TORO CO
Form 10-K
December 22, 2009

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UNITED STATES SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-K

Annual Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934
For Fiscal Year Ended October 31, 2009

THE TORO COMPANY

(Exact name of registrant as specified in its charter)

Delaware	**1-8649**	**41-0580470**
(State of incorporation)	(Commission File Number)	(I.R.S. Employer Identification Number)

8111 Lyndale Avenue South
Bloomington, Minnesota 55420-1196
Telephone number: (952) 888-8801

(Address, including zip code, and telephone number, including area code, of registrant's principal executive offices)

Securities registered pursuant to Section 12(b) of the Act:

Title of Each Class	**Name of Each Exchange on Which Registered**
Common Stock, par value $1.00 per share	New York Stock Exchange

Securities registered pursuant to Section 12(g) of the Act:
None

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes ý No o

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes o No ý

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 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 ý No o

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes o No o

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. ý

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See definitions of "large accelerated filer," "accelerated filer," and "smaller reporting company" in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer ý	Accelerated filer o	Non-accelerated filer o (Do not check if a smaller reporting company)	Smaller reporting company o

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Act). Yes o No ý

The aggregate market value of the voting stock held by non-affiliates of the registrant, based on the closing price of the Common Stock on May 1, 2009, the last business day of the registrant's most recently completed second fiscal quarter, as reported by the New York Stock Exchange, was approximately $1.1 billion.

The number of shares of Common Stock outstanding as of December 16, 2009 was 33,464,325.

Documents Incorporated by Reference

Portions of the registrant's Proxy Statement for the Annual Meeting of Shareholders to be held March 16, 2010 are incorporated by reference into Part III.

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PART I

ITEM 1. BUSINESS

Introduction

The Toro Company was incorporated in Minnesota in 1935 as a successor to a business founded in 1914 and reincorporated in Delaware in 1983. Unless the context indicates otherwise, the terms "company," "Toro," "we," "us," and "our" refer to The Toro Company and its consolidated subsidiaries. Our executive offices are located at 8111 Lyndale Avenue South, Bloomington, Minnesota, 55420-1196, telephone number (952) 888-8801. Our Internet address for corporate and investor information is www.thetorocompany.com, which also contains links to our branded product sites. The information contained on our web sites or connected to our web sites is not incorporated by reference into this Annual Report on Form 10-K and should not be considered part of this report.

We design, manufacture, and market professional turf maintenance equipment and services, turf and agricultural micro-irrigation systems, landscaping equipment, and residential yard and snow removal products. We produced our first mower for golf course use in 1921 when we mounted five reel mowers on a Toro tractor, and we introduced our first lawn mower for residential use in 1935. We have continued to enhance our product lines ever since. We classify our operations into three reportable business segments: professional, residential, and distribution. Our distribution segment, which consists of our company-owned domestic distributorship, has been combined with our corporate activities and financing functions that is shown as "Other." Net sales of our segments accounted for the following approximate percentages of our consolidated net sales for fiscal 2009: Professional, 63 percent; Residential, 35 percent; and Other, 2 percent.

Our products are advertised and sold at the retail level under the primary trademarks of Toro®, Exmark®, Irritrol®, Hayter®, Pope®, Lawn-Boy®, and Lawn Genie®, most of which are registered in the United States and/or in the principal foreign countries where we market such products. This report also contains trademarks, trade names, and service marks that are owned by other persons or entities, such as The Home Depot®.

We emphasize quality and innovation in our products, customer service, manufacturing, and marketing. We strive to provide well-built, dependable products supported by an extensive service network. We have committed funding for engineering and research in order to improve existing products and develop new products. Through these efforts, we seek to be responsive to trends that may affect our target markets now and in the future. A significant portion of our revenue has historically been, and we expect it to continue to be, attributable to new and enhanced products. At the same time, we plan to pursue targeted acquisitions using a disciplined approach that adds value while considering our existing brands and product portfolio. Our mission is to be the leading worldwide provider of outdoor landscaping products, support services, and integrated systems that help customers preserve and beautify their outdoor landscapes with environmentally responsible solutions of customer-valued quality and innovation.

Products by Market

We strive to be a leader in adapting advanced technologies to products and services that provide solutions for landscapes, agricultural fields, turf care maintenance, and residential demands. The following is a summary of our products, by market, for the professional segment and our products for the residential segment:

Professional We design professional turf and agricultural products and market them worldwide through a network of distributors and dealers as well as directly to government customers, rental companies, and large retailers. Products are sold to professional users engaged in creating landscapes, irrigating turf and agricultural fields, and maintaining turf, such as golf courses, sports fields, municipal properties, and residential and commercial landscapes.

Landscape Contractor Market. Products for the landscape contractor market include zero-turn radius riding mowers, heavy-duty walk behind mowers, mid-size walk behind mowers, stand-on mowers, compact utility loaders, and walk-behind trenchers. These products are sold through dealers and are also available through rental centers to individuals and companies who maintain and create residential and commercial landscapes on behalf of property owners. We market products to landscape contractors under the Toro and Exmark brands. In fiscal 2009, we introduced the next generation of Toro and Exmark zero-turn radius riding mowers. The Toro brand Z Master® G3 and the Exmark brand Next Lazer Z® feature more efficient designs with fewer parts and a complete set of redesigned performance, comfort, and convenience features. In fiscal 2009, we also introduced the Toro GrandStand premium stand-on mower that features our versatile fold-up platform and fatigue-reducing suspension.

Our compact utility loaders are cornerstone products for the Toro Sitework Systems product line, which are designed to improve efficiency in the creation of landscapes. We offer over 35 attachments for our compact utility loaders, including trenchers, augers, vibratory plows, and backhoes.

Sports Fields and Grounds Market. Products for the sports fields and grounds market include riding rotary mowers and attachments; aerators; and debris management products, which include versatile debris vacuums, blowers, and sweepers. Other products include multipurpose vehicles, such as the Toro Workman®, that can be used for turf maintenance, towing, and industrial hauling. These products are sold through distributors, who then sell to owners and/or managers of sports fields, municipal properties, and residential and commercial landscapes. In fiscal 2009, we introduced the redesigned Groundsmaster® 4500-D and 4700-D that features our Contour Plus rotary cutting units, SmartCool system with auto-reversing cooling fan, and full-length striping rear rollers. In fiscal 2009, we also introduced the redesigned Toro Workman® HD series of utility vehicles, featuring increased hauling and towing capacity.

Golf Course Market. Products for the golf course market include large reel and rotary riding products for fairway, rough and trim cutting; riding and walking mowers for putting greens and specialty areas; turf sprayer equipment; utility vehicles; aeration equipment; and bunker maintenance equipment. We also manufacture and market underground irrigation systems, including sprinkler heads; controllers; turf sensors; and electric, battery-operated, and hydraulic valves. Our golf course irrigation systems are designed to use computerized management systems and a variety of technologies to help customers manage their consumption of water. Our 835S/855S Series golf sprinklers are equipped with a unique TruJectory feature that provides enhanced water distribution control as well as uniformity, nozzle flexibility, and system efficiency. Our Network VP® Satellite combines modular flexibility, ease of use, and increased control in a single controller with programming to the individual station level that supports station-based flow management. Our Turf Guard® wireless soil monitoring systems are designed to measure soil moisture, salinity, and temperature through buried wireless sensors that communicate through an Internet server for processing and presentation to a user through the web. In fiscal 2009, we introduced the ProCore® SR series of deep-tine aerators that feature remote depth adjustment for aeration depths of up to 16 inches. Late in fiscal 2009, we acquired a versatile line of topdressing and material handling equipment that enhances our product offering of application and cultivation equipment to help customers achieve improved agronomic conditions of turf.

Residential/Commercial Irrigation Market. Turf irrigation products marketed under the Toro and Irritrol brands include sprinkler heads, plastic and brass valves, and electric and hydraulic control devices designed to be used in residential and commercial turf irrigation systems. These products are professionally installed as new systems and can also be used to replace or retrofit existing systems. Most of the product line is designed for underground irrigation systems. Electric and hydraulic controllers activate valves and sprinkler heads in a typical irrigation system. We also offer wired and wireless rain and freeze switches on some products in an effort to conserve water usage. Our IntelliSense and Rain Master® controllers self-adjust their watering schedules based on current environmental conditions. In fiscal 2009, we introduced a new line of Precision Series Spray nozzles, featuring our patented H^2O Chip Technology that reduces runoff and water use without affecting plant health.

Our retail irrigation products are marketed under the Toro and Lawn Genie brand names. These products are designed for homeowner installation and include sprinkler heads, valves, timers, and drip irrigation systems. Our ECXTRA sprinkler timers can be used with a home computer, and our Scheduling Advisor recommends the proper watering schedule based on the local weather, plant type, and sprinkler.

Micro-Irrigation Market. Products for the micro-irrigation market include products that regulate the flow of water for drip irrigation, including Aqua-TraXX® PBX drip tape, Aqua-TraXX® PC (pressure-compensating) drip tape, Blue Stripe® polyethylene tubing, and Drip In® drip line, all used in agriculture, mining, and landscape applications. In addition to these core products, we offer a full complement of control devices and connection options to complete the system. These products are sold primarily through dealers and distributors who then sell to end-users for use primarily in vegetable fields, fruit and nut orchards, vineyards, landscapes, and mines.

Residential We market our residential products to homeowners through a variety of distribution channels, including outdoor power equipment dealers, hardware retailers, home centers, mass retailers, and over the Internet. These products are sold mainly in North America, Europe, and Australia, with the exception of snow removal products that are sold primarily in North America and Europe. We also license our trade name to other manufacturers and retailers on certain products as a means of expanding our brand presence.

Walk Power Mower Products. We manufacture and market numerous walk power mower models under our Toro and Lawn-Boy brand names, as well as the Pope brand in Australia and the Hayter brand in the United Kingdom. Models differ as to cutting width, type of starter mechanism, method of grass clipping discharge, deck type, operational controls, and power sources, and are either self-propelled or push mowers. We also offer a line of rear roller walk power mowers, a design that provides a striped finish, for the United Kingdom market. In fiscal 2009, we introduced a new line of Lawn-Boy walk-power mowers, designed for price sensitive buyers seeking the quality and features of a Lawn-Boy. In fiscal 2009, we also introduced a new line of Toro Recycler® walk-power mowers with our innovative Bag on Demand feature and a line of Toro Super Bagger walk-power mowers with our newly designed Superior Bagging System.

Riding Products. We manufacture and market riding products under the Toro brand name worldwide and under the Hayter brand name in the United Kingdom. We also manufacture riding mower products and attachments for a third party under a private label agreement. Riding products primarily consist of zero-turn radius mowers that save homeowners time by using their superior maneuverability to cut around obstacles more quickly and easily than tractor technology. We also sell lawn and garden tractor models, as well as a rear engine riding mower manufactured and sold in the European market. Many models are available with a variety of engines, decks, transmissions, and accessories. In fiscal 2009, we introduced the all new Toro TITAN® heavy-duty residential zero-turn mowers, combining user-friendly features with features inspired by those found on our commercial zero-turn mowers.

Home Solutions Products. We design and market home solutions products under the Toro and Pope brand names, including electric and battery operated flexible line grass trimmers, electric blower-vacuums, electric blowers, and electric snow throwers. In Australia, we also design and market underground and hose-end retail irrigation products under the Pope brand name.

Gas Snow Removal Products. We manufacture and market a range of gas-powered single-stage and two-stage snow thrower models. Single-stage snow throwers are walk behind units with lightweight two- and four-cycle gasoline engines. Most single-stage snow thrower models include Power Curve® snow thrower technology and some feature our Quick Shoot control system that enables operators to quickly change snow throwing direction. Our innovative pivoting scraper also keeps the rotor in constant contact with the pavement. Our two-stage snow throwers are generally designed for relatively large areas of deep, heavy snow and use four-cycle engines. Our two-stage snow throwers include a line of innovative models featuring the Power Max® auger system for enhanced performance and the Quick Stick® chute control technology.

Financial Information about Foreign Operations and Business Segments

We manufacture our products in the United States, Mexico, Australia, Italy, and the United Kingdom for sale throughout the world and maintain sales offices in the United States, Belgium, the United Kingdom, France, Australia, Singapore, Japan, China, Italy, and Korea. New product development is pursued primarily in the United States. Our net sales outside the United States were 32.0 percent, 32.4 percent, and 29.0 percent of total consolidated net sales for fiscal 2009, 2008, and 2007, respectively.

A portion of our cash flow is derived from sales and purchases denominated in foreign currencies. To reduce the uncertainty of foreign currency exchange rate movements on these sales and purchase commitments, we enter into foreign currency exchange contracts for select transactions. For additional information regarding our foreign currency exchange contracts, see Part II, Item 7A, "Quantitative and Qualitative Disclosures about Market Risk" of this report. For additional financial information regarding our foreign operations and each of our three reportable business segments, see Note 12 of the notes to our consolidated financial statements, in the section entitled "Segment Data," included in Part II, Item 8, "Financial Statements and Supplementary Data" of this report.

Engineering and Research

We are committed to an ongoing engineering program dedicated to developing innovative new products and improvements in the quality and performance of existing products. However, a focus on innovation also carries certain risks that new technology could be slow to be accepted or not accepted by the marketplace. We attempt to mitigate this risk through our focus on and commitment to understanding our customers' needs and requirements. We are investing more time upfront with customers, using "Voice of the Customer" tools to ensure we develop innovative products that meet or exceed customer expectations. We also use Design for Manufacturing and Assembly (DFMA) tools to ensure early manufacturing involvement in new product designs to reduce production costs. DFMA focuses on reducing the number of parts required to assemble new products as well as designing products to move more efficiently through the manufacturing process. We are also making improvements to our new product development system as part of our Lean initiatives to shorten development time, reduce costs, and improve quality.

Our engineering expenses are primarily incurred in connection with the development of new products that may have additional applications or represent extensions of existing product lines, improvements to existing products, and cost reduction efforts. Our expenditures for engineering and research were $52.7 million (3.5 percent of net sales) in fiscal 2009, $63.0 million (3.4 percent of net sales) in fiscal 2008, and $59.9 million (3.2 percent of net sales) in fiscal 2007.

Manufacturing and Production

In some areas of our business we serve as a fully integrated manufacturer, while in others we are primarily an assembler. We have strategically identified specific core manufacturing competencies for vertical integration and have chosen outside vendors to provide other services. We design component parts in cooperation with our vendors, contract with them for the development of tooling, and then enter into agreements with these vendors to purchase component parts manufactured using the tooling. In addition, our vendors regularly test new technologies to be applied to the design and production of component parts. Manufacturing operations include robotic and computer-automated equipment to speed production, reduce costs, and improve the quality, fit, and finish of products. Operations are also designed to be flexible enough to accommodate product design changes that are necessary to respond to market demand.

In order to utilize our manufacturing facilities and technology more effectively, we pursue continuous improvements in our manufacturing processes with the use of Lean methods that are intended to streamline work and eliminate waste. We also have flexible assembly lines that can handle a wide product mix and deliver products to meet customer demand. Additionally, we spend considerable effort to reduce manufacturing costs through Lean methods and process improvement, product and platform design, application of advanced technologies, enhanced environmental management systems, SKU consolidation, safety improvements, and improved supply-chain management. We also manufacture products sold under a private label agreement to a third party on a competitive basis, and we have agreements with other third party manufacturers to manufacture products on our behalf.

Our professional products are manufactured throughout the year. Our residential lawn and garden products are also generally manufactured throughout the year. However, our residential snow removal equipment products are generally manufactured in the summer and fall months but may be extended into the winter months depending upon demand. Our products are tested in conditions and locations similar to those in which they are used. We use computer-aided design and manufacturing systems to shorten the time between initial concept and final production. DFMA principles are used throughout the product development process to optimize product quality and cost.

Our production levels and inventory management goals are based on estimates of retail demand for our products, taking into account production capacity, timing of shipments, and field inventory levels. In fiscal 2009, we continued to roll-out a pull-based production system at some of our manufacturing facilities to better synchronize the production of our products to meet customer demand at just the right time. Along with improved service levels for our participating suppliers, distributors, and dealers, the program has resulted in inventory reductions for us and throughout the distribution system.

We periodically shut down production at our manufacturing facilities in order to allow for maintenance, rearrangement, capital equipment installation, and as needed to adjust for market demand. Capital expenditures for fiscal 2010 are planned to be approximately $40 to $45 million as we expect to continue to invest in new product tooling, replacement production equipment, and expansion of our vertical integration capabilities.

Raw Materials

During the first half of fiscal 2009, we experienced higher average commodity costs compared to the average prices paid for commodities in fiscal 2008. During the second half of fiscal 2009, prices paid for commodities declined, which offset the negative impact of higher commodity costs on our gross margin rate during the first half of fiscal 2009. We have offset, and expect to continue to mitigate, commodity cost increases in part by continuing efforts to engage in proactive vendor negotiations, review alternative sourcing options, substitute materials, engage in internal cost reduction efforts, and increase prices on some of our products, as appropriate.

Most of the components of our products are also affected by commodity cost pressures and are commercially available from a number of sources. In fiscal 2009, we experienced no significant work stoppages as a result of shortages of raw materials or commodities. The highest raw material and component costs are generally for steel, engines, hydraulic components, transmissions, plastic resin, and electric motors, which are purchased from several suppliers around the world.

Service and Warranty

Our products are warranted to ensure customer confidence in design, workmanship, and overall quality. Warranty length varies depending on whether product usage is for "residential" or "professional" applications within individual product lines. Warranty coverage ranges from a period of six months to seven years and generally covers parts, labor, and other expenses for non-maintenance repairs. Warranty coverage generally does not cover operator abuse or improper use. An authorized distributor or dealer must perform warranty work. Distributors and dealers submit claims for warranty reimbursement and are credited for the cost of repairs, labor, and other expenses as long as the repairs meet our prescribed standards. Warranty expense is accrued at the time of sale based on the type and estimated number of products under warranty, historical average costs incurred to service warranty claims, the trend in the historical ratio of claims to sales, the historical length of time between the sale and resulting warranty claim, and other minor factors. Special warranty reserves are also accrued for major rework campaigns. Service support outside of the warranty period is provided by distributors and dealers at the customer's expense. We also sell extended warranty coverage on select products for a prescribed period after the factory warranty period expires.

Product Liability

We have rigorous product safety standards and work continually to improve the safety and reliability of our products. We monitor for accidents and possible claims and establish liability estimates with respect to claims based on internal evaluations of the merits of individual claims. We purchase excess insurance coverage for catastrophic product liability claims for incidents that exceed our self-insured retention levels.

Patents and Trademarks

We hold patents in the United States and foreign countries and apply for patents as applicable. Although we believe our patents are valuable and patent protection is beneficial, our patent protection will not necessarily deter or prevent competitors from attempting to develop similar products. We are not materially dependent on any one or more of our patents.

To prevent possible infringement of our patents by others, we periodically review competitors' products. To help avoid potential liability with respect to others' patents, we regularly review certain patents issued by the United States Patent and Trademark Office (USPTO) and foreign patent offices. We believe these activities help us minimize our risk of being a defendant in patent infringement litigation. We are currently involved in patent litigation cases, both where we are asserting patents and where we are defending against charges of infringement. While the ultimate result of our current cases are unknown at this time, we believe that the outcome of these cases is unlikely to have a material effect on our consolidated financial condition or results of operations.

Seasonality

Sales of our residential products, which accounted for approximately 35 percent of total consolidated net sales in fiscal 2009, are seasonal, with sales of lawn and garden products occurring primarily between February and May, and sales of snow removal equipment occurring primarily between July and January. Opposite seasons in some global markets somewhat moderate this seasonality of residential product sales. Seasonality of professional product sales also exists but is tempered because the selling season in the Southern states and in our markets in the Southern hemisphere continues for a longer portion of the year than in Northern regions of the world.

Overall, worldwide sales levels are historically highest in our fiscal second quarter and retail demand is generally highest in our fiscal third quarter. Typically, accounts receivable balances increase between January and April as a result of higher sales volumes and extended payment terms made available to our customers. Accounts receivable balances decrease between May and December when payments are received. Our financing requirements are subject to variations due to seasonal changes in working capital levels which typically increase in the first half of our fiscal year and then decrease in the second half of our fiscal year. Seasonal cash requirements of our business are financed from a combination of cash balances, cash flows from operations, and our bank credit lines. Peak borrowing generally occurs between January and April.

The following table shows total consolidated net sales and net earnings for each fiscal quarter as a percentage of the total fiscal year.

	Fiscal 2009		Fiscal 2008	
Quarter	**Net Sales**	**Net Earnings (Loss)**	Net Sales	Net Earnings
First	**22%**	**11%**	22%	16%
Second	**33**	**59**	34	52
Third	**26**	**31**	26	32
Fourth	**19**	**(1)**	18	

Effects of Weather

From time to time, weather conditions in a particular region or market may adversely or positively affect sales of some of our products and field inventory levels and result in a negative or positive impact on our future net sales. As the percentage of our net sales from outside the United States increases, our dependency on weather in any one part of the world decreases. Nonetheless, weather conditions could materially affect our future net sales.

Working Capital

We fund our operations through a combination of cash and cash equivalents, cash flows from operations, short-term borrowings under our credit facilities, and long-term debt. Wherever possible, cash management is centralized and intercompany financing is used to provide working capital to subsidiaries as needed. In addition, our credit facilities are available for additional working capital needs, acquisitions, or other investment opportunities.

Distribution and Marketing

We market the majority of our products through approximately 40 domestic and 110 foreign distributors, as well as a large number of outdoor power equipment dealers, hardware retailers, home centers, and mass retailers in more than 90 countries worldwide.

Residential products, such as walk power mowers, riding products, and snow throwers, are mainly sold directly to home centers, dealers, hardware retailers, and mass retailers. In certain markets, these same products are sold to distributors for resale to retail dealers. Home solutions products are primarily sold directly to home centers, mass retailers, hardware retailers, and dealers. We also sell selected residential products over the Internet. Internationally, residential products are sold directly to dealers and mass merchandisers in Australia, Belgium, Canada, and the United Kingdom. In most other countries, products are mainly sold to distributors for resale to dealers and mass retailers.

