 8.01 disclosure announcing that the United States Securities and Exchange Commission has terminated its informal investigation of us with no enforcement action recommended.

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

October 12, 2006

By:







/s/ Samuel A. Kovnat

  
Samuel A. Kovnat  
Chairman and Chief Executive Officer

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KNOW ALL PERSONS BY THESE PRESENTS, that each person whose signature appears below constitutes and appoints Samuel A. Kovnat, his attorneys-in-fact, each with the power of substitution, for him in any and all capacities, to sign any amendments to this Report on Form 10-KSB, and to file the same, with Exhibits thereto and other documents in connection therewith with the Securities and Exchange Commission, hereby ratifying and confirming all that each of said attorneys-in-fact, or substitute or substitutes may do or cause to be done by virtue hereof.

In accordance with the Exchange Act, this report has been signed below by the following persons on behalf of the registrant and in the capacities and on the dates indicated.

<u>Signature</u>	<u>Date</u>
/s/ William B. Cotton  William B. Cotton, Director, President	October 12, 2006
/s/ Frank L. Rees  Frank L. Rees, Director, Executive Vice President	October 12, 2006
/s/ David D. Cryer  David D. Cryer, Chief Financial Officer, Treasurer	October 12, 2006
/s/ C. Robert Knight  C. Robert Knight, Secretary, Vice President of Administration/ General Counsel	October 12, 2006
/s/ Kenneth S. Wood  Kenneth S. Wood, Director	October 12, 2006
/s/ Jackson Kemper 	October 12, 2006

Jackson Kemper, Director

/s/ Larry L. Pressler

October 12, 2006

[REDACTED]  
Larry L. Pressler, Director

/s/ Joseph J. Luca

October 12, 2006

[REDACTED]  
Joseph J. Luca, Director

/s/ Stephen P. Tocco

October 12, 2006

[REDACTED]  
Stephen P. Tocco, Director