Professional products are sold mainly to distributors for resale to dealers, sports complexes, industrial facilities, contractors, municipalities, rental stores, and golf courses. We also sell some professional segment products directly to government customers and rental companies, as well as directly to end-users in certain international markets. Select residential/commercial irrigation products are also sold directly to professional irrigation distributors and certain retail irrigation products are sold directly to home centers. Compact utility loaders and attachments are sold to dealers and directly to large rental companies. Toro and Exmark landscape contractor products are also sold directly to dealers in certain regions of the United States.

During fiscal 2009, we owned one domestic distribution company. During the first quarter of fiscal 2010, our wholly owned distribution company completed the purchase of certain assets and assumed certain liabilities of an independent Midwestern-based distribution company. Our primary purposes in owning domestic distributorships are to facilitate ownership transfers while improving operations and to test and deploy new strategies and business practices that could be replicated by our independent distributors.

Our distribution systems are intended to assure quality of sales and market presence as well as effective after-purchase service and support. We believe our distribution network provides a competitive advantage in marketing and selling our products in part because our primary distribution network is focused on selling and marketing our products and also because of long-term relationships they have established and experienced personnel they utilize to deliver high levels of customer satisfaction.

Our current marketing strategy is to maintain distinct brands and brand identification for Toro®, Exmark®, Irritrol®, Hayter®, Pope®, Lawn-Boy®, and Lawn Genie® products.

We advertise our residential products during appropriate seasons throughout the year on television, on the radio, in print, and via the Internet. Professional products are advertised in print and through direct mail programs, as well as on the Internet. Most of our advertising emphasizes our brand names. Advertising is purchased by us as well as through cooperative programs with distributors, dealers, hardware retailers, home centers, and mass retailers.

Customers

Overall, we believe that in the long-term we are not dependent on any single customer. However, The Home Depot accounted for approximately 14 percent of our total consolidated gross sales in fiscal 2009. The residential segment of our business is dependent on The Home Depot as a customer. While the loss of any substantial customer, including The Home Depot, could have a material adverse short-term impact on our business, we believe that our diverse distribution channels and customer base should reduce the long-term impact of any such loss.

Backlog of Orders

Our backlog of orders is dependent upon when customers place orders, and not necessarily an indicator of our expected results for the first quarter of fiscal 2010 or our fiscal 2010 net sales. The approximate backlog of orders believed to be firm as of October 31, 2009 and 2008 was $85.1 million and $77.9 million, respectively, an increase of 9.2 percent. This increase was primarily the result of open orders for snow thrower products due to the timing of the introduction for a new redesigned offering of snow thrower products that shipped in the first quarter of fiscal 2010. We expect the existing backlog of orders will be filled in early fiscal 2010.

Competition

Our products are sold in highly competitive markets throughout the world. The principal competitive factors in our markets are product innovation, quality and reliability, product support and customer service, pricing, warranty, brand awareness, reputation, distribution, shelf space, and financing options. Pricing volatility has become an increasingly important competitive factor for a majority of our products. We believe we offer total solutions and full service packages with high quality products that have the latest technology and design innovations. Also, by selling our products through a network of distributors, dealers, hardware retailers, home centers, and mass retailers, we offer comprehensive service support during and after the warranty period. We compete in many product lines with numerous manufacturers, many of which have greater operations and financial resources than us. We believe that we have a competitive advantage because we manufacture a broad range of product lines, we are committed to product innovation and customer service, we focus on Lean manufacturing methods, we have a strong focus in maintaining landscapes, and our distribution channels position us well to compete in various markets.

Internationally, residential segment products face more competition where foreign competitors manufacture and market products in their respective countries. We experience this competition primarily in Europe. In addition, fluctuations in the value of the U.S. dollar may affect the price of our products in foreign markets, thereby impacting their competitiveness. We provide pricing support to foreign customers, as needed, to remain competitive in international markets.

Environmental Matters and Other Governmental Regulation

We are subject to numerous federal, state, international, and other governmental laws, rules, and regulations relating to, among others, climate change; emissions to air and discharges to water; product and associated packaging; import and export compliance, including country of origin certification requirements; worker and product user health and safety; and the generation, use, handling, labeling, collection, management, storage, transportation, treatment, and disposal of hazardous substances, wastes, and other regulated materials. For example:

> The United States Environmental Protection Agency (EPA), the California Air Resources Board, and similar regulators in other U.S. states and foreign jurisdictions in which we sell our products have phased in, or are phasing in, certain emission regulations setting

maximum emission standards for certain equipment.

Certain U.S. states and foreign jurisdictions in which we sell our products, including the European Union (EU), and each of its member states, have implemented (i) the Waste Electrical and Electronic Equipment (WEEE) directive or similar substance level laws, rules, or regulations, which mandate the labeling, collection, and disposal of certain waste electrical and electronic equipment, (ii) the Restriction on the use of Hazardous Substances (RoHS) directive or similar substance level laws, rules, or regulations, which restrict the use of several specified hazardous materials in the manufacture of specific types of electrical and electronic equipment, and (iii) country of origin laws, rules, or regulations, which require certification of the geographic origin of finished goods and/or components through documentation and/or physical markings, as applicable.

Our residential products are subject to various federal, state, and international laws, rules, and regulations that are designed to protect consumers and we are subject to the administrative jurisdiction of the Consumer Product Safety Commission.

Although we believe that we are in substantial compliance with applicable laws, rules, and regulations, we are unable to predict the ultimate impact of adopted or future laws, rules, and regulations on our business. Such laws, rules, or regulations may cause us to incur significant expenses to achieve or maintain compliance, may require us to modify our products, may adversely affect the demand for some of our products, and may ultimately affect the way we conduct our operations. Failure to comply with these regulations could lead to fines and other penalties, including restrictions on the importation of our products into, or the sale of our products in, one or more jurisdictions until compliance is achieved.

We are also involved in the evaluation and clean-up of a limited number of properties currently and previously owned. We do not expect that these matters will have a material adverse effect on our consolidated financial position or results of operations.

Customer Financing

Wholesale Financing. Toro Credit Company (TCC), our wholly owned finance subsidiary, provided financing throughout most of fiscal 2009 for select products that we manufacture and sell to our U.S. distributors, select distributors of our products in Canada, and approximately 150 select U.S. dealers. In October 2009, TCC sold its receivable portfolio to Red Iron Acceptance, LLC (Red Iron), a recently established joint venture between Toro and TCF Inventory Finance, Inc. (TCFIF), a subsidiary of TCF National Bank. Red Iron provides inventory financing, including floor plan financing, to distributors and dealers of our products in the U.S. and to select distributors of our products in Canada. Under a separate arrangement, TCF Commercial Finance Canada, Inc. (TCFCFC) implemented a program to provide inventory financing to dealers of our products in Canada during the first quarter of fiscal 2010. In connection with the establishment of the joint venture, we terminated our agreement with a third party financing company that previously provided floor plan financing to dealers of our products in the U.S. and Canada. Red Iron began financing open account receivables, as well as floor plan receivables previously financed by such third party financing company, during our first quarter of fiscal 2010. Under these financing arrangements, down payments are not required and, depending on the finance program for each product line, finance charges are incurred by us, shared between us and the distributor and/or the dealer, or paid by the distributor or dealer. Red Iron retains a security interest in the distributors' and dealers' financed inventories, and those inventories are monitored regularly. Floor plan terms to the distributors and dealers require payment as the equipment, which secures the indebtedness, is sold to customers, or when payment terms become due, whichever occurs first. Rates are generally indexed to LIBOR plus a fixed percentage that differs based on whether the financing is for a distributor or dealer. Rates may also vary based on the product that is financed.

We continue to provide inventory financing to mass market retail customers; general line irrigation dealers; wholly owned distributors; international distributors and dealers, excluding the Canadian distributors and dealers that Red Iron provides financing arrangements; and government entity customers. Some independent international dealers continue to finance their products with third party sources.

End-User Financing. We have agreements with third party financing companies to provide lease-financing options to golf course and sports fields and grounds equipment customers in the U.S. and Europe. The purpose of these agreements is to increase sales by giving buyers of our products alternative financing options when purchasing our products.

We also have agreements with third party financing companies to provide financing programs under a private label program in the U.S. This program, offered primarily to Toro and Exmark dealers, provides end-user customers a revolving line of credit for Toro and Exmark products, parts, and services.

Distributor Financing. Occasionally, we enter into long-term loan agreements with some distributors. These transactions are used for expansion of the distributors' businesses, acquisitions, refinancing working capital agreements, or ownership transitions.

Employees

During fiscal 2009, we employed an average of 4,612 employees. The total number of employees as of October 31, 2009 was 4,414. We consider our employee relations to be good. Three collective bargaining agreements cover approximately 17 percent of these employees. These three agreements expire in May 2010, October 2010, and October 2011. From time to time, we also retain temporary and part-time workers, independent contractors, and consultants.

Available Information

Filings with the SEC. We are a reporting company under the Securities Exchange Act of 1934, as amended, and file reports, proxy statements, and other information with the Securities and Exchange Commission (SEC). Copies of these reports, proxy statements, and other information can be inspected and copied at the SEC's Public Reference Room at 100 F Street N.E., Washington, D.C. 20549. You may obtain information on the operation of the Public Reference Room by calling the SEC at

1-800-SEC-0330. Because we make filings to the SEC electronically, you may also access this information from the SEC's home page on the Internet at http://www.sec.gov.

We make available, free of charge on our Internet web site www.thetorocompany.com (select the "Investor Information" link and then the "Financials" link), our annual reports on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, proxy statements on Schedule 14A, amendments to those reports, and other documents filed or furnished pursuant to Section 13(a) or 15(d) of the Securities Exchange Act of 1934, as amended, as soon as reasonably practicable after we electronically file such material with, or furnish it to, the SEC. The information contained on our web site or connected to our web site is not incorporated by reference into this Annual Report on Form 10-K and should not be considered part of this report.

Corporate Governance. We have a Code of Ethics for our CEO and Senior Financial Officers, a Code of Conduct for all employees, and a Board of Directors Business Ethics Policy Statement. Copies of these documents are posted on our website at www.thetorocompany.com (select the "Investor Information" link and then the "Corporate Governance" link).

We also make available, free of charge on our web site at www.thetorocompany.com (select the "Investor Information" link and then the "Corporate Governance" link) and in print to any shareholder who requests, our Corporate Governance Guidelines and the charters of our Audit Committee, Compensation and Human Resources Committee, Nominating and Governance Committee, and Finance Committee of our Board of Directors. Requests for copies can be directed to Investor Relations at 888-237-3054.

We have furnished to the SEC the required certifications under Section 302 of the Sarbanes-Oxley Act of 2002 regarding the quality of our public disclosures as Exhibits 31.1 and 31.2 to this report. We have filed with the New York Stock Exchange (NYSE) the CEO certification regarding our compliance with the NYSE's corporate governance listing standards as required by NYSE Rule 303A.12(a) on March 18, 2009.

Forward-Looking Statements

This Annual Report on Form 10-K contains, or incorporates by reference, not only historical information, but also forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended, and that are subject to the safe harbor created by those sections. In addition, we or others on our behalf may make forward-looking statements from time to time in oral presentations, including telephone conferences and/or web casts open to the public, in press releases or reports, on our web sites or otherwise. Statements that are not historical are forward-looking and reflect expectations and assumptions. We try to identify forward-looking statements in this report and elsewhere by using words such as "expect," "strive," "looking ahead," "outlook," "forecast," "optimistic," "anticipate," "continue," "plan," "estimate," "believe," "should," "could," "will," "would," "possible," "may," "likely," "intend," and similar expressions or future dates. Our forward-looking statements generally relate to our future performance, including our anticipated operating results, liquidity requirements, and financial condition; our business strategies and goals; and the effect of laws, rules, regulations, new accounting pronouncements, and outstanding litigation on our business and future performance.

Forward-looking statements involve risks and uncertainties. These risks and uncertainties include factors that affect all businesses operating in a global market as well as matters specific to Toro. The most significant factors known to us that could materially adversely affect our business, operations, industry, financial position, or future financial performance are described below in Part I, Item 1A,"Risk Factors." We wish to caution readers not to place undue reliance on any forward-looking statement which speaks only as of the date made and to recognize that forward-looking statements are predictions of future results, which may not occur as anticipated. Actual results could differ materially from those anticipated in the forward-looking statements and from historical results, due to the risks and uncertainties described elsewhere in this report, including in Part I, Item 1A, "Risk Factors," as well as others that we may consider immaterial or do not anticipate at this time. The risks and uncertainties described in this report, including in Part I, Item 1A, "Risk Factors," are not exclusive and further information concerning our company and our businesses, including factors that potentially could materially affect our operating results or financial condition, may emerge from time to time.

We assume no obligation to update forward-looking statements to reflect actual results or changes in factors or assumptions affecting such forward-looking statements. We advise you, however, to consult any further disclosures we make on related subjects in our future quarterly reports on Form 10-Q and current reports on Form 8-K that we file with or furnish to the SEC.

ITEM 1A. RISK FACTORS

The following are significant factors known to us that could materially adversely affect our business, operating results, financial condition, or future financial performance.

Economic conditions and outlook in the United States and around the world could continue to adversely affect our net sales and earnings.

Demand for our products depends upon economic conditions and outlook, which include but are not limited to recessionary conditions in the U.S. and other regions around the world and worldwide slow or negative economic growth rates; slow down or reductions in levels of golf course development, renovation, and improvement; slow down or reductions in levels of home ownership, construction, and home sales; consumer spending levels; credit availability and credit terms for our distributors, dealers, and end-user customers; short-term, mortgage, and other interest rates; unemployment rates; interest rates; inflation; consumer confidence; and general economic and political conditions and expectations in the U.S. and the foreign economies in which we conduct business. Slow or negative economic growth rates; inflationary pressures; higher commodity costs and fuel prices; slow downs or reductions in golf course development, renovation, and improvement; slow downs or reductions in home construction and sales; home foreclosures; reduced credit availability or unfavorable credit terms for our distributors, dealers, and end-user customers; higher short-term, mortgage, and other interest rates; unemployment rates; and recessionary economic conditions and outlook could cause our distributors, dealers, and end-user customers to reduce spending, which may cause them to delay or forego purchases of our products and could have an adverse effect on our net sales and earnings.

Increases in the cost, or disruption in the availability, of raw materials and components that we purchase and increases in our other costs of doing business, such as transportation costs, may adversely affect our profit margins and business.

We purchase raw materials such as steel, aluminum, fuel, petroleum-based resins, linerboard, and other commodities, and components, such as engines, transmissions, transaxles, hydraulics, and electric motors, for use in our products. Increases in the cost of such raw materials and components may adversely affect our profit margins if we are unable to pass along to our customers these cost increases in the form of price increases or otherwise reduce our cost of goods sold. Historically, we have used internal cost reduction efforts, proactive vendor negotiations, alternate sourcing options, substitute materials, and moderate price increases on some of our products to offset a portion of increased raw material, component, and other costs. However, we may not be able to fully offset any such increased costs in the future. Further, if our price increases are not accepted by our customers and the market, our net sales, earnings, and market share could be adversely affected. Although most of the raw materials and components used in our products are commercially available from a number of sources and in adequate supply, any disruption in the availability of such raw materials and components, our inability to timely or otherwise obtain substitutes for such items, or any deterioration in our relationships with or the financial viability of our suppliers could adversely affect our business. Increases in our other costs of doing business may also adversely affect our profit margins and business. For example, an increase in fuel costs may result in an increase in our transportation costs, which also could adversely affect our operating results and business.

Weather conditions may reduce demand for some of our products and adversely affect our net sales.

From time to time, weather conditions in a particular geographic region may adversely affect sales of some of our products and field inventory levels. For example, in the past, drought conditions have had an adverse effect on sales of certain mowing equipment products, unusually rainy weather or severe drought conditions that result in watering bans have had an adverse effect on sales of our irrigation products, and lower snow fall accumulations in key markets have had an adverse effect on sales of our snow thrower products. To the extent that such unfavorable weather conditions are exacerbated by global climate change or otherwise, our sales may be affected to a greater degree than we have previously experienced.

Our professional segment net sales are dependent upon the level of residential and commercial construction, the level of homeowners' outsourcing lawn care, the amount of investment in golf course renovations and improvements, new golf course development, golf course closures, the amount of government spending, and other factors.

Our professional segment products are sold by distributors or dealers, or directly to government customers, rental companies, and professional users engaged in maintaining and creating landscapes, such as golf courses, sports fields, municipal properties, and residential and commercial landscapes. Accordingly, our professional segment net sales are impacted by the level of residential and commercial construction, the level of homeowners' outsourcing lawn care, the amount of investment in golf course renovations and improvements, new golf course construction, availability of credit to finance product purchases, and the amount of government spending. Among other things, any one or a combination of the following factors could have an adverse effect on our professional segment net sales:

reduced tax revenue, increased governmental expenses in other areas, tighter government budgets and government deficits, generally resulting in reduced government spending for grounds maintenance equipment;

reduced consumer and business spending, causing homeowners not to outsource lawn care and causing landscape contractor professionals to forego or postpone purchases of our products;

reduced levels of commercial and residential construction, resulting in a decrease in demand for our products; and

reduced levels of new golf course construction and investment in golf course renovations and improvements, reduced number of golf rounds played at public and private golf courses resulting in reduced revenue for such golf courses, decreased membership at private golf courses resulting in reduced revenue and, in certain cases, financial difficulties for such golf courses, and golf course closures, any of which could result in a decrease in spending and demand for our products.

Our residential segment net sales are dependant upon consumer spending levels, the amount of product placement at retailers, changing buying patterns of customers, and The Home Depot, Inc. as a major customer.

The elimination or reduction of shelf space assigned to our residential products by retailers could adversely affect our residential segment net sales. Our residential segment net sales are also dependent upon changing buying patterns of customers. For example, there has been a trend away from purchases at dealer outlets and hardware retailers to home centers and mass retailers, as well as a trend for broader and lower price points at home centers and mass retailers. This trend has resulted in a demand for residential products purchased at retailers, such as The Home Depot, which accounted for approximately 10 to 14 percent of our total consolidated net sales in each of fiscal 2009, 2008, and 2007. We believe that our diverse distribution channels and customer base should reduce the long-term impact on us if we were to lose The Home Depot or any other substantial customer. However, the loss of any substantial customer, a significant reduction in sales to The Home Depot or other customers, or our inability to respond to future changes in buying patterns of customers and new distribution channels could have a material impact on our business and operating results. Changing buying patterns of customers also could result in reduced sales of one or more of our residential segment products, resulting in increased inventory levels. Although our residential lawn and garden products are generally manufactured throughout the year, our residential snow removal equipment products are generally manufactured in the summer and fall months but may be extended into the winter months depending upon demand. Our production levels and inventory management goals are based on estimates of retail demand for our products, taking into account production capacity, timing of shipments, and field inventory levels. If we overestimate or underestimate demand during a given season, we may not maintain the appropriate inventory levels, which could negatively impact our net sales, working capital, or hinder our ability to meet customer demand.

If we are unable to continue to enhance existing products and develop and market new products that respond to customer needs and preferences and achieve market acceptance, we may experience a decrease in demand for our products, and our business could suffer.

One of our growth strategies is to develop innovative, customer-valued products to generate revenue growth. Our sales from new products in the past have represented a significant component of our net sales and are expected to continue to represent a significant component of our future net sales. We may not be able to compete as effectively with our competitors, and ultimately satisfy the needs and preferences of our customers, unless we can continue to enhance existing products and develop new innovative products in the markets in which we compete. Product development requires significant financial, technological, and other resources. Although in the past we have implemented Lean manufacturing and other productivity improvement initiatives to provide investment funding for product enhancements and new products, we cannot be certain that we will be able to continue to do so in the future. Product improvements and new product introductions also require significant planning, design, development, and testing at the technological, product, and manufacturing process levels and we may not be able to timely develop product improvements or new products. Our competitors' new products may beat our products to market, be more effective with more features and/or less expensive than our products, obtain better market acceptance, or render our products obsolete. Any new products that we develop may not receive market acceptance or otherwise generate any meaningful net sales or profits for us relative to our expectations based on, among other things, existing and anticipated investments in manufacturing capacity and commitments to fund advertising, marketing, promotional programs, and research and development.

We face intense competition in all of our product lines with numerous manufacturers, including from some that have greater operations and financial resources than us. We may not be able to compete effectively against competitors' actions, which could harm our business and operating results.

Our products are sold in highly competitive markets throughout the world. Principal competitive factors in our markets include product innovation, quality and reliability, product support and customer service, pricing, warranty, brand awareness, reputation, distribution, shelf space, and financing options. We compete in all of our product lines with numerous manufacturers, some which have substantially greater operations and financial resources than us. As a result, they may be able to adapt more quickly to new or emerging technologies and changes in customer preferences, or to devote greater resources to the development, promotion, and sale of their products than we can. In addition, competition could increase if new companies enter the market or if existing competitors expand their product lines or intensify efforts within existing product lines. Our current products, products under development, and our ability to develop new and improved products may be insufficient to enable us to compete effectively with our competitors. Internationally, our residential segment products typically face more competition where foreign competitors manufacture and market products in their respective countries. We experience this competition primarily in Europe. In addition, fluctuations in the value of the U.S. dollar may affect the price of our products in foreign markets, thereby impacting their competitiveness. Pricing volatility has also become an increasingly important competitive factor for many of our products. We may not be able to compete effectively against competitors' actions, which may include the movement by competitors of significant manufacturing to low cost countries for significant cost and price reductions, and could harm our business and operating results.

A significant percentage of our consolidated net sales are generated outside of the United States, and we intend to continue to expand our international operations. Our international operations require significant management attention and financial resources, expose us to difficulties presented by international economic, political, legal, accounting, and business factors, and may not be successful or produce desired levels of net sales.

We manufacture our products in the United States, Mexico, Australia, the United Kingdom, and Italy for sale throughout the world and maintain sales offices in the United States, Belgium, the United Kingdom, France, Australia, Singapore, Japan, China, Italy, and Korea. Our net sales outside the United States were 32.0 percent, 32.4 percent, and 29.0 percent of our total consolidated net sales for fiscal 2009, 2008, and 2007, respectively. International markets have, and will continue to be, a focus for revenue growth. We believe many opportunities exist in the international markets, and over time we intend for international net sales to comprise a larger percentage of our total consolidated net sales. Several factors, including weakened international economic conditions, could adversely affect such growth. Additionally, the expansion of our existing international operations and entry into additional international markets require significant management attention and financial resources. Many of the countries in which we sell our products, or otherwise have an international presence are, to some degree, subject to political, economic, and/or social instability, including cartel-related violence. Our international operations expose us and our representatives, agents, and distributors to risks inherent in operating in foreign jurisdictions. These risks include:

- increased costs of customizing products for foreign countries;
- difficulties in managing and staffing international operations and increases in infrastructure costs including legal, tax, accounting, and information technology;
- the imposition of additional U.S. and foreign governmental controls or regulations; new or enhanced trade restrictions and restrictions on the activities of foreign agents, representatives, and distributors; and the imposition of increases in costly and lengthy import and export licensing and other compliance requirements, customs duties and tariffs, license obligations, and other non-tariff barriers to trade;
- the imposition of U.S. and/or international sanctions against a country, company, person, or entity with whom we do business that would restrict or prohibit our continued business with the sanctioned country, company, person, or entity;
- international pricing pressures;
- laws and business practices favoring local companies;
- adverse currency exchange rate fluctuations;
- longer payment cycles and difficulties in enforcing agreements and collecting receivables through certain foreign legal systems;
- difficulties in enforcing or defending intellectual property rights; and

multiple, changing, and often inconsistent enforcement of laws, rules, and regulations, including rules relating to environmental, health, and safety matters.

Our international operations may not produce desired levels of net sales or one or more of the factors listed above may harm our business and operating results. Any material decrease in our international sales or profitability could also adversely impact our operating results.

Fluctuations in foreign currency exchange rates could result in declines in our reported net sales and net earnings.

Because the functional currency of our foreign operations is the applicable local currency, we are exposed to foreign currency exchange rate risk arising from transactions in the normal course of business, such as sales and loans to wholly owned subsidiaries as well as sales to third party customers, purchases from suppliers, and bank lines of credit with creditors denominated in foreign currencies. Our reported net sales and net earnings are subject to fluctuations in foreign currency exchange rates. Because our products are manufactured or sourced primarily from the United States and Mexico, a stronger U.S. dollar and Mexican peso generally has a negative impact on results from operations, while a weaker dollar and peso generally has a positive effect. Our primary foreign currency exchange rate exposure is with the EU Euro, the Australian dollar, the Canadian dollar, the British pound, the Mexican peso, and the Japanese yen against the U.S. dollar. While we actively manage the exposure of our foreign currency market risk in the normal course of business by entering into various foreign exchange contracts, these instruments may not effectively limit our underlying exposure from currency exchange rate fluctuations or minimize our net earnings and cash volatility associated with foreign currency exchange rate changes. Further, a number of financial institutions similar to those that serve as counterparties to our foreign exchange contracts have been adversely affected by the unprecedented distress in the worldwide credit markets. The failure of one or more counterparties to our foreign currency exchange rate contracts to fulfill their obligations to us could adversely affect our operating results.

We manufacture our products at and distribute our products from several locations in the United States and internationally. Any disruption at any of these facilities or our inability to cost-effectively expand existing and/or move production between manufacturing facilities could adversely affect our business and operating results.

We manufacture most of our products at seven locations in the United States, two locations in Mexico, and one location in each of Australia, Italy, and the United Kingdom. We also have several locations that serve as distribution centers, warehouses, test facilities, and corporate offices. In addition, we have agreements to manufacture products at several third-party manufacturers. These facilities may be affected by natural or man-made disasters. In the event that one of our manufacturing facilities was affected by a disaster, we could be forced to shift production to one of our other manufacturing facilities. Although we purchase insurance for damage to our property and disruption of our business from casualties, such insurance may not be sufficient to cover all of our potential losses. Any disruption in our manufacturing capacity could have an adverse impact on our ability to produce sufficient inventory of our products or may require us to incur additional expenses in order to produce sufficient inventory, and therefore, may adversely affect our net sales and operating results. Any disruption or delay at our manufacturing facilities, including a work slowdown, strike, or similar action at any one of our three facilities operating under a collective bargaining agreement or the failure to renew or enter into new collective bargaining agreements, including two such agreements that expire in fiscal 2010, could impair our ability to meet the demands of our customers, and our customers may cancel orders or purchase products from our competitors, which could adversely affect our business and operating results. Our operating results may also be adversely affected if we are unable to cost-effectively expand existing and move production between manufacturing facilities as needed from time to time.

We intend to grow our business through additional acquisitions and alliances, stronger customer relations, and new joint ventures and partnerships, which are risky and could harm our business.

One of our growth strategies is to drive growth in our businesses and accelerate opportunities to expand our global presence through targeted acquisitions, alliances, stronger customer relations, and new joint ventures and partnerships that add value while considering our existing brands and product portfolio. The benefits of an acquisition or new joint venture or partnership may take more time than expected to develop or integrate into our operations, and we cannot guarantee that previous or future acquisitions, alliances, joint ventures, or partnerships will in fact produce any benefits. In addition, acquisitions, alliances, joint ventures, and partnerships involve a number of risks, including:

diversion of management's attention;

difficulties in integrating and assimilating the operations and products of an acquired business or in realizing projected efficiencies, cost savings, and synergies;

potential loss of key employees or customers of the acquired businesses or adverse effects on existing business relationships with suppliers and customers;

adverse impact on overall profitability if acquired businesses do not achieve the financial results projected in our valuation models;

reallocation of amounts of capital from other operating initiatives and/or an increase in our leverage and debt service requirements to pay the acquisition purchase prices, which could in turn restrict our ability to access additional capital when needed or to pursue other important elements of our business strategy;

inaccurate assessment of undisclosed, contingent or other liabilities or problems, unanticipated costs associated with an acquisition, and an inability to recover or manage such liabilities and costs; and

incorrect estimates made in the accounting for acquisitions, incurrence of non-recurring charges, and write-off of significant amounts of goodwill or other assets that could adversely affect our operating results.

Our ability to grow through acquisitions will depend, in part, on the availability of suitable acquisition candidates at acceptable prices, terms, and conditions, our ability to compete effectively for these acquisition candidates, and the availability of capital and personnel to complete such acquisitions and run the acquired business effectively. These risks could be heightened if we complete a large acquisition or multiple acquisitions within a relatively short period of time. In addition, some acquisitions may require the consent of the lenders under our credit agreements. We cannot predict whether such approvals would be forthcoming or the terms on which the lenders would approve such acquisitions. Any potential acquisition could impair our operating results, and any large acquisition could impair our financial condition, among other things.

As a result of our recently established financing joint venture, we are dependent upon the joint venture to provide competitive inventory financing programs, including floor plan and open account receivable financing, to certain distributors and dealers of our products. Any difficulty in transitioning our inventory financing programs to the joint venture, any material change in the availability or terms of credit offered to our customers by the joint venture, any termination or disruption of our joint venture relationship or any delay in securing replacement credit sources could adversely affect our net sales and operating results.

Historically, most of our dealers and distributors generally financed their inventories with either TCC, our wholly owned finance subsidiary, or third party financing companies. As a result of our recent joint venture with TCFIF, we are dependent upon the joint venture for our inventory financing programs, including floor plan and open account receivable financing, for distributors and dealers of our products in the U.S. and to select distributors of our products in Canada. The purpose of the joint venture is to provide access to reliable, competitive financing to our distributors and dealers in the U.S. and to select distributors of our products in Canada to support their businesses and increase our net sales, as well as to free up our working capital for other strategic purposes. Additionally, in connection with the joint venture, we are dependent upon TCFCFC to provide inventory financing to dealers of our products in Canada.

The availability of financing from our joint venture or otherwise will be affected by many factors, including, among others, the overall credit markets, the credit worthiness of our dealers and distributors, and regulations that may affect TCFIF, as the majority owner of the joint venture and a subsidiary of TCF National Bank, a national banking association. Any difficulty in the continued transitioning of our inventory financing programs to the joint venture, whether as a result of delays in the availability of enhancements to the wholesale management software system, documentation of customers, or other transition items, could adversely affect our sales and operating results. Further, any material change in the availability or terms of credit offered to our customers by the joint venture, any termination or disruption of our joint venture relationship or any delay in securing replacement credit sources could adversely affect our sales and operating results. Similarly, significant financed product repurchase requirements could have a material impact on our future operating results.

We rely on our management information systems for inventory management, distribution, and other functions. If our information systems fail to adequately perform these functions or if we experience an interruption in their operation, our business and operating results could be adversely affected.

The efficient operation of our business is dependent on our management information systems. We rely on our management information systems to effectively manage accounting and financial functions, manage manufacturing and supply chain processes, and maintain our research and development data. The failure of our management information systems to perform properly could disrupt our business and product development and could result in decreased sales, increased overhead costs, excess inventory, and product shortages, causing our business and operating results to suffer. In addition, our management information systems, including our computer systems, Internet web sites, telecommunications, and data networks, are vulnerable to damage or interruption from natural or man-made disasters, terrorist attacks and attacks by computer viruses or hackers, or power loss. Any such interruption could adversely affect our business and operating results.

Our reliance upon patents, trademark laws, and contractual provisions to protect our proprietary rights may not be sufficient to protect our intellectual property from others who may sell similar products. Our products may infringe the proprietary rights of others.

We hold patents relating to various aspects of our products and believe that proprietary technical know-how is important to our business. Proprietary rights relating to our products are protected from unauthorized use by third parties only to the extent that they are covered by valid and enforceable patents or are maintained in confidence as trade secrets. We cannot be certain that we will be issued any patents from any pending or future patent applications owned by or licensed to us or that the claims allowed under any issued patents will be sufficiently broad to protect our technology.

In the absence of enforceable patent protection, we may be vulnerable to competitors who attempt to copy our products or gain access to our trade secrets and know-how. Others may initiate litigation to challenge the validity of our patents, or allege that we infringe their patents, or they may use their resources to design comparable products that do not infringe our patents. We may incur substantial costs if our competitors initiate litigation to challenge the validity of our patents, or allege that we infringe their patents, or if we initiate any proceedings to protect our proprietary rights. If the outcome of any such litigation is unfavorable to us, our business, operating results, and financial condition could be adversely affected. We also cannot be certain that our products or technologies have not infringed or will not infringe the proprietary rights of others. Any such infringement could cause third parties, including our competitors, to bring claims against us, resulting in significant costs, possible damages and substantial uncertainty. We could also be forced to develop an alternative that could be costly and time-consuming, or acquire a license, which we might not be able to do on terms favorable to us, or at all. For example, we are currently a defendant in an action in which Textron Innovations, Inc. is alleging that we willfully infringe certain claims of three patents by selling our Groundsmaster® commercial mowers. Textron Innovations, Inc. seeks damages for past sales and an injunction against future infringement. This litigation is currently stayed as our reexamination applications are pending in the USPTO. For additional information regarding this lawsuit, see Part I, Item 3 "Legal Proceedings" of this report. While we do not believe that this litigation will have a material adverse effect on our financial condition, an unfavorable resolution or outcome could be material to our operating results.

In addition, we rely on trade secrets and proprietary know-how that we seek to protect, in part, by confidentiality agreements with our employees and consultants. These agreements may be breached, and we may not have adequate remedies for any such breach. Even if these confidentiality agreements are not breached, our trade secrets may otherwise become known or be independently developed by competitors.

Our business, properties, and products are subject to governmental regulation with which compliance may require us to incur expenses or modify our products or operations and non-compliance may expose us to penalties. Governmental regulation may also adversely affect the demand for some of our products and our operating results.

Our business, properties, and products are subject to numerous international, federal, state, and other governmental laws, rules, and regulations relating to, among other things, climate change; emissions to air and discharges to water; product and associated packaging; import and export compliance, including country of origin certification requirements; worker and product user health and safety; and the generation, use, handling, labeling, collection, management, storage, transportation, treatment, and disposal of hazardous substances, wastes, and other regulated materials. Although we believe that we are in substantial compliance with applicable laws, rules, and regulations, we are unable to predict the ultimate impact of adopted or future laws, rules, and regulations on our business, properties, or products. Any of these laws, rules, or regulations may cause us to incur significant expenses to achieve or maintain compliance, require us to modify our products, adversely affect the demand for some of our products, and ultimately affect the way we conduct our operations. Failure to comply with any of these laws, rules, or regulations could lead to fines and other penalties, including restrictions on the importation of our products into, and the sale of our products in, one or more jurisdictions until compliance is achieved.

Because we own and lease real property, various environmental laws also may impose liability on us for the costs of cleaning up and responding to hazardous substances that may have been released on our property, including releases unknown to us. These environmental laws and regulations also could require us to pay for environmental remediation and response costs at third-party locations where we disposed of or recycled hazardous substances. We are currently involved in the evaluation and clean-up of a limited number of properties we either currently or previously owned. Although we do not expect that these current matters will have a material adverse effect on our financial position or operating results, our future costs of complying with the various environmental requirements, as they now exist or may be altered in the future, could adversely affect our financial condition and operating results.

In addition, governmental restrictions placed on water usage as well as water availability may adversely affect demand for our irrigation products. Changes in laws and regulations, including changes in accounting standards, taxation changes, including tax rate changes, new tax laws, and revised tax law interpretations, also may adversely affect our operating results.

Legislative enactments could impact the competitive landscape within our markets and affect demand for our products.

Various legislative proposals, if enacted, could put us in a competitively advantaged or disadvantaged position and affect customer demand for our products relative to the product offerings of our competitors. For example, any fiscal-stimulus or other legislative enactment that impacts the lawn and garden, outdoor power equipment, or irrigation industries generally by promoting the purchase, such as through customer rebate or other incentive programs, of certain types of mowing or irrigation equipment or other products that we sell, could impact us positively or negatively, depending on whether we manufacture products that meet the specified legislative criteria, including in areas such as fuel efficiency, alternative energy or water usage, or if, as a result of such legislation, customers perceive our product offerings to be relatively more or less attractive than our competitors' product offerings. We cannot currently predict whether any such legislation will be enacted, what any such legislation's specific terms and conditions would encompass, how any such legislation would impact the competitive landscape within our markets, or how, if at all, any such legislation might ultimately affect customer demand for our products or our operating results.

We are subject to product liability claims, product quality issues, and other litigation from time to time that could adversely affect our operating results or financial condition.

The manufacture, sale, and usage of our products expose us to significant risks associated with product liability claims. If a product liability claim or series of claims is brought against us for uninsured liabilities or in excess of our insurance coverage, and it is ultimately determined that we are liable, our business could suffer. While we instruct our customers on the proper usage of our products, we cannot ensure that they will implement our instructions accurately or completely. If our products are defective or used incorrectly by our customers, injury may result and this could give rise to product liability claims against us or adversely affect our brand image or reputation. Any losses that we may suffer from any liability claims, and the effect that any product liability litigation may have upon the reputation and marketability of our products, may have a negative impact on our business and operating results. Some of our products or product improvements were developed relatively recently and defects or risks that we have not yet identified may give rise to product liability claims. Additionally, we could experience a material design or manufacturing failure in our products, a quality system failure, other safety issues, or heightened regulatory scrutiny that could warrant a recall of some of our products. A recall of some of our products could also result in increased product liability claims. Unforeseen product quality problems in the development and production of new and existing products could also result in loss of market share, reduced sales, and higher warranty expense.

We are also subject to other litigation from time to time that could adversely affect our operating results or financial condition. For example, we are currently one of several defendants in lawsuits filed in various federal and state courts in which the plaintiffs are alleging that the horsepower labels on the products the plaintiffs purchased were inaccurate. For additional information regarding this lawsuit, see Part I, Item 3, "Legal Proceedings" of this report. In the event that settlement discussions do not result in an executed or court approved settlement agreement and these lawsuits go to trial, even if the plaintiffs' claims are found to be without merit, we have incurred, and expect to continue to incur, substantial costs in defending the lawsuit. The lawsuit could divert the time and attention of our management and could result in adverse publicity, either of which could significantly harm our operating results and financial condition. In addition, an unfavorable resolution or outcome could have a material adverse effect on our operating results or financial condition.

If we are unable to retain our key employees and attract and retain other qualified personnel, we may not be able to meet strategic objectives and our business could suffer.

Our ability to meet our strategic objectives and otherwise grow our business will depend to a significant extent on the continued contributions of our leadership team. Our future success will also depend in large part on our ability to identify, attract, and retain other highly qualified managerial, technical, sales and marketing, and customer service personnel. Competition for these individuals is intense, and we may not succeed in identifying, attracting, or retaining qualified personnel. The loss or interruption of services of any of our key personnel, the inability to identify, attract, or retain qualified personnel in the future, delays in hiring qualified personnel, or any employee work slowdowns, strikes, or similar actions could make it difficult for us to conduct and manage our business and meet key objectives, which could harm our business, financial condition, and operating results.

The terms of our credit arrangements and the indentures governing our senior notes and debentures could limit our ability to conduct our business, take advantage of business opportunities and respond to changing business, market, and economic conditions. Additionally, we are subject to counterparty risk in our credit arrangements.

Our credit arrangements and the indentures governing our 6.625% senior notes and 7.800% debentures include a number of financial and operating restrictions. For example, our credit arrangements contain financial covenants that, among other things, require us to maintain a minimum interest coverage ratio and a maximum debt to total capitalization ratio. Our credit arrangements and/or indentures also contain provisions that restrict our ability, subject to specified exceptions, to, among other things:

- make loans or investments, including acquisitions;
- create liens or other encumbrances on our assets;
- sell assets;
- engage in mergers or consolidations; and

pay dividends that are significantly higher than those currently being paid, make other distributions to our shareholders or redeem shares of our common stock.

These provisions may limit our ability to conduct our business, take advantage of business opportunities, and respond to changing business, market, and economic conditions. In addition, they may place us at a competitive disadvantage relative to other companies that may be subject to fewer, if any, restrictions or may otherwise adversely affect our business. Transactions that we may view as important opportunities, such as significant acquisitions, may be subject to the consent of the lenders under our credit arrangements, which consent may be withheld or granted subject to conditions specified at the time that may affect the attractiveness or viability of the transaction.

Distress in the worldwide credit markets has had an adverse impact on the availability of credit. Although our $225 million revolving credit facility does not expire until January 2012, market deterioration could jeopardize the counterparty obligations of one or more of the banks participating in our facility, which could have an adverse effect on our business if we are not able to replace such credit facility or find other sources of liquidity on acceptable terms.

If we are unable to comply with the terms of our credit arrangements and indentures, especially the financial covenants, our credit arrangements could be terminated and our senior notes and debentures could become due and payable.

We cannot assure you that we will be able to comply with all of the terms of our credit arrangements and indentures, especially the financial covenants. Our ability to comply with such terms depends on the success of our business and our operating results. Various risks, uncertainties, and events beyond our control could affect our ability to comply with the terms of our credit arrangements and/or indentures. If we were out of compliance with any covenant required by our credit arrangements following any applicable cure periods, the banks could terminate their commitments unless we could negotiate a covenant waiver. The banks could condition such waiver on amendments to the terms of our credit arrangements that may be unfavorable to us. In addition, our 6.625% senior notes and 7.800% debentures could become due and payable if we were unable to obtain a covenant waiver or refinance our medium-term debt under our credit arrangements. If our credit rating falls below investment grade, the interest rate we currently pay on outstanding debt under our credit arrangements could increase, which could adversely affect our operating results.

Our business is subject to a number of other miscellaneous risks that may adversely affect our operating results, financial condition, or business.

Other miscellaneous risks that could affect our business include:

- natural or man-made disasters, which may result in shortages of raw materials and components, higher fuel costs, and increase in insurance premiums;
- financial viability of distributors and dealers, changes in distributor ownership, our success in partnering with new dealers, and our customers' ability to pay amounts owed to us; and
- continued threat of terrorist acts and war, which may result in heightened security and higher costs for import and export shipments of components or finished goods, reduced leisure travel, and contraction of the U.S. and worldwide economies.

ITEM 1B. UNRESOLVED STAFF COMMENTS

None.

ITEM 2. PROPERTIES

As of October 31, 2009, we utilized manufacturing, distribution, warehouse, and office facilities totaling approximately 5.6 million square feet of space. We also had approximately 72 acres of excess land in Wisconsin adjacent to a distribution center, 36 acres of land in Minnesota utilized as a testing and storage facility, 15 acres of land in Minnesota held for future expansion, 21 acres of land in California used as a testing facility, and 2 acres of land in Nebraska used as a parking lot. Plant utilization varies during the year depending on the production cycle. We consider each of our current facilities in use to be in good operating condition and adequate for its present use. Management believes we have sufficient manufacturing capacity for fiscal 2010. The below schedule outlines our significant facilities by location, ownership, and function as of October 31, 2009:

Location	Ownership	Products Manufactured / Use
Bloomington, MN	Owned/Leased	Corporate headquarters, warehouse, and test facility
El Paso, TX	Owned/Leased	Components for professional and residential products, and distribution center
Plymouth, WI	Owned	Professional and residential parts distribution center
Juarez, Mexico	Leased	Professional and residential products
Tomah, WI	Owned/Leased	Professional products and warehouse
Windom, MN	Owned/Leased	Residential and professional products and warehouse
Baraboo, WI	Leased	Professional and residential distribution center
Beatrice, NE	Owned/Leased	Professional products, office and test facility
Riverside, CA	Owned/Leased	Office and test facility
Lakeville, MN	Leased	Residential and professional distribution center
Hertfordshire, United Kingdom	Owned	Professional and residential products, distribution center and office
Shakopee, MN	Owned	Components for professional and residential products
Braeside, Australia	Leased	Distribution center
El Cajon, CA	Owned/Leased	Professional and residential products, distribution center and office
Brooklyn Center, MN	Leased	Distribution facility and office
Hazelwood, MO	Leased	Distribution facility and office
Sanford, FL	Leased	Professional products and distribution center
Fiano Romano, Italy	Owned	Professional products, warehouse, and office
Beverley, Australia	Owned	Professional products, office and distribution center
Capena, Italy	Leased	Distribution center
Oevel, Belgium	Owned	Distribution center and office
Abilene, TX	Leased	Office, professional products, and service center

ITEM 3. LEGAL PROCEEDINGS

General

We are a party to litigation in the ordinary course of business. Litigation occasionally involves claims for punitive as well as compensatory damages arising out of use of our products. Although we are self-insured to some extent, we maintain insurance against certain product liability losses. We are also subject to administrative proceedings with respect to claims involving the discharge of hazardous substances into the environment. Some of these claims assert damages and liability for remedial investigations and clean up costs. We are also typically involved in commercial disputes, employment disputes, and patent litigation cases in the ordinary course of business. To prevent possible infringement of our patents by others, we periodically review competitors' products. To avoid potential liability with respect to others' patents, we regularly review certain patents issued by the USPTO and foreign patent offices. We believe these activities help us minimize our risk of being a defendant in patent infringement litigation. We are currently involved in patent litigation cases, both where we are asserting patents and where we are defending against charges of infringement.

Lawnmower Engine Horsepower Marketing and Sales Practices Litigation

In June 2004, individuals who claim to have purchased lawnmowers in Illinois and Minnesota filed a class action lawsuit in Illinois state court against us and other defendants alleging that the horsepower labels on the products the plaintiffs purchased were inaccurate. Those individuals later amended their complaint to add additional plaintiffs and an additional defendant. The plaintiffs asserted violations of the federal Racketeer

Influenced and Corrupt Organizations Act (RICO) and state statutory and common law claims. The plaintiffs sought certification of a class of all persons in the United States who, beginning January 1, 1994 through the present, purchased a lawnmower containing a two-stroke or four-stroke gas combustible engine up to 30 horsepower that was manufactured or sold by the defendants. The amended complaint also sought an injunction, unspecified compensatory and punitive damages, treble damages under RICO, and attorneys' fees.

In May 2006, the case was removed to federal court in the Southern District of Illinois. In August 2006, we, together with the other defendants other than MTD Products Inc. (MTD), filed a motion to dismiss the amended complaint. Also in August 2006, the plaintiffs filed a motion for preliminary approval of a settlement agreement with MTD and certification of a settlement class. In December 2006, another defendant, American Honda Motor Company (Honda), notified us and the other defendants that it had reached a settlement agreement with the plaintiffs.

In May 2008, the court issued a memorandum and order that (i) dismissed the RICO claim in its entirety; (ii) dismissed all non-Illinois state-law claims but with instructions that such claims could be re-filed in local courts; and (iii) rejected the proposed settlement with MTD. The proposed Honda settlement was not under consideration by the court and was not addressed in the memorandum and order. Also in May 2008, the plaintiffs (i) re-filed the Illinois claims with the court; and (ii) filed non-Illinois claims in federal courts in the District of New Jersey and the Northern District of California with essentially the same state law claims.

In June 2008, the plaintiffs filed a motion with the United States Judicial Panel on Multidistrict Litigation (the MDL Panel) that (i) stated their intent to file lawsuits in all 50 states and the District of Columbia; and (ii) sought to have all of the cases transferred for coordinated pretrial proceedings. In August 2008, the MDL Panel issued an order denying the transfer request. Additional lawsuits, some of which included additional plaintiffs, were filed in various federal and state courts asserting essentially the same state law claims. To date, lawsuits have been filed in federal and state courts throughout the United States, which collectively assert claims under the laws of each state.

In September 2008, we and other defendants filed a motion with the MDL Panel that sought to transfer the multiple actions for coordinated pretrial proceedings. In early December 2008, the MDL Panel issued an order that (i) transferred 23 lawsuits, which collectively asserted claims under the laws of 16 states, for coordinated or consolidated pretrial proceedings; (ii) selected the United States District Court for the Eastern District of Wisconsin as the transferee district; and (iii) provided that additional lawsuits will be treated as "tag-along" actions in accordance with its rules.

An initial hearing was held in the United States District Court for the Eastern District of Wisconsin in January 2009. At that hearing, the Court (i) appointed lead plaintiffs' counsel; and (ii) entered a stay of all litigation so that the parties could explore mediation. Formal mediation proceedings were commenced and settlement discussions are continuing. At this time, we are unable to provide any assurance that such discussions will ultimately result in an executed or court-approved settlement agreement.

We continue to evaluate these lawsuits and, in the absence of such a settlement, are unable to assess at this time whether these lawsuits will have a material adverse effect on our annual consolidated operating results or financial condition, although an unfavorable resolution or outcome could be material to our consolidated operating results for a particular period.

Textron Innovations Inc. v. The Toro Company

In July 2005, Textron Innovations Inc., the patent holding company of Textron, Inc., filed a lawsuit in Delaware Federal District Court against us for patent infringement. Textron alleges that we willfully infringed certain claims of three Textron patents by selling its Groundsmaster® commercial mowers. Textron seeks damages for our past sales and an injunction against future infringement. In August and November 2005, we answered the complaint, asserting defenses and counterclaims of non-infringement, invalidity, and equitable estoppel. Following the Court's order in October 2006 construing the claims of Textron's patents, discovery in the case was closed in February 2007. In March 2007, following unsuccessful attempts to mediate the case, we filed with the USPTO to have Textron's patents reexamined. The reexamination proceedings are pending in the USPTO, and all of the claims asserted against us in all three patents stand rejected. In April 2007, the Court granted our motion to stay the litigation and, in June 2007, denied Textron's motion for reconsideration of the Court's order staying the proceedings.

We continue to evaluate this lawsuit and are unable to reasonably estimate the likelihood of loss or the amount or range of potential loss that could result from the litigation. Therefore, no accrual has been established for potential loss in connection with this lawsuit. We are also unable to assess at this time whether this lawsuit will have a material adverse effect on our annual consolidated operating results or financial condition, although an unfavorable resolution or outcome could be material to our consolidated operating results for a particular period.

ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

No matters were submitted to a vote of our shareholders during the fourth quarter of fiscal 2009.

EXECUTIVE OFFICERS OF THE REGISTRANT

The list below identifies those persons designated by our Board of Directors as "executive officers" of the company subject to Section 16 under the Securities Exchange Act of 1934, as amended. The list sets forth each such person's age and position with the company as of December 16, 2009, as well as positions held by them for at least the last five years. There are no family relationships between any director, executive officer, or person nominated to become a director or executive officer of the company. There are no arrangements or understandings between any executive officer and any other person pursuant to which he or she was selected as an officer of the company.

Name, Age, and Position with the Company	Business Experience During the Last Five or More Years
Michael J. Hoffman 54, Chairman of the Board, President and Chief Executive Officer	Chairman of the Board since March 2006, Chief Executive Officer since March 2005 and President since October 2004. He also served as Chief Operating Officer from October 2004 to March 2005.
Judy L. Altmaier 48, Vice President, Operations	Vice President, Operations since October 2009. From January 2009 to October 2009, she served as Vice President/General Manager of Operations, Auto Group Americas for Eaton Corporation, a diversified industrial manufacturer. From July 2007 to January 2009, she served as Vice President/General Manager of Global Engine Valve Division in Turin, Italy for Eaton Corporation. From October 2003 to July 2007, she served as Manufacturing Operations Manager for Eaton Corporation's Engine Air Management Operations.
William E. Brown, Jr. 48, Vice President, Residential and Landscape Contractor Businesses	Vice President, Residential and Landscape Contractor Businesses since February 2009. From November 2006 to February 2009, he served as Vice President, Consumer and Landscape Contractor Business Toro. From February 2003 to October 2006, he served as Vice President and General Manager, Commercial Business.
Philip A. Burkart 47, Vice President, Irrigation Businesses	Vice President, Irrigation Businesses since November 2006. From February 2003 to October 2006, he served as Vice President and General Manager, Irrigation Business.
Timothy P. Dordell 47, Vice President, Secretary and General Counsel	Vice President, Secretary and General Counsel since May 2007. From November 2006 to May 2007, he served as Vice President, Deputy General Counsel. From May 2002 to November 2006, he served as Associate General Counsel-Corporate and Assistant Secretary at Ecolab Inc., a developer and marketer of products and services for the hospitality, foodservice, healthcare, and industrial markets.
Michael D. Drazan 52, Vice President, Contractor Business and Chief Information Officer	Vice President, Contractor Business and Chief Information Officer since February 2009. From November 2007 to February 2009, he served as Chief Information Officer and Vice President, Corporate Services. From November 2006 to October 2007, he served as Vice President, Chief Information Officer. From March 2000 to November 2006, he served as Vice President, Corporate Information Services.

Blake M. Grams 42, Vice President, Corporate Controller	Vice President, Corporate Controller since December 2008. From February 2006 to December 2008, he served as Managing Director, Corporate Controller. From November 2003 to January 2006, he served as Director, Corporate Finance.
Michael J. Happe 38, Vice President, Commercial Business	Vice President, Commercial Business since December 2008. From November 2007 to December 2008, he served as General Manager, Commercial Business. From November 2006 to October 2007, he served as Managing Director, Commercial Business. From November 2004 to October 2006, he served as Director of Marketing, International Business.
Thomas J. Larson 52, Vice President, Treasurer	Vice President, Treasurer since December 2008. From February 2006 to December 2008, he served as Treasurer. From November 2003 to January 2006, he served as Assistant Treasurer.
Peter M. Ramstad 52, Vice President, Human Resources and Business Development	Vice President, Human Resources and Business Development since November 2007. From November 2006 to November 2007, he served as Vice President, Business and Strategic Development. From December 2003 to November 2006, he served as Executive Vice President, Strategy and Finance at Personnel Decisions International, a consulting company that helps clients build organizational and talent strategies and assess and develop leaders.
Darren L. Redetzke 45, Vice President, International Business	Vice President, International Business since December 2008. From November 2007 to December 2008, he served as General Manager, International Business. From October 2006 to November 2007, he served as Managing Director, International Business. From November 2004 to October 2006, he served as Director of Marketing Golf for the Commercial Business.
Richard W. Rodier 49, General Manager, Sitework Systems	General Manager, Sitework Systems since February 2009. From November 2004 to February 2009, he served as General Manager, Landscape Contractor Business Toro.
Mark B. Stinson 44, General Manager, Exmark	General Manager, Exmark since November 2004.
Stephen P. Wolfe 61, Vice President, Finance and Chief Financial Officer	Vice President, Finance and Chief Financial Officer since February 2006. From June 1997 to February 2006, he served as Vice President Finance, Treasurer and Chief Financial Officer.

PART II

ITEM 5. MARKET FOR REGISTRANT'S COMMON EQUITY, RELATED STOCKHOLDER MATTERS, AND ISSUER PURCHASES OF EQUITY SECURITIES

Toro common stock is listed for trading on the New York Stock Exchange and trades under the symbol "TTC." The high, low, and last sales prices for Toro common stock and cash dividends paid for each of the quarterly periods for fiscal 2009 and 2008 were as follows:

Fiscal year ended October 31, 2009	**First**	**Second**	**Third**	**Fourth**
Market price per share of common stock				
High sales price	**$ 36.55**	**$ 31.66**	**$ 36.18**	**$ 42.03**
Low sales price	**24.80**	**20.26**	**26.57**	**34.06**
Last sales price	**29.61**	**29.75**	**34.66**	**37.02**
Cash dividends per share of common stock1	**0.15**	**0.15**	**0.15**	**0.15**

Fiscal year ended October 31, 2008	First	Second	Third	Fourth
Market price per share of common stock				
High sales price	$59.16	$ 51.99	$42.20	$ 46.67
Low sales price	40.74	37.92	30.05	27.16
Last sales price	50.93	40.81	33.13	33.64
Cash dividends per share of common stock1	0.15	0.15	0.15	0.15

[1] Future cash dividends will depend upon the company's financial condition, capital requirements, results of operations, and other factors deemed relevant by the Board of Directors.

Common Stock 100,000,000 shares authorized, $1.00 par value, 33,369,486 and 35,484,766 shares outstanding as of October 31, 2009 and 2008, respectively.

Preferred Stock 1,000,000 voting shares authorized and 850,000 non-voting shares authorized, $1.00 par value, no shares outstanding.

Shareholders As of December 16, 2009, Toro had approximately 4,255 shareholders of record.

Issuance of Unregistered Securities On October 19, 2009, Toro awarded 4,752 restricted shares of Toro common stock to an executive officer as an employment inducement award. The restricted stock will vest in full on October 19, 2012 and may vest earlier upon the occurrence of certain events, including death or disability or a change of control of Toro. In the event the executive voluntarily terminates the executive's employment prior to October 19, 2012, the entire restricted stock grant will be forfeited and the shares will be returned to Toro's treasury account. The restricted shares were issued in reliance upon the exemption from registration provided under Section 4(2) of the Securities Act of 1933, as amended.

The following table sets forth information with respect to shares of Toro common stock purchased by the company during each of the three fiscal months in the period ended October 31, 2009.

Period	Total Number of Shares Purchased1,2	Average Price Paid Per Share	Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs	Maximum Number of Shares that May Yet be Purchased Under the Plans or Programs1,2
August 1, 2009 through August 28, 2009	512,177	$ 36.22	512,177	5,068,918
August 29, 2009 through September 25, 2009	772,206	38.89	772,206	4,296,712
September 26, 2009 through October 31, 2009	291,2263	40.34	289,000	4,007,712
Total	1,575,609	$ 38.29	1,573,383	

[1] On May 21, 2008, the company's Board of Directors authorized the repurchase of an additional 4,000,000 shares of the company's common stock in open-market or in privately negotiated transactions. This program has no expiration date but may be terminated by the company's Board of Directors at any time. The company purchased an aggregate of 581,095 shares during the periods indicated above under this program. There are no shares remaining for repurchase under this program.

[2] On July 21, 2009, the company's Board of Directors authorized the repurchase of an additional 5,000,000 shares of the company's common stock in open-market or in privately negotiated transactions. This program has no expiration date but may be terminated by the company's Board of Directors at any time. The company purchased an aggregate of 992,288 shares during the periods indicated under this program.

[3] Includes 2,226 units (shares) of Toro common stock purchased in open-market transactions at an average price of $38.92 per share on behalf of a rabbi trust formed to pay benefit obligations of the company to participants in deferred compensation plans. These 2,226 shares were not repurchased under the company's repurchase programs, as described in footnotes 1 and 2 above.

The Toro Company Common Stock Comparative Performance Graph

The information contained in The Toro Company Common Stock Comparative Performance Graph section shall not be deemed to be "soliciting material" or "filed" or incorporated by reference in future filings with the SEC, or subject to the liabilities of Section 18 of the Securities Exchange Act of 1934, as amended, except to the extent that we specifically request that it be treated as soliciting material or incorporate it by reference into a document filed under the Securities Act of 1933, as amended, or the Securities Exchange Act of 1934, as amended.

The following graph and table depict the cumulative total shareholder return (assuming reinvestment of dividends) on $100 invested in each of Toro common stock, the S&P 500 Index, and an industry peer group for the five year period from October 31, 2004 through October 31, 2009.

Fiscal year ending October 31,	**2004**	**2005**	**2006**	**2007**	**2008**	**2009**
The Toro Company	**$100.00**	**$107.63**	**$128.25**	**$166.88**	**$102.27**	**$114.72**
S&P 500	**100.00**	**108.72**	**126.49**	**144.90**	**92.60**	**101.68**
Peer Group	**100.00**	**110.06**	**136.97**	**184.90**	**97.61**	**130.67**

The industry group index is based on the companies previously included in the Fortune 500 Industrial and Farm Equipment Index, which was discontinued after 2002 and includes: AGCO Corporation, The Alpine Group, The Black & Decker Corporation, Briggs & Stratton Corporation, Caterpillar Inc., Crane Co., Cummins Engine Company, Inc., Deere & Company, Dover Corporation, Flowserve Corporation, General Cable Corporation, Harsco Corporation, Illinois Tool Works Inc., International Game Technology, ITT Industries, Inc., Kennametal Inc., Lennox International Inc., Milacron Inc., NACCO Industries, Inc., Pall Corporation, Parker-Hannifin Corporation, Pentair, Inc., Snap-On Incorporated, The Shaw Group Inc., Tecumseh Products Company, Teleflex, Terex Corporation, Timken Company, and Walter Industries Inc.

ITEM 6. SELECTED FINANCIAL DATA

(Dollars in thousands, except per share data)	om >	
Fiscal years ended October 31		
	12,782	$10,734

Environmental Tectonics Corporation

Notes to Consolidated Financial Statements, continued

(amounts in dollars, except where noted and share and per share information)

(unaudited)

Revenue Recognition

The Company recognizes revenue using three methods:

On long-term contracts over $250,000 in value and six months in length, the percentage-of-completion (POC) method is applied based on costs incurred as a percentage of estimated total costs. This percentage is multiplied by the total estimated revenue under a contract to calculate the amount of revenue recognized in an accounting period. Revenue recognized on uncompleted long-term contracts in excess of amounts billed to customers is reflected as an asset. Amounts billed to customers in excess of revenue recognized on uncompleted long-term contracts are reflected as a liability. When it is estimated that a contract will result in a loss, the entire amount of the loss is accrued. The effect of revisions in cost and profit estimates for long-term contracts is reflected in the accounting period in which the Company learns the facts which require it to revise the cost and profit estimates. Contract progress billings are based upon contract provisions for customer advance payments, contract costs incurred, and completion of specified contract milestones. Contracts may provide for customer retainage of a portion of amounts billed until contract completion. Retainage is generally due within one year of completion of the contract. Revenue recognition under the POC method involves significant estimates.

Revenue for contracts under $250,000, or to be completed in less than six months, and where there are no post-shipment services included in the contract, is recognized on the date that the finished product is shipped to the customer. Revenue on contracts under $250,000, or to be completed in less than six months, and where post-shipment services (such as installation and customer acceptance) are required, is recognized following customer acceptance.

Revenue derived from the sale of parts and services is recognized on the date that either the part is shipped to the customer or the service is completed. Revenue for service contracts is recognized ratably over the life of the contract with related material costs expensed as incurred.

In accordance with accounting principles generally accepted in the United States of America, recognizing revenue on contract claims and disputes related to customer caused delays, errors in specifications and designs, and other unanticipated causes, and for amounts in excess of contract value, is generally appropriate if it is probable that the claim will result in additional contract revenue and if the Company can reliably estimate the amount of additional contract revenue it may receive. However, revenue recorded on a contract claim cannot exceed the incurred contract costs related to that claim. Claims are subject to negotiation, arbitration and audit by the customer or governmental agency.

Environmental Tectonics Corporation

Notes to Consolidated Financial Statements, continued

(amounts in dollars, except where noted and share and per share information)

(unaudited)

Net loss per share

Basic loss per share is computed by dividing the net loss (the numerator) by the weighted average number of common shares outstanding (the denominator) during the period. Shares outstanding during the period and shares reacquired during the period are weighted for the portion of the period that they were outstanding. The computation of diluted loss per share is similar to the computation of basic loss per share except that the denominator is increased to include the number of additional common shares that would have been outstanding if the dilutive potential common shares had been issued (e.g., upon exercise of common stock options or warrants). Potentially dilutive common shares are not included in the computation of diluted loss per share if they are anti-dilutive. Net loss per share as reported for each period was not adjusted for potential common shares, as they are anti-dilutive. The following table illustrates the reconciliation of net loss from operations for fiscal 2007 to net loss applicable to common shareholders:

	Thirteen weeks ended November 24, 2006	**Thirty-nine weeks ended November 24, 2006**
	(amounts in thousands)	
Net loss, as reported	$1,866	$5,786
Plus: preferred stock dividends	90	169
Net loss applicable to common shareholders	$1,956	$5,955
Loss per share of common stock-basic and diluted:	$0.22	$0.66

At November 24, 2006, potentially dilutive common shares which were not included in the computation of diluted loss per share included the following:

A. Outstanding options to purchase the Company s common stock totaling 371,928 shares.

B. Convertible subordinated debt, with a face value of $10,000,000, which is convertible into shares of common stock at an exercise price of $6.05 per share, equating to 1,652,893 shares of common stock if fully converted. Upon each conversion of the subordinated note, the holder will be entitled to receive a warrant to purchase additional shares of common stock equal to ten percent of the shares issued pursuant to such conversion. If the entire face value of the subordinated note were to be converted into shares of common stock, then warrants to purchase an additional 165,289 shares of common stock would be issued, bringing the total number of shares of common stock to be issued to 1,818,182.

C. Convertible preferred stock issued in fiscal 2007 totaling $6,000,000 which is convertible into 1,055,161 shares of common stock. The conversion price for $3,000,000 of the preferred stock is $4.95 per common share and the remaining $3,000,000 is convertible at $6.68 per common share.

None of these shares were included in the computation of diluted loss per share as the effect would be anti-dilutive.

Environmental Tectonics Corporation

Notes to Consolidated Financial Statements, continued

(amounts in dollars, except where noted and share and per share information)

(unaudited)

At November 25, 2005, potentially dilutive common shares which were not included in the computation of diluted loss per share included the following:

A. Outstanding options to purchase the Company s common stock totaling 247,939 shares.

B. Convertible subordinated debt with a face value of $10,000,000, which is convertible into shares of common stock at an exercise price of $6.05 per share, equating to 1,652,893 shares of common stock if fully converted. Upon each conversion of the subordinated note, the holder will be entitled to receive a warrant to purchase additional shares of common stock equal to ten percent of the shares issued pursuant to such conversion. If the entire face value of the subordinated note were to be converted into shares of common stock, then warrants to purchase an additional 165,289 shares of common stock would be issued, bringing the total number of shares of common stock to be issued to 1,818,182.

None of these shares were included in the computation of diluted loss per share as the effect would be anti-dilutive.

Share-Based Compensation

The Company adopted Statement of Financial Accounting Standard (SFAS) No. 123(R) effective February 25, 2006. SFAS No. 123(R) requires the Company to recognize expense related to the fair value of stock-based compensation awards, including employee stock options. Prior to the adoption of SFAS No. 123(R), the Company accounted for stock options using the intrinsic value method of APB Opinion No. 25, and it did not recognize compensation expense in its income statement for options granted that had an exercise price equal to the market value of the underlying common stock on the date of grant. The Company also provided certain pro forma disclosures for stock option awards as if the fair value-based approach of SFAS No. 123(R) had been applied.

The Company has elected to use the modified prospective transition method as permitted by SFAS No. 123(R) and therefore has not restated its financial results for prior periods. Under this transition method, the Company will apply the provisions of SFAS No. 123(R) to new awards and to awards modified, repurchased or cancelled after February 24, 2006. Additionally, for unvested awards granted prior to the effective date of the Company s adoption of SFAS No. 123(R), the Company recognizes compensation expense in the same manner as was used in its income statement or for pro-forma disclosures prior to the effective date of its adoption of SFAS No. 123(R).

The cost for stock option employee compensation was $22,000 and $37,000, respectively, for the thirteen and thirty-nine week periods ending November 24, 2006.

As of November 24, 2006, the remaining prospective pre-tax cost of unvested stock option employee compensation was $186,000, which will be expensed on a pro-rata basis going forward.

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Notes to Consolidated Financial Statements, continued

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The following table illustrates the effect on net loss and net loss per common share as if the Company had applied the fair value recognition provisions of SFAS No. 123(R) to stock option employee compensation for the thirteen and thirty-nine week periods ended November 25, 2005:

	Thirteen weeks ended November 25, 2005	**Thirty-nine weeks ended November 25, 2005**
	(amounts in thousands)	
Net loss, as reported	$1,327	$4,670
Plus: stock-based compensation costs determined under fair market value based methods for all awards	7	22
Net loss, pro forma	$1,334	$4,692
Loss per share of common stock-basic and diluted:		
As reported	$0.15	$0.52
Pro forma	$0.15	$0.52

During the thirteen and thirty-nine weeks ended November 24, 2006, options to purchase a total of 44,639 shares of the Company s common stock were granted. There were no grants of stock options during the thirty-nine weeks ended November 25, 2005.

2. Accounts Receivable:

The components of accounts receivable at November 24, 2006 and February 24, 2006 are as follows:

	November 24, 2006	**Feb. 24, 2006**
	(amounts in thousands)	
U.S. Government receivables billed and unbilled contract costs subject to negotiation	$3,142	$3,346
U.S. commercial receivables billed	1,173	2,297
International receivables billed	4,442	1,343
	8,757	6,986

Less allowance for doubtful accounts	(376)	(965)
	$8,381	$6,021

U.S. government receivables billed and unbilled contract costs subject to negotiation:

Unbilled contract costs subject to negotiation as of November 24, 2006 and February 24, 2006, respectively, represent claims made against the U.S. Government under a contract for a submarine rescue decompression chamber project. These costs, totaling $3,004,000, were recorded beginning in fiscal year 2002. In November 2003, the U.S. Government completed an audit of the claim, rejecting most of the items due to audit or engineering reasons. The Company submitted a written rebuttal to the draft report. On July 22, 2004, the U.S. Government s contracting officer issued a final decision on the claim, denying the claim in full. The Company updated the claim for additional costs expended on claimable items since the original submission and converted the claim to a complaint, which was filed in the Court of Federal Claims in July 2005. This claim is currently in the discovery phase, including the mutual exchange of documents. Depositions are expected to last through the end of January 2007. Assuming no further delays, the case is scheduled to go to trial in July 2007.

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Notes to Consolidated Financial Statements, continued

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This U. S. Government claim has followed the typical process of claim notification, preparation, submittal, government audit and review by the contracting officer. Historically, the Company s experience has been that most claims are initially denied in part or in full by the contracting officer (or no decision is forthcoming, which is then taken to be a deemed denial) which then forces the Company to seek relief in a court of law.

The Company considers the recorded costs to be realizable due to the fact that the costs relate to customer caused delays, errors and changes in specifications and designs, disputed liquidated damages and other out of scope items. The U.S. Government, citing failure to deliver the product within contract terms, has assessed liquidated damages but has not offset or withheld any progress payments due to the Company under the contract. The Company disputes the basis for these liquidated damages, noting that applicable U.S. Government purchasing regulations allow for a waiver of these charges if the delay is beyond the control and not due to the fault or negligence of the Company. However, following accounting principles generally accepted in the United States of America, the Company has reduced contract values and corresponding revenue recognition for an estimated amount of $330,000 to cover the delay through the extended delivery period.

International receivables billed:

International receivables billed include $315,000 and $700,000, respectively, at November 24, 2006 and February 24, 2006, related to a contract with the Royal Thai Air Force (RTAF).

In October 1993, the Company was notified by the RTAF that the RTAF was terminating a $4,600,000 simulator contract with the Company. Although the Company had performed in excess of 90% of the contract, the RTAF alleged a failure to completely perform. In connection with this termination, the RTAF made a call on a $230,000 performance bond, as well as a draw on an approximately $1,100,000 advance payment letter of credit. Work under this contract had stopped while under arbitration, but on October 1, 1996, the Thai Trade Arbitration Counsel rendered a decision under which the contract was reinstated in full and the Company was given a period of nine months to complete the remainder of the work. Except as noted in the award, the rights and obligations of the parties remained as stated in the original contract including the potential invoking of penalties or termination of the contract for delay. On December 22, 1997, the Company successfully performed acceptance testing and the unit passed with no discrepancy reports. Although the contract was not completed in the time allotted, the Company had requested an extension on the completion time due to various extenuating circumstances, including allowable force majeure events, one of which was a delay in obtaining an export license to ship parts required to complete the trainers. On August 30, 2001, the Company received a payment of $230,000 representing the amount due on the performance bond.

On June 16, 2003, the Company filed for arbitration in Thailand seeking recovery of the $700,000 open balance on this contract. On March 23, 2006, the arbitration panel awarded the Company $314,813 plus interest from March 1, 2006 as full settlement of this dispute. Although this award is final with the arbitration panel, the RTAF has filed a motion in the Thai court to void the award, citing that the award was illegal and thus against the public order and unfair to the RTAF. On August 9, 2006, the Company filed its defense to this motion with the court. In September 2006, at a pre-trial session the court ordered the parties to produce witnesses to testify. This testimony has been scheduled for August and September 2007.

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Notes to Consolidated Financial Statements, continued

(amounts in dollars, except where noted and share and per share information)

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If the RTAF loses on its motion but does not honor the decision, the award will have to be enforced through the court system in Thailand, a process which may be time consuming and costly. The assets of the RTAF are not subject to attachment. At this point, the Company is not able to determine the ultimate outcome of this dispute. However, the Company has established sufficient receivable reserves so that any resolution will not have a material impact on the Company s financial position or its results of operations.

Historically, the Company has had positive experience with regard to its contract claims in that recoveries have exceeded the carrying value of claims. Although the claim with the U.S. Government was filed in the Court of Federal Appeals whereas prior claims have been filed with the Armed Services Board of Contract Appeals (ASBCA), the litigation has followed a consistent process and time frame as prior claims. The dispute with the RTAF has been outstanding for over 10 years, although the arbitration award occurred on March 23, 2006.

There is no assurance that the Company will always have positive experience with regard to recoveries for its contract claims.

3. Stockholders Equity

The components of stockholders equity at November 24, 2006 and February 24, 2006 were as follows (amounts in thousands, except share information):

		Common Stock					
	Preferred Stock	Shares	Amount	Additional Paid in Capital	Accumulated Other Comp. Loss	Retained Earnings (Deficit)	Total
Balance at February 24, 2006		9,024,804	$ 451	$16,584	$ (249)	$ 767	$17,553
Net loss for the thirty-nine weeks ended November 24, 2006						(5,786)	(5,786)
Foreign currency translation adjustment					70		70
Total comprehensive loss							(5,716)
Preferred stock	6,000						6,000
Dividends on preferred stock						(169)	(169)
Compensation cost				37			37

Other shares issued		2,154		3			3
Balance at November 24, 2006	$ 6,000	9,026,958	$ 451	$16,624	$ (179)	$ (5,188)	$17,708

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Notes to Consolidated Financial Statements, continued

(amounts in dollars, except where noted and share and per share information)

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4. Long-Term Obligations and Credit Arrangements:

The following table lists the long-term debt and other long-term obligations of the Company as of November 24, 2006:

	Payments Due by Period				
	Total	**Less Than 1 Year**	**1-3 Years**	**4-5 Years**	**After 5 Years**
	(in thousands)				
Long-term debt, including current maturities	$8,709	$	$8,709	$	$
Operating leases	567	32	338	197	
Total	$9,276	$32	$9,047	$197	$

Long-term debt is reported net of unamortized discount of $1,291,000 on the Company s subordinated debt.

As part of the Company s credit agreement (the PNC Agreement) with PNC Bank, National Association (PNC Bank), at February 24, 2006 the Company was required to maintain a minimum tangible net worth (defined as total assets minus intangible assets minus all liabilities) (Tangible Net Worth) at the end of each fiscal quarter and fiscal year of $12,000,000. This was reduced to $9,000,000 under the November 16, 2006 Letter Agreement (see a full description below.)

As part of the Company s subordinated debt agreement, at the end of each fiscal quarter and fiscal year, the Company must meet three financial covenants: (a) a maximum Leverage Ratio (defined as the ratio of total debt to annualized earnings before interest, taxes, depreciation and amortization (EBITDA) of 4.03 times; (b) a minimum Fixed Charge Ratio (defined as the ratio of the annualized sum of EBITDA minus expenditures for capital equipment and capitalized software to annualized fixed charges (interest payments, income taxes paid, and any cash dividends) of 1.06 times, and (c) a minimum Tangible Net Worth Ratio, which adjusts quarterly, based on net income and common stock proceeds.

At November 24, 2006, the Company failed to meet the covenants contained in the subordinated debt agreement but has obtained a waiver of such violations from the subordinated lender. This waiver applies to all periods through November 25, 2007. Except as specified, the waiver does not constitute a modification or alteration of any other terms or conditions in the respective agreements, or a release of any of the lender s rights or remedies, all of which are reserved, nor does it release the Company or any guarantor from any of its duties, obligations, covenants or agreements including the consequences of any event of default, except as specified.

Refinancing

The Company has historically financed operations through a combination of cash generated from operations, equity offerings, subordinated borrowings and bank debt. On February 19, 2003, the Company refinanced its outstanding indebtedness (the Refinancing). The Refinancing was effected through the issuance of subordinated, convertible notes to H.F. Gerry Lenfest (referred to as Mr. Lenfest throughout the remainder of this Quarterly Report on Form 10-Q), an individual, and entering into the PNC Agreement. The total proceeds from the Refinancing were $29,800,000.

Bank Credit and Facility

Since its inception, the PNC Agreement has undergone numerous amendments. As of November 24, 2006, the facility total was $5,000,000 and use of this amount was restricted to the issuance of international letters of credit. This line was secured by all assets of the Company as well as a $5,000,000 personal guarantee by Mr. Lenfest.

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Notes to Consolidated Financial Statements, continued

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On June 28, 2006, the Company signed an amendment to the PNC Agreement which (i) extended the agreement s termination date to the earlier of June 30, 2007 or such date to which the Company and PNC Bank have agreed in writing, (ii) terminated the Security Agreement and Mortgage, thereby releasing the Company s assets as collateral for the facility, (iii) adjusted the Tangible Net Worth covenant to a minimum of $9,000,000, and (iv) made other changes to the PNC Agreement.

On November 16, 2006, the Company entered into a Letter Agreement with PNC Bank. This Letter Agreement amended, restated and replaced the existing PNC Credit Agreement. Pursuant to such agreement, PNC Bank (i) terminated ETC s Credit Agreement dated as of February 18, 2003 (ii) re-approved the Company s $5 million Line of Credit for Letters of Credit, and (iii) re-affirmed the Tangible Net Worth covenant (as defined in the Agreement) to a be a minimum of $9,000,000. The $5 million Line of Credit for Letters of Credit will continue to be guaranteed by Mr. Lenfest, the holder of the Company s subordinated debt and a party to the Company s Preferred Stock Purchase Agreement, which is described below.

As of November 24, 2006, the Company had used approximately $3,208,000 of the availability under the PNC Agreement for international letters of credit.

Equity Line

On April 7, 2006, the Company entered into a Preferred Stock Purchase Agreement (the Equity Agreement) with Mr. Lenfest, a Director, significant shareholder and holder of the Company s subordinated debt. The Equity Agreement permits ETC to unilaterally draw down up to $15 million prior to October 2007 in exchange for shares of the Company s newly-created Series B Cumulative Convertible Preferred Stock (Preferred Stock). The Preferred Stock provides for a dividend equal to six percent per annum. After three years, the Preferred Stock will be convertible, at Mr. Lenfest s request, into ETC common shares at a conversion price (the Conversion Price) which will be set on the day of each draw down. The Conversion Price will be equal to the closing price of the Company s common stock on the trading day immediately preceding the day in which the draw down occurs, subject to a floor price of $4.95 per common share. Drawdowns are not permitted on any day when the Conversion Price would be less than this floor price. On the sixth anniversary of the Equity Agreement, any issued and outstanding Preferred Stock will be mandatorily converted into ETC common stock at each set Conversion Price. The Equity Agreement also allows for the Company to redeem any outstanding Preferred Stock any time within the six-year term of the Equity Agreement. The Preferred Stock is entitled to vote with the ETC common stock on an as converted basis.

In connection with the execution of the Equity Agreement, in April 2006 the Company drew down $3 million by issuing 3,000 shares of Preferred Stock with a Conversion Price equal to $4.95 per share. Additionally, on July 31, 2006, the Company drew down an additional $3 million by issuing 3,000 shares of Preferred Stock at a Conversion Price equal to $6.68 per common share.

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Unsecured Promissory Note

On November 16, 2006, the Company executed an Unsecured Promissory Note (the Lenfest Note) in favor of H.F. Lenfest in the aggregate principal amount of $3,000,000. Pursuant to the terms of the Lenfest Note, ETC can borrow up to $3,000,000, in increments of $1,000,000, prior to the maturity date of October 6, 2007. On November 17, 2006, ETC borrowed $3,000,000. The Lenfest Note plus all accrued interest was repaid in full on December 13, 2006.

All outstanding and unpaid interest on the Lenfest Note is due and payable on the earlier of (i) October 6, 2007 or (ii) such date as ETC draws down funds sufficient to repay the amount due under the Lenfest Note pursuant to the Preferred Stock Purchase Agreement, dated as of April 6, 2006, between ETC and Mr. Lenfest.

Borrowings made pursuant to the Lenfest Note will bear interest at an annual rate of six (6%) percent with such interest beginning to accrue on the date of the funding of each loan and, to the extent not paid, compounding on the first day of each month.

The Lenfest Note provides for customary events of default including, but not limited to, the nonpayment of any amount payable when due, certain bankruptcy, insolvency or receivership events and the imposition of certain judgments. Upon the occurrence of an event of default, Mr. Lenfest has the right to accelerate the maturity date of the Lenfest Note and demand immediate payment of all amounts payable there under.

Subordinated Convertible Debt

In connection with the financing provided by PNC Bank on February 19, 2003, the Company entered into a Convertible Note and Warrant Purchase Agreement with Mr. Lenfest pursuant to which the Company issued to Mr. Lenfest (i) a senior subordinated convertible promissory note (the Senior Subordinated Note) in the original principal amount of $10,000,000 and (ii) warrants to purchase 803,048 shares of the Company s common stock. Upon the occurrence of certain events, the Company would be obligated to issue additional warrants to Mr. Lenfest. The Senior Subordinated Note accrues interest at the rate of 10% per annum (Mr. Lenfest has reduced the rate to 8% on a temporary basis for the period December 1, 2004 through November 30, 2006) and matures on February 18, 2009. At the Company s option, the quarterly interest payments may be deferred and added to the outstanding principal. The Senior Subordinated Note entitles Mr. Lenfest to convert all or a portion of the outstanding principal of, and accrued and unpaid interest on, the note into shares of common stock at a conversion price of $6.05 per share. The warrants were exercisable into shares of common stock at an exercise price equal to the lesser of $4.00 per share or two-thirds of the average of the high and low sale prices of the common stock for the 25 consecutive trading days immediately preceding the date of exercise.

The obligations of the Company to Mr. Lenfest under the Convertible Note and Warrant Purchase Agreement are secured by a second lien on all of the assets of the Company, junior in rights to any lien (if any is in place) in favor of PNC Bank, including all real property owned by the Company.

Subordinated Convertible Debt Discount

In fiscal 2003, the Company recorded $2,609,000 in additional paid-in capital representing an allocation of the proceeds from the convertible debt element of its financing with PNC Bank and Mr. Lenfest. This allocation represented the value assigned to the beneficial conversion option of the Senior Subordinated Note and the value of the associated warrants. Such values were derived pursuant to an independent appraisal of these financial instruments obtained by the Company. Accreted interest expense related to the beneficial conversion option and the warrants were $116,000 and $333,000 for the thirteen and thirty-nine week periods ending November 24, 2006, respectively, and $384,000 in fiscal 2006.

As a condition of amending the PNC Agreement on August 24, 2004, Mr. Lenfest agreed to issue to PNC Bank on the Company s behalf a limited guarantee to secure up to $5,000,000 in principal amount of any letters of credit issued under the amended facility. In consideration for issuing this guarantee, Mr. Lenfest receives a fee of 0.75% per annum of the average amount of letters of credit outstanding, payable on a quarterly basis, and did receive a warrant to purchase 200,000 shares of common stock under the same terms and conditions as his warrant to purchase 803,048 shares of common stock.

On February 14, 2005, Mr. Lenfest exercised all of his outstanding warrants and received 1,003,048 shares of common stock in exchange for a payment of approximately $3.9 million. Additionally, on February 14, 2005, Mr. Lenfest purchased 373,831 shares of the Company s common stock for approximately $2.0 million.

Long-Term Bonds

On March 15, 2000, the Company issued approximately $5,500,000 of unregistered Taxable Variable Rate Demand/Fixed Rate Revenue Bonds (Series of 2000). Net proceeds from these bonds were used to repay a $4,100,000 advance taken on the Company s revolving credit facility and to finance construction of an addition to the Company s main plant in Southampton, Pennsylvania. The bonds were secured by a $5,000,000 irrevocable direct pay Letter of Credit issued by PNC Bank which was scheduled to expire on February 17, 2006 and which was secured by all assets of the Company. At February 25, 2005, the bonds were fully cash collateralized. The bonds carried a maturity date of April 1, 2020, bore a variable interest rate which adjusted each week to a rate required to remarket the bonds at full principal value with a cap of 17%, and were subject to mandatory redemption of $275,000 per year for 19 years and $245,000 for the 20th year.

On June 30, 2005, the Company directed the trustee for the bonds to issue a redemption notice for all of the outstanding bonds and, on August 1, 2005 the Company utilized the restricted cash held by PNC Bank to redeem the bonds. As of May 27, 2005, all deferred financing charges associated with this bond issue had been fully amortized to the Company s statement of operations.

Environmental Tectonics Corporation

Notes to Consolidated Financial Statements, continued

(amounts in dollars, except where noted and share and per share information)

(unaudited)

Liquidity

At any particular time, the Company s cash position is affected by the timing of cash receipts for milestone payments on open orders, product sales and maintenance services and its payments for inventory and operating expenses, including legal expenses, resulting in significant quarter-to-quarter, as well as within a quarter, fluctuations in the Company s cash balances. The Company faces increased liquidity risk if it does not receive cash flow from operating activities as planned. The Company s principal sources of liquidity are its cash balances, cash from operations and its promissory note and equity line with Mr. Lenfest. As of December 29, 2006, the Company had available a total of $9,000,000 under the promissory note and equity line with Mr. Lenfest and approximately $1,800,000 available under the Letter of Credit line with PNC. Given the Company s lack of an operating facility with PNC Bank and certain restrictions in the Equity Agreement, the Company may need to obtain additional sources of capital in order to continue growing and operating its business. This capital may be difficult to obtain and the cost of this additional capital is likely to be relatively high. However, because the Company has established businesses in many markets, significant fixed assets including a building, and other valuable business assets which can be used for security, the Company believes that it will be able to locate such additional capital and that the actions by PNC Bank will not have a long-term material adverse effect on its business.

The Company s plans project that its current cash resources, including cash on hand, its promissory note and equity line with Mr. Lenfest, and cash to be generated from operating activities should be adequate for at least the next twelve months. The Company s plans assume customer acceptances and subsequent collections from a few large customers, as well as cash receipts on new bookings.

In reference to the Company s outstanding claims with the U.S. Navy, to the extent the Company is unsuccessful in recovering a significant portion of recorded claim contract costs, and to the extent that significant additional legal expenses are required to bring the dispute to resolution, such events could have a material adverse effect on the Company s liquidity and results of operations. Historically, the Company has had favorable experience in that recoveries have exceeded recorded claims, including significant settlement agreements in fiscal 2003, 2004 and 2005. (See Note 2 to the Consolidated Financial Statements, Accounts Receivable).

Environmental Tectonics Corporation

Notes to Consolidated Financial Statements, continued

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5. Segment Information:

The Company primarily manufactures under contract various types of high-technology equipment that it has designed and developed. The Company considers its business activities to be divided into two segments: Aircrew Training Systems (ATS) and the Industrial Group. The ATS business segment produces devices which create and monitor the physiological effects of motion, including spatial disorientation and centrifugal forces for the medical, training, research and entertainment markets. This group includes pilot training systems (PTS), disaster management software and products (ADMS), and entertainment products. The Industrial Group produces chambers that create environments that are used for sterilization, research, and medical applications. This group includes sterilizers, environmental test equipment and hyperbaric (high-oxygen) chambers. The following segment information reflects the accrual basis of accounting:

	ATS	**Industrial Group**	**Total**
	(amounts in thousands)		
Thirteen weeks ended November 24, 2006			
Net Sales	**$2,533**	**$2,185**	**$4,718**
Interest Expense	**217**	**74**	**291**
Depreciation and Amortization	**214**	**238**	**452**
Operating Loss	**(847)**	**(497)**	**(1,344)**
Income Tax	**4**		**4**
Goodwill and Intangibles	**455**		**455**
Identifiable Assets	**22,577**	**6,629**	**29,206**
Expenditures For Segment Assets	**29**	**1**	**30**
Thirteen weeks ended November 25, 2005			
Net Sales	$3,605	$2,601	$6,206
Interest Expense	223	98	321
Depreciation and Amortization	244	189	433
Operating Loss	(467)	(285)	(752)
Goodwill and Intangibles	477		477
Identifiable Assets	16,245	7,177	23,422
Expenditures For Segment Assets	18	7	25

	Thirteen weeks ended November	**Thirteen weeks ended November**

	24, 2006	**25, 2005**
Reconciliation to consolidated amounts		
Segment Assets	$29,206	$23,422
Corporate Assets	9,234	12,178
Total Assets	$38,440	$35,600
Segment operating loss	$(1,344)	$(752)
Less interest expense	(291)	(321)
Less income tax	(4)	
Total loss for segments	(1,639)	(1,073)
Corporate home office expenses	(237)	(234)
Interest and other expenses	43	(10)
Income tax		(4)
Minority interest	(33)	(6)
Net loss	$(1,866)	$(1,327)

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	ATS	Industrial Group	Total
	(amounts in thousands)		
Thirty-nine weeks ended November 24, 2006			
Net Sales	**$ 7,951**	**$ 5,671**	**$13,622**
Interest Expense	**635**	**222**	**857**
Depreciation and Amortization	**748**	**624**	**1,372**
Operating Loss	**(2,477)**	**(1,774)**	**(4,251)**
Income Tax	**13**		**13**
Goodwill and Intangibles	**455**		**455**
Identifiable Assets	**22,577**	**6,629**	**29,206**
Expenditures For Segment Assets	**145**	**43**	**188**
Thirty-nine weeks ended November 25, 2005			
Net Sales	$ 10,218	$ 8,158	$18,376
Interest Expense	865	400	1,265
Depreciation and Amortization	796	607	1,403
Operating Loss	(1,194)	(1,427)	(2,621)
Goodwill and Intangibles	477		477
Identifiable Assets	16,245	7,177	23,422
Expenditures For Segment Assets	857	406	1,263

	Thirty-nine weeks ended November 24, 2006	Thirty-nine weeks ended November 25, 2005
Reconciliation to consolidated amounts		
Segment Assets	$ 29,206	$ 23,422
Corporate Assets	9,234	12,178
Total Assets	$ 38,440	$ 35,600
Segment operating loss	$ (4,251)	$ (2,621)
Less interest expense	(857)	(1,265)
Less income tax	(13)	

Total loss for segments	(5,121)	(3,886)
Corporate home office expenses	(685)	(666)
Interest and other expenses	36	(110)
Income tax		(4)
Minority interest	(16)	(4)
Net loss	$ (5,786)	$ (4,670)

Segment operating income consists of net sales less applicable costs and expenses relating to these revenues. Unallocated general corporate expenses, letter of credit fees, interest expense and minority interest have been excluded from the determination of the total profit/loss for segments. Corporate home office expenses are primarily central administrative office expenses. Interest and other expenses include banking and letter of credit fees. Property, plant and equipment are not identified with specific business segments, as these are common resources shared by all segments.

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(amounts in dollars, except where noted and share and per share information)

(unaudited)

Approximately 46% of sales totaling $2,169,000 in the thirteen weeks ended November 24, 2006 were made to one international customer in the ATS segment, one international customer in the industrial segment and a domestic customer purchasing from the Company s Polish subsidiary. Approximately 34% of sales totaling $2,135,000 in the thirteen weeks ended November 25, 2005 were made to one domestic customer and one international customer in the ATS segment.

Approximately 23% of sales totaling $3,127,000 in the thirty-nine weeks ended November 24, 2006 were made to one international customer in the ATS segment. Approximately 17% of sales totaling $3,163,000 in the thirty-nine weeks ended November 25, 2005 were made to one domestic customer in the ATS segment**.**

Included in the segment information for the thirteen weeks ended November 24, 2006 are export sales (which includes sales of the Company s foreign subsidiaries) of $3,637,000. Of this amount, there are sales of 10% or more to or relating to governments or commercial accounts in Japan ($615,000), Australia ($662,000) and a domestic customer purchasing from the Company s Polish subsidiary ($892,000). Sales to the U.S. Government and its agencies were $27,000 for the period.

Included in the segment information for the thirteen weeks ended November 25, 2005 are export sales (which includes sales of the Company s foreign subsidiaries) of $3,625,000. Of this amount, there are sales of 10% or more to or relating to governments or commercial accounts in Pakistan ($948,000), Japan ($451,000), and a domestic customer purchasing from the Company s Polish subsidiary ($1,187,000). Sales to the U.S. Government and its agencies aggregated $249,000 for the period.

Included in the segment information for the thirty-nine weeks ended November 24, 2006 are export sales (which includes sales of the Company s foreign subsidiaries) of $8,907,000. Of this amount, there are sales to or relating to commercial accounts in Japan ($3,127,000), and a domestic customer purchasing from the Company s Polish subsidiary ($1,195,000). Sales to the U.S. Government and its agencies aggregated $445,000 for the period.

Included in the segment information for the thirty-nine weeks ended November 25, 2005 are export sales (which includes sales of the Company s foreign subsidiaries) of $8,799,000. Of this amount, there are sales of 10% or more to or relating to commercial or government accounts in Pakistan ($1,386,000) and a domestic customer purchasing from the Company s Polish subsidiary ($3,163,000). Sales to the U.S. Government and its agencies aggregated $2,370,000 for the period.

Environmental Tectonics Corporation

Notes to Consolidated Financial Statements, continued

(amounts in dollars, except where noted and share and per share information)

(unaudited)

6. Recent Accounting Pronouncements

Accounting for Share-Based Payments

In December 2004, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards (SFAS) Statement No. 123(R), *Share-Based Payments*. Statement No. 123(R) requires that the costs of employee share-based payments be measured at fair value on the awards grant date using an option-pricing model and recognized in the financial statements over the requisite service period. In March 2005, the SEC issued staff Accounting Bulletin (SAB) No. 107, Share-Based Payment , regarding the interaction between SFAS No. 123(R) and certain SEC rules and regulations. Statement No. 123(R) does not change the accounting for stock ownership plans, which is subject to American Institute of Certified Public Accountants SOP 93-6, Employer s Accounting for Employee Stock Ownership Plans. Statement No. 123(R) supersedes Opinion 25, Accounting for Stock Issued to Employees and its related interpretations, and eliminates the alternative to use Opinion 25 s intrinsic value method of accounting, which the Company has used in prior reporting periods.

Statement 123(R) allows for two alternative transition methods. The first method is the modified prospective application whereby compensation cost for the portion of awards for which the requisite service has not yet been rendered that are outstanding as of the adoption date will be recognized over the remaining service period. The compensation cost for that portion of awards will be based on the grant-date fair value of those awards as calculated for pro forma disclosures under Statement No. 123, as originally issued. All new awards and awards that are modified, repurchased, or cancelled after the adoption date will be accounted for under the provisions of Statement No. 123(R). The second method is the modified retrospective application, which requires that the Company restate prior period financial statements. The modified retrospective application may be applied either to all prior periods or only to prior interim periods in the year of adoption of Statement No. 123(R). The Company adopted SFAS 123(R) effective February 25, 2006 utilizing the modified prospective application described above. Under this application, the Company recognizes compensation expense related to share-based payments on a straight-line basis over the requisite service period for share-based payment awards granted on or after February 25, 2006. For unvested awards granted prior to the effective date of the Company s adoption of SFAS No. 123(R), the Company recognizes compensation expense in the same manner as was used in its income statement or for pro-forma disclosures prior to the effective date of its adoption of SFAS No. 123(R). See Note 1, Stock-Based Compensation, for more information regarding the adoption of SFAS No. 123(R).

Accounting Changes and Error Corrections

In May 2005, the FASB issued FAS 154 *Accounting Changes and Error Corrections*. FAS 154, which supersedes Accounting Principles Bulletin (APB) 20, clarifies the accounting for accounting changes which includes

A change in accounting principle from one generally accepted accounting principle to another alternative that is considered preferable
A change in an accounting estimate
A change in the reporting entity

FAS 154 requires retrospective application of a newly adopted accounting principle, including changes in accounting principle required by newly issued pronouncements. It also requires the reporting of a change in depreciation, amortization, or depletion method as a change in an accounting estimate rather than a change in principle. It specifically restricts the use of the term restatement to the correction of accounting errors (i.e., mathematical mistakes, mistakes in applying accounting principles, oversight or misuse of available facts, and use of unacceptable GAAP) in previously issued financial statements.

Environmental Tectonics Corporation

Notes to Consolidated Financial Statements, continued

(amounts in dollars, except where noted and share and per share information)

(unaudited)

FAS 154 is effective for accounting changes and error corrections made in fiscal years beginning after December 15, 2005. The Company adopted Statement 154 effective with the first fiscal quarter of fiscal 2007 without any significant impact on the Company s consolidated financial position, results of operations or cash flow.

Accounting for Uncertainty in Income Taxes

In July 2006, the FASB issued FASB Interpretation 48, *Accounting for Uncertainty in Income Taxes: an Interpretation of FASB Statement No. 109* (FIN 48 *).* FIN 48 clarifies Statement 109, *Accounting for Income Taxes*, to indicate a criterion that an individual tax position would have to meet for some or all of the benefit of that position to be recognized in an entity s financial statements. The Interpretation applies to all business enterprises including not-for-profit organizations. In applying FIN 48, an entity must evaluate a tax position, as defined, using a two-step process.

Evaluation for recognition: An entity should recognize the financial statement benefit of a tax position if it determines that it is more likely than not (i.e., a likelihood of more than 50 percent) that the position will be sustained on examination.

Measurement of the benefit: The amount recognized should be the largest benefit that has a greater than 50 percent likelihood of being realized upon ultimate settlement.

FIN 48 also allows for subsequent recognition and derecognition.

FIN 48 is effective for fiscal years beginning after December 15, 2006. The Company is not able at this time to determine what impact, if any, adoption of FIN 48 will have on the results of operations.

Accounting for Misstatements in Prior Year Financial Statements

In September 2006 the SEC issued Staff Accounting Bulletin 108, Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements (SAB 108). SAB 108 provides guidance on how prior year misstatements should be considered when quantifying misstatements in the current year financial statements. The SAB requires registrants to quantify misstatements using both a balance sheet and an income statement approach and evaluate whether either approach results in quantifying a misstatement that, when all relevant quantitative and qualitative factors are considered, is material. SAB 108 does not change the guidance in SAB 99, Materiality , when evaluating the materiality of misstatements. SAB 108 is effective for fiscal years ending after November 15, 2006. upon initial application, SAB 108 permits a one-time cumulative effect adjustment to beginning retained earnings. The Company is not able at this time to determine what impact, if any, adoption of SAB 108 will have on our consolidated financial statements.

Item 2. Management s Discussion and Analysis of Results of Operations and Financial Condition

FORWARD-LOOKING STATEMENTS

This Quarterly Report on Form 10-Q includes forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. These forward-looking statements are based on our current expectations and projections about future events. These forward-looking statements are subject to known and unknown risks, uncertainties and assumptions about us and our subsidiaries that may cause actual results, levels of activity, performance or achievements to be materially different from any future results, levels of activity, performance or achievements expressed or implied by such forward-looking statements.

These forward-looking statements include statements with respect to our vision, mission, strategies, goals, beliefs, plans, objectives, expectations, anticipations, estimates, intentions, financial condition, results of operations, future performance and business, including but not limited to, (i) projections of revenues, costs of raw materials, income or loss, earnings or loss per share, capital expenditures, growth prospects, dividends, capital structure, other financial items and the effects of currency fluctuations, (ii) statements of the plans and objectives of the Company or its management or Board of Directors, including the introduction of new products and lines of business, our ability to obtain financing, or estimates or predictions of actions of customers, suppliers, competitors or regulatory authorities, (iii) statements of future economic performance, (iv) statements of assumptions and other statements about us or our business, (v) statements made about the possible outcomes of our litigation; and (vi) statements preceded by, followed by or that include the words, may, could, should, looking forward, would, believe, expect, anticipate, plan, or the negative of such terms or similar expressions. These forward-looking statements involve risks and uncertainties which are subject to change based on various important factors. Some of these risks and uncertainties, in whole or in part, are beyond our control. Factors that might cause or contribute to such a material difference include, but are not limited to, those discussed in our Annual Report on Form 10-K, in the section entitled Risks Particular to Our Business. Shareholders are urged to review these risks carefully prior to making an investment in our common stock.

The Company cautions that the foregoing list of important factors is not exclusive. The Company does not undertake to update any forward-looking statement that may be made from time to time by or on behalf of the Company.

Overview

We are principally engaged in the design, manufacture and sale of software driven products used to create and monitor the physiological effects of motion on humans, real time interactive training programs, and equipment to control, modify, simulate and measure environmental conditions. These include pilot training systems (PTS), disaster management software and products and entertainment products (collectively grouped as Aircrew Training Systems (ATS) products) and sterilizers, environmental test equipment and hyperbaric chambers and other products that involve similar manufacturing techniques and engineering technologies (collectively known as Industrial Group products).

Management s Discussion and Analysis of Results of Operations and Financial Condition, continued

The following factors have had an adverse impact on our performance for fiscal 2007:

- unfavorable global economic and political conditions for our aeromedical products;

Historically our ATS sales have primarily consisted of aeromedical simulation equipment which was installed at our military customer s locations (aeromedical centers or airbases) throughout the world. This equipment was operated by flight doctors, physiologists and other personnel with the primary purpose of either evaluation or training of pilots in the physiological effects of flight in high performance jet aircraft. Our open contract mix often included one large order (e.g., a centrifuge or an order for an entire training center of equipment), a few medium-priced simulators, and other low-end trainers. Large dollar contracts deliverable over multiple years tended to be received every 18 months to two years. The events of September 11, 2001 and the resulting emphasis on world terriorism basically ended this cycle. The recent performance in our ATS line reflects the results of these events.

In an effort to penetrate a new market segment for our training devices, we have developed the Advanced Tactical Flight Simulation (ATFS) technology. In fiscal 2007, we continued our education and marketing efforts to introduce our ATFS technology to the U.S. military. Although the cost of developing and marketing this technology is high, the evolution of these state-of-the-art technologies is an important step in our goal of integrating flight and aeromedical training in a simulator device. This technology allows a fighter pilot to practice tactical air combat maneuvers such as dodging enemy missiles, ground fire and aircraft obstacles while experiencing the real life environment of a high-G Force fighter aircraft. These flight trainers provide a low cost and extremely less risky alternative to actual air flight. We believe that armed forces agencies of various governments will appreciate the efficiency of these technologies, especially in this time of fiscal conservatism and budgetary constraints throughout the world.

A significant use of our cash is our continued construction of the National AeroSpace Training and Research Center (NASTAR Center). Although in the past we have occasionally offered aeromedical training to pilots and other personnel, the NASTAR approach represents a completely different business model. Under the business model we intend to develop, our ATS group would evolve to become a services versus product supplier. The NASTAR revenue model is theoretically much more predictable than the current varied mix of medium and large ticket product sales requiring multiple years of development and production.

NASTAR Center, set to open in the first quarter of 2007, will offer a complete range of aviation training and research support for military and civil aviation as well as space travel and tourism. The NASTAR Center will house state of the art equipment including the ATFS-400, GYROLAB GL-2000 Advanced Spatial Disorientation Trainer, Hypobaric Chamber and Night Vision and Night Vision Goggle Training System. These products represent ETC s 37 years of pioneering development and training solutions for the most rigorous stresses encountered during high performance aircraft flight including the effects of altitude exposure, High G exposure, spatial disorientation and escape from a disabled aircraft.

- continued development of flexibility and functionality in our Advanced Disaster Management Simulation product line;

Management s Discussion and Analysis of Results of Operations and Financial Condition, continued

We have made significant progress in advancing and enhancing our ADMS line of products. Graphics are sharper and more realistic, interactivity and connectivity of objects are tighter, additional disaster scenarios have been added, and we have made the hardware configuration more user friendly. However, this effort has put pressure on our gross margins. In fiscal 2007, we are continuing to invest in marketing efforts to evaluate the appropriate business model for this unique approach to first responder training.

limited revenue generation coupled with high development costs in our low-end entertainment products;

Certain actions by a former major entertainment customer have effectively closed the high-end amusement market to us. Our low-end products have encountered customer resistance due to pricing and those units under a revenue share contract have failed to generate sufficient income to justify an expansion of this line. Consequently, this line has suffered from high development costs with low returns.

higher costs of capital;

Although down from the prior period, interest expense continues to be significant. For the thirty-nine weeks ended November 24, 2006, interest expense was $857,000, or 6.3% of sales. In addition to cash interest payments on the Company s subordinated debt, we have issued preferred stock which has a 6% per annum dividend rate and during the third fiscal quarter of 2007 we borrowed $3,000,000 under the Lenfest Note at an annual interest rate of 6%. The Lenfest Note plus all accrued interest was repaid in full on December 13, 2006.

higher inventory reserves;

Reflecting our reduced sales level and order flow, during the thirty-nine weeks ended November 24, 2006 we increased our excess and obsolete product inventory reserves for some of our mid-line pilot trainers, which have experienced slow sales in the most recent periods.

litigation and claims costs;

Although down significantly from prior levels, litigation and claim costs have averaged approximately 6.4% of sales in fiscal 2007. We anticipate that these costs will continue to be a major component of our general, administrative and selling costs.

cash flow;

Beginning in fiscal 2006, we saw a major change in our ATS business not only in the amount of new contract awards but also in the payment terms offered by our customers. Whereas most of our contracts previously included milestone payments and were cash positive for most of the design and production periods, in our two largest currently open ATS contracts most of the contract payment is due at shipment or after in-country acceptance. Obviously, funding these contracts has required a significant amount of operating funds during the fiscal year. (In December 2006, approximately 50% of these funds were collected and the balance is expected to be collected by fiscal year end).

Management s Discussion and Analysis of Results of Operations and Financial Condition, continued

On June 28, 2006, we signed an amendment to the PNC Agreement which (i) extended the Agreement termination date to the earlier of June 30, 2007 or such date to which we and PNC have agreed in writing, (ii) terminated the Security Agreement and Mortgage, thereby releasing our assets as collateral for the facility, (iii) adjusted the Tangible Net Worth covenant to a minimum of $9,000,000, and (iv) made other changes to the PNC Agreement. This $5,000,000 facility remains restricted to use for issuing letters of credit.

On November 16, 2006, we entered into a Letter Agreement with PNC Bank. This Letter Agreement amended, restated and replaced the existing PNC Credit Agreement. Pursuant to such agreement, PNC Bank (i) terminated our Credit Agreement dated as of February 18, 2003 (ii) re-approved our $5 million Line of Credit for Letters of Credit, and (iii) re-affirmed the Tangible Net Worth covenant (as defined in the Letter Agreement) to be a minimum of $9,000,000. The $5 million Line of Credit for Letters of Credit will continue to be guaranteed by Mr. Lenfest.

The Company s principal sources of liquidity are its cash balances, cash from operations and its promissory note and equity line with Mr. Lenfest. As of December 29, 2006, the Company had available a total of $9,000,000 under the promissory note and equity line with Mr. Lenfest and approximately $1,800,000 available under the Letter of Credit line with PNC. Given our low beginning sales backlog and ongoing difficulty in obtaining new contracts, we may need to obtain additional sources of capital in order to continue growing and operating our business. Because we have established businesses in many markets, significant fixed assets including a building, and other business assets which can be used as collateral for an investor or lender, we believe that we will be able to locate such additional sources of capital, although there is no assuredness that we will be successful in this endeavor.

We face the following challenges and business goals in order to make fiscal 2007 a successful year:

Aircrew Training Systems

- Complete the construction of building modifications and produce the equipment for the NASTAR Center. Our challenge in fiscal 2007 continues to be to secure funding to support this initiative.
- Continue to evolve our Advanced Tactical Flight Simulation (ATFS) business. Our challenge will be to obtain funding to continue this critical development objective, either through federal, state or local government grants or a customer order.

ADMS

In prior years, we have spent significant time and funds to develop and refine this technology. During 2007, we need to emphasize our sales and marketing efforts for this product group through demonstrations, exhibiting at trade shows, tele-marketing and visiting potential customer sites. These and other approaches need to be explored to develop awareness for this simulation product. An additional objective for fiscal 2007 is to develop a business model which will effectively deliver this program.

Management s Discussion and Analysis of Results of Operations and Financial Condition, continued

Claims/Litigation

We will continue to pursue outstanding commercial litigation and our claim against the U.S. government with a goal of mediation or settlement.

ETC-PZL

During fiscal 2006, ETC-PZL performed under a significant contract from L-3 Communications. This contract was virtually complete at the end of fiscal 2006. ETC-PZL will need to replace this revenue with other contracts, either in or outside of Poland.

Liquidity

We do not currently have a bank facility which can be used to borrow funds for operations.

On June 28, 2006, we signed an amendment to the PNC Agreement which (i) extended the PNC Agreement s termination date to the earlier of June 30, 2007 or such date to which we and PNC Bank have agreed in writing, (ii) terminated the Security Agreement and Mortgage, thereby releasing our assets as collateral for the facility, (iii) adjusted the Tangible Net Worth covenant to a minimum of $9,000,000, and (iv) made other changes to the PNC Agreement. This $5,000,000 facility remains restricted to use for issuing letters of credit.

On November 16, 2006, we entered into a Letter Agreement with PNC Bank. This Letter Agreement amended, restated and replaced the existing PNC Credit Agreement. Pursuant to such agreement, PNC Bank (i) terminated ETC s Credit Agreement dated as of February 18, 2003 (ii) re-approved our $5 million Line of Credit for Letters of Credit, and (iii) re-affirmed the Tangible Net Worth covenant (as defined in the Agreement) to a be a minimum of $9,000,000. The $5 million Line of Credit for Letters of Credit will continue to be guaranteed by Mr. Lenfest. As of November 24, 2006, we had used approximately $3,200,000 million of this facility for international letters of credit.

On April 7, 2006, we entered into a Preferred Stock Purchase Agreement (the Equity Agreement) with Mr. Lenfest. The Equity Agreement permits us to unilaterally draw down up to $15 million prior to October 2007 in exchange for shares of our newly-created Series B Cumulative Convertible Preferred Stock (Preferred Stock). The Preferred Stock provides for a dividend equal to six percent per annum. After three years, the Preferred Stock will be convertible, at Mr. Lenfest s request, into ETC common shares at a conversion price (the Conversion Price) which will be set on the day of each draw down. The Conversion Price will be equal to the closing price of our common stock on the trading day immediately preceding the day in which the draw down occurs, subject to a floor price of $4.95 per common share. Drawdowns are not permitted on any day when the Conversion Price would be less than this floor price. On the sixth anniversary of the Equity Agreement, any issued and outstanding Preferred Stock will be mandatorily converted into ETC common stock at each set Conversion Price. The Equity Agreement also allows for us to redeem any outstanding Preferred Stock any time within the six-year term of the Equity Agreement. The Preferred Stock is entitled to vote with the ETC common stock on an as converted basis.

Management s Discussion and Analysis of Results of Operations and Financial Condition, continued

In connection with the execution of the Equity Agreement, in April 2006 we drew down $3,000,000 by issuing 3,000 shares of Preferred Stock with a Conversion Price equal to $4.95 per share. Additionally, on July 31, 2006, we drew down an additional $3,000,000 by issuing 3,000 shares of Preferred Stock at a Conversion Price equal to $6.68 per common share.

On November 16, 2006, we executed an Unsecured Promissory Note (the Lenfest Note) in favor of Mr. Lenfest in the aggregate principal amount of $3,000,000. Pursuant to the terms of the Lenfest Note, ETC can borrow up to $3,000,000 in increments of $1,000,000 prior to the maturity date of October 6, 2007. Pursuant to the terms and conditions of the Lenfest Note, on November 17, 2006, ETC borrowed $3,000,000. The Lenfest Note plus all accrued interest was repaid in full on December 13, 2006.

All outstanding and unpaid interest on the Lenfest Note is due and payable on the earlier of (i) October 6, 2007 or (ii) such date as ETC draws down funds sufficient to repay the amount due under the Lenfest Note pursuant to the Preferred Stock Purchase Agreement.

Borrowings made pursuant to the Lenfest Note will bear interest at an annual rate of six (6%) percent with such interest beginning to accrue on the date of the funding of each loan and, to the extent not paid, compounding on the first day of each month.

The Lenfest Note provides for customary events of default including, but not limited to, the nonpayment of any amount payable when due, certain bankruptcy, insolvency or receivership events and the imposition of certain judgments. Upon the occurrence of an event of default, Mr. Lenfest has the right to accelerate the maturity date of the Lenfest Note and demand immediate payment of all amounts payable there under.

As of December 29, 2006, the Company had available a total of $9,000,000 under the promissory note and equity line with Mr. Lenfest and approximately $1,800,000 available under the Letter of Credit line with PNC.

Critical Accounting Policies

The discussion and analysis of our financial condition and results of operation are based upon our consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States of America. The preparation of these financial statements requires us to make estimates and judgments that affect the reported amount of assets and liabilities, revenues and expenses, and related disclosure of contingent assets and liabilities at the date of our financial statements. Actual results may differ from these estimates under different assumptions or conditions.

Critical accounting policies are defined as those that reflect significant judgments and uncertainties, and potentially result in materially different results under different assumptions and conditions. We believe that our critical accounting policies include those described below. For a detailed discussion on the application of these and other accounting policies, see Note 1 to the Consolidated Financial Statements, Summary of Significant Accounting Policies, in the Company s Annual Report on Form 10-K for the fiscal year ended February 24, 2006, which was filed with the Securities and Exchange Commission on May 25, 2006.

Management s Discussion and Analysis of Results of Operations and Financial Condition, continued

There have been no changes to our critical accounting policies since fiscal 2006 year-end. The reader is referred to the Company s Annual Report on Form 10-K for the fiscal year ended February 24, 2006 in the section entitled Critical Accounting Policies under the Management s Discussion and Analysis of Financial Condition and Results of Operations.

Management s Discussion and Analysis of Results of Operations and Financial Condition, continued

Results of Operations

Thirteen weeks ended November 24, 2006 compared to thirteen weeks ended November 25, 2005.

We have historically experienced significant variability in our quarterly revenue, earnings and other operating results, and our performance may fluctuate significantly in the future.

Summary Table of Results

	13 weeks ended 24-Nov-06	**13 weeks ended 25-Nov-05**	**Variance $**	**Variance %**
	(amounts in thousands)			
Sales:				
Domestic	$1,054	$ 2,332	($1,278)	(54.8)%
US Government	27	249	(222)	(89.2)%
International	3,637	3,625	12	0.3%
Total Sales	4,718	6,206	(1,488)	(24.0)%
Gross Profit	1,030	1,367	(337)	(24.7)%
Selling, general & administrative	2,568	2,267	(301)	(13.3)%
Research & development	43	86	43	50.0%
Operating loss	(1,581)	(986)	(595)	(60.3)%
Interest expense, net	291	321	30	9.4%
Other (income) expense, net	(43)	10	53	530.0%
Income taxes	4	4	0	0.0%
Minority interest	33	6	(27)	(450.0)%
Net loss	($1,866)	($1,327)	($539)	(40.6)%
Net loss per common share	$0.22	$ 0.15	($0.07)	(46.7)%

Net Loss.

We had a net loss of $1,866,000, or $.22 per share (diluted), during the third quarter of fiscal 2007 versus a net loss of $1,327,000, or $.15 per share (diluted), for the third quarter of fiscal 2006, representing an increase in net loss of $539,000 or 40.6%. This increase in net loss reflected a reduced gross profit (down $337,000, 24.7%) on reduced sales compounded with higher general and administrative expenses. Acting as partial offsets were reduced research and development expenses (down $43,000, 50.0%) and reduced interest and other expenses.

Sales.

Sales for the third quarter of fiscal 2007 were $4,718,000 as compared to $6,206,000 for the third quarter of fiscal 2006, a decrease of $1,488,000 or 24.0%. Sales decreases were evidenced in the domestic and government markets and in a majority of product areas, most notably environmental (down $792,000 domestically and $708,000 in total) and ETC Southampton PTS (down $672,000 internationally and $797,000 in total). Acting as partial offsets were international sterilizer sales (up $910,000) and hyperbaric (up $107,000 overall). We have historically experienced significant variability in our sales performance. This reflects the existing sales backlog, product and the nature of contract (size and performance time) mix, the manufacturing cycle and amount of time to effect installation and customer acceptance, and certain factors not in our control such as customer delays and the time required to obtain U.S. Government export licenses. One or a few contract sales may and typically account for a substantial percentage of our quarterly revenue.

Management s Discussion and Analysis of Results of Operations and Financial Condition, continued

Our combined sales backlog at November 24, 2006 for work to be performed and revenue to be recognized under written agreements after such dates was $10,545,000.

Domestic Sales.

Overall, domestic sales in the third quarter of fiscal 2007 were $1,054,000 as compared to $2,332,000 in the third quarter of fiscal 2006, a decrease of $1,278,000 or 54.8%. Significant sales decreases were evidenced in sterilizers and environmental products (down approximately 44% and 94%, respectively, from the prior period). The sterilizer reduction reflected fewer contracts for both steam and ETO applications. Environmental in the prior period benefited from multiple contracts for automotive applications. Domestic sales represented 22.3% of our total sales in the third quarter of fiscal 2007, down from 37.6% for the third quarter of fiscal 2006. Sales to the U.S. Government in the third quarter of fiscal 2007 were $27,000 as compared to $249,000 in the third quarter of fiscal 2006, and represented 0.6% of total sales in the third quarter of fiscal 2007 versus 4.0% for the third quarter of fiscal 2006.

International Sales.

International sales for the third quarter of fiscal 2007, including sales of our foreign subsidiaries, were $3,637,000 as compared to $3,625,000 in the third quarter of fiscal 2006, an increase of $12,000 or 0.3%, and represented 77.1% of total sales as compared to 58.4% in the third quarter of fiscal 2006. This increase resulted from a slight (9.9%) increase in ETC Southampton which was mostly offset by a 17.5% decrease in ETC-PZL on reduced production for the L-3 simulator contract. Throughout our history, most of the sales for PTS have been made to international customers. In the third quarter of fiscal 2007, international sales totaling at least ten percent of total international sales were made to or relating to governments or commercial accounts in Japan ($615,000), Australia ($662,000) and a domestic customer purchasing from ETC-PZL ($892,000). In the third quarter of fiscal 2006, there were sales of 10% or more to or relating to governments or commercial accounts in Japan ($451,000), Pakistan ($948,000) and a domestic customer purchasing from ETC-PZL ($1,187,000). Fluctuations in sales to international countries from year to year primarily reflect revenue recognition on the level and stage of development and production on multi-year long-term contracts.

Gross Profit.

Gross profit for the third quarter of fiscal 2007 was $1,030,000 as compared to $1,367,000 in the third quarter of fiscal 2006, a decrease of $337,000 or 24.7%. This decrease primarily reflected the decrease in sales between the two periods as the gross profit rate as a percentage of sales between the periods was comparable. During the current period a significantly reduced gross profit and profit rate on lower sales in ETC Southampton was mostly offset by a gross profit improvement both in dollars and as a percentage of sales in ETC-PZL. We have historically experienced significant fluctuations in gross profit margins and, consequently, our operating results, and we expect such fluctuations to continue. Gross margins are routinely affected by selling prices, the engineering cost of product enhancements, the amount of new product development required to meet contract specifications, the mix of materials, labor content and the engineering effort in manufacturing costs.

Management s Discussion and Analysis of Results of Operations and Financial Condition, continued

Selling and Administrative Expenses.

Selling and administrative expenses for the third quarter of fiscal 2007 were $2,568,000 as compared to $2,267,000 in the third quarter of fiscal 2006, an increase of $301,000 or 13.3%, primarily reflecting increased consulting fees and start-up expenses associated with the development of the NASTAR Center in ETC Southampton. Acting as a partial offset was reduced commission expense on reduced sales and a favorable sales mix. Although down from the prior period, spending on legal matters is expected to continue to be significant for the foreseeable future.

A significant portion of our selling and administrative spending is related to three activities: 1. legal and contract claims costs, 2. outside agent and sales personnel commissions on booked contracts and 3. additional accounting, legal and stockholder s costs required to comply with applicable statutes, rules and regulations as a public company. In fiscal 2006, we instituted a series of cost cutting measures and we continue to monitor these spending categories very closely.

Research and Development Expenses.

Research and development expenses, which are charged to operations as incurred, were $43,000 for the third quarter of fiscal 2007 as compared to $86,000 for the third quarter of fiscal 2006, reflecting a decrease of $43,000 or 50.0%. The current period reflected the receipt of research credits in our Turkish subsidiary.

Most of our research efforts, which were and continue to be a significant cost of our business, are included in cost of sales for applied research for specific contracts, as well as research for feasibility and technology updates. Most of our products require a significant amount of continued development effort to implement new applications, design product extensions, and integrate new technology into existing products.

Where appropriate under applicable accounting principles we capitalize the qualifying costs of developing software contained in certain products.

Interest Expense.

Interest expense for the third quarter of fiscal 2007 was $291,000, a decrease of $30,000 or 9.4% from the prior period. The decrease reflected no amortization in the current period of deferred finance expenses from our February 2003 refinancing and stock warrants issued in connection with modifications to the PNC Agreement. These amounts had been fully amortized to our Consolidated Statement of Operations as of February 24, 2006.

Management s Discussion and Analysis of Results of Operations and Financial Condition, continued

Other Income/Expense, net.

Other income/expense, net, was income of $43,000 for the third quarter of fiscal 2007 versus expense of $10,000 for the third quarter of fiscal 2006, a decrease of $53,000. The current quarter included higher foreign exchange gain in ETC-PZL.

Income Taxes

Deferred tax assets and liabilities are determined based on differences between financial reporting and tax bases of assets and liabilities and operating loss and tax credit carry forwards and are measured using the enacted tax rates and laws that will be in effect when the differences and carry forwards are expected to be recovered or settled. In accordance with SFAS No. 109, Accounting for Income Taxes, a valuation allowance for deferred tax assets is provided when we estimate that it is more likely than not that all or a portion of the deferred tax assets may not be realized through future operations. This assessment is based upon consideration of available positive and negative evidence, which includes, among other things, our most recent results of operations and expected profitability. We consider our actual historical results to have stronger weight than other more subjective indicators when considering whether to establish or reduce a valuation allowance on deferred tax assets. During the current fiscal quarter, no offsetting income tax benefit and corresponding deferred tax receivable was recorded. The tax accrual of $4,000 reflected tax liability in ETC-PZL. We will recognize deferred tax benefits only as reassessment demonstrates that they are realizable. Realization is entirely dependent upon future earnings in specific tax jurisdictions.

As of February 24, 2006, we had approximately $11.7 million of federal and $4.8 million of state net loss carry forwards available to offset future income taxes, expiring in 2025. We have established a full valuation allowance of the same amount against these carry forward benefits. While the need for this valuation allowance is subject to periodic review, if the allowance is reduced, the tax benefits of the carry forwards will be recorded in future operations as a reduction of the company s income tax expense.

The income tax expense in the third quarter of fiscal 2006 reflected tax liability in ETC-PZL.

Management s Discussion and Analysis of Results of Operations and Financial Condition, continued

Results of Operations

Thirty-nine weeks ended November 24, 2006 compared to thirty-nine weeks ended November 25, 2005.

We have historically experienced significant variability in our revenue, earnings and other operating results, and our performance may fluctuate significantly in the future.

Summary Table of Results

	39 weeks ended 24-Nov-06	39 weeks ended 25-Nov-05	Variance $	Variance %
	(amounts in thousands)			
Sales:				
Domestic	$4,270	$ 7,207	($2,937)	(40.8)%
US Government	445	2,370	(1,925)	(81.2)%
International	8,907	8,799	108	1.2%
Total Sales	13,622	18,376	(4,754)	(25.9)%
Gross Profit	2,538	4,102	(1,564)	(38.1)%
Selling, general & administrative	6,945	7,142	197	2.8%
Research & development	529	247	(282)	(114.2)%
Operating loss	(4,936)	(3,287)	(1,649)	(50.2)%
Interest expense, net	857	1,265	408	32.3%
Other (income) expense, net	(36)	110	146	132.7%
Income taxes	13	4	(9)	(225.0)%
Minority interest	16	4	(12)	(300.0)%
Net loss	($5,786)	($4,670)	($1,116)	(23.9)%
Net loss per common share	$0.66	$ 0.52	($0.14)	(26.9)%

Net Loss.

We had a net loss of $5,786,000 or $.66 per share (diluted), during the thirty-nine weeks ended November 24, 2006 versus a net loss of $4,670,000 or $.52 per share (diluted), for the thirty-nine weeks ended November 25, 2005, representing an increase in net loss of $1,116,000 or 23.9%. This increase in net loss reflected a reduced gross profit (down $1,564,000, 38.1%) on reduced sales compounded with higher research and development expenses. Acting as partial offsets were reduced selling, general and administrative expenses (down $197,000, 2.8%) and significantly reduced interest (down $408,000, 32.2%) and other expenses (down $146,000, 132.7%).

Management s Discussion and Analysis of Results of Operations and Financial Condition, continued

Sales.

Sales during the thirty-nine weeks ended November 24, 2006 were $13,622,000 as compared to $18,376,000 for the thirty-nine weeks ended November 25, 2005, a decrease of $4,754,000 or 25.9%. Geographically, the sales decrease was split between domestic (down $2,937,000, 40.8%) and U.S. government (down $1,925,000, 81.2%). International sales were up $108,000 or 1.2% between the periods. We have historically experienced significant variability in our sales performance. This reflects the existing sales backlog, product and the nature of contract (size and performance time) mix, the manufacturing cycle and amount of time to effect installation and customer acceptance, and certain factors not in our control such as customer delays and the time required to obtain U.S. Government export licenses. One or a few contract sales may and typically do account for a substantial percentage of our revenue.

Our combined sales backlog at November 24, 2006 for work to be performed and revenue to be recognized under written agreements after such dates was $10,545,000.

Domestic Sales.

Overall, domestic sales during the thirty-nine weeks ended November 24, 2006 were $4,270,000 as compared to $7,207,000 for the thirty-nine weeks ended November 25, 2005, a decrease of $2,937,000 or 40.8%. The decrease in domestic sales reflected declines in all product groups except simulation and entertainment, with the greatest decline being evidenced in the environmental product line (down $2,037,000, 80.0%). In general, the sales performance for fiscal 2007 has reflected the lower beginning backlog and timing of the booking of new contracts within the period. Domestic sales represented 31.4% of our total sales during the thirty-nine weeks ended November 24, 2006, compared to 39.2% for the thirty-nine weeks ended November 25, 2005. Sales to the U.S. Government during the thirty-nine weeks ended November 24, 2006 $445,000 as compared to $2,370,000 for the first half of fiscal 2006, a decrease of $1,925,000 or 81.2%, and represented 3.3% of total sales during the thirty-nine weeks ended November 24, 2006 versus 12.9% for the thirty-nine weeks ended November 25, 2005. The major decrease in U. S. Government sales in the current period represented percentage of completion revenue recognized in the prior period for a Pilot Selection System purchased by the Army Corps of Engineers for use in a foreign country.

International Sales.

International sales during the thirty-nine weeks ended November 24, 2006 were $8,907,000 as compared to $8,799,000 for the thirty-nine weeks ended November 25, 2005, an increase of $108,000 or 1.2%, and represented 65.3% of total sales during the thirty-nine weeks ended November 24, 2006, compared to 47.9% for the thirty-nine weeks ended November 25, 2005. International sales in the current period were up in ETC Southampton in all product categories except environmental and simulation. Significant increases were evidenced in PTS (up $1,272,000, 31.9%), sterilizers (up $1,046,000), and hyperbaric (up $209,000, 47.5%). These increases were nearly offset by a decrease in ETC PZL sales of $1,712,000, 53.9%, on reduced production for the L-3 simulator contract. During the thirty-nine weeks ended November 24, 2006, international sales totaling at least ten percent of total international sales were made to or relating to commercial accounts in Japan ($3,127,000) and a domestic customer purchasing from ETC-PZL ($1,195,000). In the thirty-nine weeks ended November 25, 2005, there were sales of 10% or more to or relating to a commercial account in Pakistan ($1,386,000) and a domestic customer purchasing from ETC-PZL ($3,163,000). Fluctuations in sales to international countries from year to year primarily reflect revenue recognition on the level and stage of development and production on multi-year long-term contracts.

Gross Profit.

Gross profit for the thirty-nine weeks ended November 24, 2006 was $2,538,000 as compared to $4,102,000 for the thirty-nine weeks ended November 25, 2005, a decrease of $1,564,000 or 38.1%. This decrease reflected the decrease in sales between the two periods coupled with a 3.7 percentage point decrease in the gross profit rate as a percent of sales. Gross profit rate performance by product was mixed. The primary contributor to the reduced margin was ETC Southampton PTS which experienced both a decreased sales volume and gross profit rate. By division, a decrease in ETC Southampton was partially offset by a significant improvement (up 49.4 percentage points) in ETC-PZL reflecting a favorable gross profit albeit at a lower sales volume for the L-3 simulator contract.

We have historically experienced significant fluctuations in gross profit margins and, consequently, our operating results, and we expect such fluctuations to continue. Gross margins are routinely affected by selling prices, the amount of new product development required to meet contract specifications, the mix of materials, labor content and engineering effort in manufacturing costs, and labor difficulties in field work including installation and customer acceptance, and the impact of claims settlements.

Selling and Administrative Expenses.

Selling and administrative expenses for the thirty-nine weeks ended November 24, 2006 were $6,945,000 as compared to $7,142,000 for the thirty-nine weeks ended November 25, 2005, a decrease of $197,000 or 2.8%, primarily reflecting a significant reduction in sales commissions, legal costs associated with our ongoing litigation and contract claims activities, and bad debt expense. Acting as a partial offset were increased consulting fees and start-up expenses associated with the development of the NASTAR Center in Southampton. Although reduced from the prior period, spending on legal matters is expected to continue to be significant for the foreseeable future.

A significant portion of our selling and administrative spending is related to three activities: 1. legal and contract claims costs, 2. outside agent and sales personnel commissions on booked contracts and 3. additional accounting, legal and stockholder s costs required to comply with applicable statutes, rules and regulations as a public company. In fiscal 2006, we instituted a series of cost cutting measures and we continue to monitor these spending categories very closely.

Research and Development Expenses.

Research and development expenses, which are charged to operations as incurred, were $529,000 for the thirty-nine weeks ended November 24, 2006 as compared to $247,000 for the thirty-nine weeks ended November 25, 2005, an increase of $282,000 or 114.2%. This increase reflected less reimbursement from the Turkish government under grant programs coupled with additional projects in ETC Southampton.

Most of our research efforts, which were and continue to be a significant cost of our business, are included in cost of sales for applied research for specific contracts, as well as research for feasibility and technology updates. Most of our products require a significant amount of continued development effort to implement new applications, design product extensions, and integrate new technology into existing products.

Management s Discussion and Analysis of Results of Operations and Financial Condition, continued

Where appropriate under applicable accounting principles, we capitalize the qualifying costs of developing software contained in certain products.

Interest Expense.

Interest expense for the thirty-nine weeks ended November 24, 2006 was $857,000 as compared to $1,265,000 for the thirty-nine weeks ended November 25, 2005, a decrease of $408,000 or 32.3%. The decrease reflected no amortization in the current period of deferred finance expenses from our February 2003 refinancing and stock warrants issued in connection with modifications to the PNC Agreement. These amounts have been fully amortized to our Consolidated Statements of Operations as of February 24, 2006. Additionally, the prior period included cash interest payments on our long-term bonds which were redeemed on August 1, 2005.

Other Income/Expense, Net.

Other income/expense, net, was income of $36,000 for the thirty-nine weeks ended November 24, 2006 as compared to expense of $110,000 for the thirty-nine weeks ended November 25, 2005, a decrease of $146,000 or 132.7%. The current period included higher foreign exchange gain in ETC-PZL and lower bank charges.

Income Taxes

Deferred tax assets and liabilities are determined based on differences between financial reporting and tax bases of assets and liabilities and operating loss and tax credit carry forwards and are measured using the enacted tax rates and laws that will be in effect when the differences and carry forwards are expected to be recovered or settled. In accordance with SFAS No. 109, Accounting for Income Taxes, a valuation allowance for deferred tax assets is provided when we estimate that it is more likely than not that all or a portion of the deferred tax assets may not be realized through future operations. This assessment is based upon consideration of available positive and negative evidence, which includes, among other things, our most recent results of operations and expected profitability. We consider our actual historical results to have stronger weight than other more subjective indicators when considering whether to establish or reduce a valuation allowance on deferred tax assets. During the current fiscal quarter, no offsetting income tax benefit and corresponding deferred tax receivable was recorded. The tax accrual of $13,000 reflected tax liability in ETC-PZL. We will recognize deferred tax benefits only as reassessment demonstrates that they are realizable. Realization is entirely dependent upon future earnings in specific tax jurisdictions.

As of February 24, 2006, we had approximately $11.7 million of federal and $4.8 million of state net loss carry forwards available to offset future income taxes, expiring in 2025. We have established a full valuation allowance of the same amount against these carry forward benefits. While the need for this valuation allowance is subject to periodic review, if the allowance is reduced, the tax benefits of the carry forwards will be recorded in future operations as a reduction of the company s income tax expense.

The income tax accrual of $4,000 in the prior period reflected tax liability in ETC-PZL.

Management s Discussion and Analysis of Results of Operations and Financial Condition, continued

Liquidity and Capital Resources

During the thirty-nine weeks ended November 24, 2006, operating activities required $8,182,000 of our cash. Cash was primarily used to fund the operating loss, a build in inventories (NASTAR equipment) and receivables (a major portion of which was collected in December, 2006) and increased costs and estimated earnings in excess of billings on uncompleted long-term contracts (one large contract currently in progress does not allow for billing until the device is shipped or accepted). The major offsets to this operating usage were non-cash expenses (depreciation, software amortization and non-cash interest expense), an increase in billings in excess of costs and estimated earnings on uncompleted long-term contracts and higher customer deposits.

Our investing activities required $283,000 during the thirty-nine weeks ended November 24, 2006, consisting of purchases of capital equipment and capitalized software. This was down significantly from the prior period.

Our financing activities generated $8,831,000 during the thirty-nine weeks ended November 24, 2006, reflecting the receipt of $6,000,000 in exchange for the issuance of shares of our preferred stock under the Lenfest Equity Line and $3,000,000 from the issuance of a short-term note, which was repaid in full on December 13, 2006.

Refinancing

We have historically financed operations through a combination of cash generated from operations, equity offerings, subordinated borrowings and bank debt. On February 19, 2003, we refinanced our operations (the Refinancing). The Refinancing was effected through the issuance of subordinated, convertible notes to Mr. Lenfest and entering into a credit agreement (the PNC Agreement) with PNC Bank. The total proceeds from the Refinancing were $29,800,000.

Bank Credit and Facility

Since inception, the PNC Agreement has had numerous amendments. As of February 24, 2006, the facility total was $5,000,000 and use of this amount was restricted to the issuance of international letters of credit. This line was secured by all of our assets as well as a $5,000,000 personal guarantee by Mr. Lenfest.

On June 28, 2006, we signed an amendment to the PNC Agreement which (i) extended the agreement s termination date to the earlier of June 30, 2007 or such date to which we and PNC Bank have agreed in writing, (ii) terminated the Security Agreement and Mortgage, thereby releasing our assets as collateral for the facility, (iii) adjusted the Tangible Net Worth covenant to a minimum of $9,000,000, and (iv) made other changes to the PNC Agreement. This $5,000,000 facility remains restricted to use for issuing letters of credit.

On November 16, 2006, we entered into a Letter Agreement with PNC Bank. This Letter Agreement amended, restated and replaced the existing PNC Credit Agreement. Pursuant to such agreement, PNC Bank (i) terminated our Credit Agreement dated as of February 18, 2003 (ii) re-approved our $5,000,000 Line of Credit for Letters of Credit, and (iii) re-affirmed the Tangible Net Worth covenant (as defined in the Letter Agreement) to be a minimum of $9,000,000. The $5 million Line of Credit for Letters of Credit will continue to be guaranteed by Mr. Lenfest. As of November 24, 2006, we had used approximately $3,200,000 million of this facility for international letters of credit.

Management s Discussion and Analysis of Results of Operations and Financial Condition, continued

Equity Line

On April 7, 2006, ETC entered into a Preferred Stock Purchase Agreement (the Equity Agreement) with Mr. Lenfest, a Director, significant shareholder and holder of our subordinated debt. The Equity Agreement permits us to unilaterally draw down up to $15 million prior to October 2007 in exchange for shares of our newly-created Series B Cumulative Convertible Preferred Stock (Preferred Stock). The Preferred Stock provides for a dividend equal to six percent per annum. After three years, the Preferred Stock will be convertible, at Mr. Lenfest s request, into ETC common shares at a conversion price (the Conversion Price) which will be set on the day of each draw down. The Conversion Price will be equal to the closing price of our common stock on the trading day immediately preceding the day in which the draw down occurs, subject to a floor price of $4.95 per common share. Draw downs will not be permitted on any day when the Conversion Price would be less than this floor price. On the sixth anniversary of the Equity Agreement, any issued and outstanding Preferred Stock will be mandatorily converted into ETC common stock at each set Conversion Price. The Equity Agreement also allows us to redeem any outstanding Preferred Stock any time within the six-year term of the Equity Agreement. The Preferred Stock is entitled to vote with the ETC common stock on an as converted basis.

In connection with the execution of the Equity Agreement, in April 2006 we drew down $3,000,000 by issuing 3,000 shares of Preferred Stock with a Conversion Price equal to $4.95 per share. Additionally, on July 31, 2006, we drew down an additional $3,000,000 by issuing 3,000 shares of Preferred Stock at a Conversion Price equal to $6.68 per common share.

Unsecured Promissory Note

On November 16, 2006, we executed an Unsecured Promissory Note (the Lenfest Note) in favor of Mr. Lenfest in the aggregate principal amount of $3,000,000. Pursuant to the terms of the Lenfest Note, ETC can borrow up to $3,000,000 in increments of $1,000,000 prior to the maturity date of October 6, 2007. On November 17, 2006, ETC borrowed $3,000,000. The Lenfest Note plus all accrued interest was repaid in full on December 13, 2006.

All outstanding and unpaid interest on the Lenfest Note is due and payable on the earlier of (i) October 6, 2007 or (ii) such date as we draw down funds sufficient to repay the amount due under the Lenfest Note pursuant to the Preferred Stock Purchase Agreement.

Borrowings made pursuant to the Lenfest Note will bear interest at an annual rate of six (6%) percent with such interest beginning to accrue on the date of the funding of each loan and, to the extent not paid, compounding on the first day of each month.

The Lenfest Note provides for customary events of default including, but not limited to, the nonpayment of any amount payable when due, certain bankruptcy, insolvency or receivership events and the imposition of certain judgments. Upon the occurrence of an event of default, Mr. Lenfest has the right to accelerate the maturity date of the Lenfest Note and demand immediate payment of all amounts payable there under.

Management s Discussion and Analysis of Results of Operations and Financial Condition, continued

Subordinated Convertible Debt

In connection with the financing provided by PNC on February 19, 2003, we entered into a Convertible Note and Warrant Purchase Agreement with Mr. Lenfest, pursuant to which we issued to Mr. Lenfest (i) a senior subordinated convertible promissory note (the Senior Subordinated Note) in the original principal amount of $10,000,000 and (ii) warrants to purchase 803,048 shares of our common stock. Upon the occurrence of certain events, we will be obligated to issue additional warrants to Mr. Lenfest. The Senior Subordinated Note accrues interest at the rate of 10% per annum (Mr. Lenfest reduced the rate to 8% on a temporary basis for the period December 1, 2004 through November 30, 2006) and matures on February 18, 2009. At our option, the quarterly interest payments may be deferred and added to the outstanding principal. The Senior Subordinated Note entitles Mr. Lenfest to convert all or a portion of the outstanding principal of, and accrued and unpaid interest on, the note into shares of common stock at a conversion price of $6.05 per share. The warrants could be exercised into shares of common stock at an exercise price equal to the lesser of $4.00 per share or two-thirds of the average of the high and low sale prices of the common stock for the 25 consecutive trading days immediately preceding the date of exercise.

Our obligations to Mr. Lenfest under the Convertible Note and Warrant Purchase Agreement are secured by a second lien on all of our assets, junior in rights to any lien (if any is in place) in favor of PNC Bank, including all of our real property.

As a condition of amending the PNC Agreement on August 24, 2004, Mr. Lenfest agreed to issue to PNC Bank on our behalf a limited guarantee to secure up to $5,000,000 in principal amount of any letters of credit issued under the amended facility. In consideration for issuing this guarantee, Mr.Lenfest receives a fee of 0.75% per annum of the average amount of letters of credit outstanding, payable on a quarterly basis, and received a warrant to purchase 200,000 shares of stock under the same terms and conditions as his existing warrant for 803,048 shares.

On February 14, 2005, Mr. Lenfest exercised all of his outstanding warrants and received 1,003,048 shares of common stock for approximately $3.9 million. Additionally, on February 14, 2005, Mr. Lenfest purchased 373,831 shares of common stock for approximately $2.0 million.

Under the Senior Subordinated Note, we must meet certain financial covenants including a Leverage Ratio, a Fixed Charge Ratio and a Tangible Net Worth Ratio. At November 24, 2006, we failed to meet any of these financial covenants but have obtained a waiver from Mr. Lenfest. This waiver applies to all periods through November 25, 2007. Except as specified, the waiver does not constitute a modification or alteration of any other terms or conditions in the Note, or a release of any of the lender s rights or remedies, all of which are reserved, nor does it release us or any guarantor from any duties, obligations, covenants or agreements including the consequences of any event of default, except as specified.

Long-Term Bonds

On March 15, 2000, we issued approximately $5,500,000 of unregistered Taxable Variable Rate Demand/Fixed Rate Revenue Bonds (Series of 2000). Net proceeds from these bonds were used to repay a $4,100,000 advance taken on our revolving credit facility and to finance construction of an addition to our main plant in Southampton, Pennsylvania. The bonds were secured by a $5,000,000 irrevocable direct pay Letter of Credit issued by PNC Bank which was scheduled to expire on February 17, 2006 and which was secured by all of our assets. At February 25, 2005, the bonds were fully cash collateralized. The bonds carried a maturity date of April 1, 2020, bore a variable interest rate which adjusted each week to a rate required to remarket the bonds at full principal value with a cap of 17%, and were subject to mandatory redemption of $275,000 per year for 19 years and $245,000 for the 20th year.

Management s Discussion and Analysis of Results of Operations and Financial Condition, continued

On June 30, 2005, we directed the trustee for the bonds to issue a redemption notice for all of our outstanding bonds and, on August 1, 2005, we utilized the restricted cash held by PNC Bank to redeem all outstanding bonds. As of May 27, 2005, all deferred financing charges associated with this bond issue had been fully amortized to our Consolidated Statements of Operations.

Liquidity

At any particular time, our cash position is affected by the timing of cash receipts for milestone payments on open orders, product sales and maintenance services and payments we make for inventory and on account of operating expenses, including legal expenses, resulting in significant quarter-to-quarter, as well as within a quarter, fluctuations in our cash balances. We face increased liquidity risk if we do not receive cash flow from operating activities as planned. Our principal sources of liquidity are our cash balances, cash from operations and our promissory note and equity line with Mr. Lenfest. Given our inability to borrow cash under the amended PNC Agreement and certain restrictions in the Equity Agreement, we may need to obtain additional sources of capital in order to continue growing and operating our business. This capital may be difficult to obtain and the cost of this additional capital is likely to be relatively high. However, because we have established businesses in many markets, significant fixed assets including a building, and other valuable business assets which can be used as collateral for an investor or lender, we believe that we will be able to locate such additional capital and that the actions by PNC Bank will not have a long-term material adverse effect on our business.

In reference to our outstanding claims with the U.S. Navy, to the extent we are unsuccessful in recovering a significant portion of recorded claim contract costs, and to the extent that significant additional legal expenses are required to bring the dispute to resolution, such events could have a material adverse effect on our liquidity and results of operations. Historically, we have had favorable experience in that recoveries have exceeded recorded claims, including significant settlement agreements in fiscal 2003, 2004 and 2005. (See Note 2 to the Consolidated Financial Statements, Accounts Receivable).

Most of our contracts include stage or milestone payment clauses in which the customer advances funds to facilitate the cost of engineering, purchase of materials and production. These advance funds are a significant source of working capital, especially where the project is high in dollar value and requires multiple years to complete.

We are evaluating different business models to generate sales and working capital. These include providing contract training, revenue sharing and leasing our products to third parties. If successful, these alternate approaches may provide a more consistent and predictable cash flow to support our operations.

Management s Discussion and Analysis of Results of Operations and Financial Condition, continued

The following table presents our contractual cash flow commitments on long-term debt and operating leases.

	Payments Due by Period				
	Total	Less Than 1 Year	1-3 Years	4-5 Years	After 5 Years
	(in thousands)				
Long-term debt, including current maturities	$8,709	$	$8,709	$	$
Operating leases	567	32	338	197	
Total	$9,276	$32	$9,047	$197	$

Long-term debt is reported net of unamortized discount of $1,291,000 on the Company s subordinated debt.

As of December 29, 2006, the Company had available a total of $9,000,000 under the promissory note and equity line with Mr. Lenfest and approximately $1,800,000 available under the Letter of Credit line with PNC.

We believe that existing cash balances at November 24, 2006, cash generated from operating activities as well as future availability under our promissory note and equity line with Mr. Lenfest will be sufficient to meet our future obligations through at least November 25, 2007. Our plans assume customer acceptances and subsequent collections from a few large customers, as well as cash receipts on new bookings.

As of November 24, 2006, claims recorded against the U.S. Government totaled $3,004,000. To the extent we are unsuccessful in recovering a significant portion of recorded claim contract costs, and to the extent that significant additional legal expenses are required to bring the dispute to resolution, such events could have a material adverse effect on our liquidity and results of operations. Historically, we have had favorable experience in that recoveries have exceeded recorded claims, including significant settlement agreements in fiscal 2003, 2004 and 2005. However, there is no assurance that we will continue to have positive experience with regard to recoveries for our contract claims. (See Note 2 to the Consolidated Financial Statements, Accounts Receivable).

Claim costs have been incurred in connection with customer caused delays, errors in specifications and designs, other out-of-scope items and exchange losses and may not be received in full during fiscal 2007. In conformity with accounting principles generally accepted in the United States of America, revenue recorded for a claim may not exceed the incurred contract costs related to the claim.

In November 2003, the U.S. Government completed an audit of the submarine rescue decompression chamber project claim, rejecting most of the items due to audit or engineering reasons. We were not provided a copy of the Government s Technical Report which questioned approximately half of the claim costs. We have submitted a written rebuttal to the draft report. On July 22, 2004, the U.S. Government s contracting officer issued a final decision on the claim, basically denying the claim in full. We have updated the claim for additional costs expended on claimable items since the original submission and have converted the claim to a complaint which was filed in the Court of Federal Claims in July 2005. On November 7, 2005 the U.S. Government filed its response to our complaint, contesting each of the items.

Management s Discussion and Analysis of Results of Operations and Financial Condition, continued

This claim is currently in the discovery phase, including the mutual exchange of documents. Depositions are expected to last through the end of January 2007. Assuming no further delays, the case is scheduled to go to trial in July 2007.

This U. S. Government claim has followed the typical process of claim notification, preparation, submittal and government audit and review by the contracting officer. Historically, our experience has indicated that most claims are initially denied in part or in full by the contracting officer (or no decision is forthcoming, which is then taken to be a deemed denial) which then forces us to seek relief in a court of law.

We consider the recorded costs to be realizable due to the fact that the costs relate to customer caused delays, errors and changes in specifications and designs, disputed liquidated damages and other out of scope items. The U.S. Government, citing failure to deliver the product within contract terms, has assessed liquidated damages but has not offset or withheld any progress payments due to us under the contract. We dispute the basis for these liquidated damages, noting that applicable U.S. Government purchasing regulations allow for a waiver of these charges if the delay is beyond the control and not due to our fault or negligence. However, following accounting principles generally accepted in the United States of America, we have reduced contract values and corresponding revenue recognition by an estimated amount of $330,000 to cover a delay through the extended delivery period.

On June 16, 2003, we filed for arbitration in Thailand seeking recovery of the $700,000 open balance on the RTAF contract. On March 23, 2006, the Arbitration panel awarded us $314,813 plus interest from March 1, 2006 as full settlement of this dispute. Although the award is final with the arbitration panel, the RTAF has filed a motion in the Thai court to void the award, citing that the award was illegal and thus against the public order and unfair to the RTAF. On August 9, 2006, we filed our defense to this motion with the court. In September 2006, at a pre-trial session the court ordered the parties to produce witnesses to testify. This testimony has been scheduled for August and September 2007.

If the RTAF loses on its motion but does not honor the decision, the award will have to be enforced through the court system in Thailand, a process which may be time consuming and costly. The assets of the RTAF are not subject to enforcement. At this point, we are not able to determine what the ultimate result of this dispute will be. However, we have established sufficient receivable reserves so that any resolution will not have a material impact on our financial position or results of operations.

Historically, the Company has had positive experience with regard to its contract claims in that recoveries have exceeded the carrying value of claims. Although the claim with the U.S. Government was filed in the Court of Federal Appeals whereas prior claims have been filed with the Armed Services Board of Contract Appeals (ASBCA), the litigation has followed a consistent process and time frame as prior claims. The dispute with the RTAF has been outstanding for over 10 years, although the arbitration award occurred on March 23, 2006.

There is no assurance that the Company will always have positive experience with regard to recoveries for its contract claims.

Management s Discussion and Analysis of Results of Operations and Financial Condition, continued

Backlog

Our sales backlog at November 24, 2006 and February 24, 2006, for work to be performed and revenue to be recognized under written agreements after such dates, was $9,097,000 and $8,132,000, respectively. In addition, our training, maintenance and upgrade contracts backlog at November 24, 2006 and February 24, 2006, for work to be performed and revenue to be recognized after such dates under written agreements, was $1,448,000 and $1,774,000, respectively. Of the November 24, 2006 backlog, we have contracts totaling approximately $5,250,000 for PTS and PTS maintenance support, including $1,969,000 for Indonesia. Our order flow does not follow any seasonal pattern as we receive orders in each fiscal quarter of its fiscal year.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

We are exposed to various market risks, including changes in interest rates. Market risk is the potential loss arising from adverse changes in market rates and prices, such as interest rates and foreign currency exchange rates. We do not enter into derivatives or other financial instruments for trading or speculative purposes. We also have not entered into financial instruments to manage and reduce the impact of changes in interest rates and foreign currency exchange rates although we may enter into such transactions in the future. Although currently none of our debt bears interest at rates that vary with the prime rate of interest, it is expected that any additional debt which we might incur would carry a floating rate. If this were the case, any increases in the applicable prime rate of interest would reduce our earnings. With respect to currency risk, where we have a contract which is denominated in a foreign currency, we often establish local in-country bank accounts and fund in-country expenses in the local currency, thus creating a natural currency hedge for a portion of the contract.

Item 4. Controls and Procedures

Under the supervision and with the participation of our management, including our chief executive officer and chief financial officer, we have evaluated the effectiveness of the design and operation of our disclosure controls and procedures as of November 24, 2006 (the Evaluation Date), and, based on this evaluation, our chief executive officer and chief financial officer have concluded that these controls and procedures were effective as of the Evaluation Date. There were no significant changes in our internal controls or in other factors that could significantly affect these controls subsequent to the Evaluation Date.

Disclosure controls and procedures (as defined in Rules 13a-14(c) and 15(d)-14(c) under the Securities Exchange Act of 1934, as amended) are our internal controls and other procedures that are designed to ensure that information we are required to disclose in the reports that we file or submit under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission s rules and forms. Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed by us in the reports that we file under the Exchange Act is accumulated and communicated to our management, including our chief executive officer and chief financial officer, as appropriate to allow timely decisions regarding required disclosure.

A control system, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the internal control system are met. Because of the inherent limitations of any internal control system, no evaluation of controls can provide absolute assurance that all control issues, if any, within a company have been detected.

Part II OTHER INFORMATION

Item 1. Legal Proceedings

In April 2003, Boenning & Scattergood, Inc. (B&S) filed suit against ETC in the Court of Common Pleas in Philadelphia, Pennsylvania, seeking payment of $901,843.46 for financing fees allegedly due to B&S pursuant to the terms of an agreement for investment banking services, which was entered into with a predecessor of B&S (the B&S Agreement). B&S alleged that it contacted the investors in ETC s February 2003 financing transaction and that it earned the claimed financing fees pursuant to the terms of the B&S Agreement. On August 17, 2005, ETC entered into an agreement to settle this litigation. The agreement was entered into for the purpose of resolving contested claims and disputes as well as avoiding the substantial costs, expenses and uncertainties associated with protracted and complex litigation, and was not an admission of fault or liability by either party. Under the guidance of FASB Statement No.5, an amount representing a probable settlement had been accrued in a prior period, so the payment under the settlement had no material impact on ETC s results of operations for the fiscal second quarter of fiscal 2006.

In June 2003, Entertainment Technology Corporation (EnTCo), our wholly-owned subsidiary, filed suit against Walt Disney World Co. and other entities (Disney) in the United States District Court for the Eastern District of Pennsylvania, alleging breach of contract for, among other things, failure to pay all amounts due under contract for the design and production of the amusement park ride Mission: Space located in Disney s Epcot Center. In response, in August 2003, Disney filed counterclaims against both EnTCo and us (under a guarantee) for, among other things, alleged failures in performance and design in the contract. Disney is seeking damages in excess of $65 million plus punitive damages. In December 2005 EnTCo filed a second suit against Disney, alleging breach of confidentiality and unfair trade practices. Both EnTCo and we believe that we have valid defenses to each of Disney s counterclaims and intend to vigorously defend ourselves against these counterclaims. Discovery is expected to be completed in the first quarter of fiscal 2007. The parties participated in a structured mediation in early December 2005 on the first suit, with no agreement forthcoming. The case is not currently scheduled for trial. Neither EnTCo nor we are able to predict the outcome of this matter.

Certain other claims, suits, and complaints arising in the ordinary course of business have been filed or are pending against us.

In our opinion, after consultation with legal counsel handling these specific maters, all such matters are reserved for or adequately covered by insurance or, if not so covered, are without merit or are of such kind, or involve such amounts, as would not have a significant effect on our financial position or results of operations if disposed of unfavorably.

Item 1A. Risk Factors

There have been no material changes to the Company s risk factors since fiscal 2006-year end. The reader is referred to Part I of the Company s Annual Report on Form 10-K for the fiscal year ended February 24, 2006, in the section entitled Risks Particular to our Business .

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

Please see Note 4 to the Notes to Consolidated Financial Statements of the Company, together with the Company s Current Report on Form 8-K, dated April 6, 2006, and the Company s Current Report on Form 8-K, dated July 31, 2006 for further information regarding the Company s sale of Series B Cumulative Convertible Preferred Stock to H.F. Lenfest under the Lenfest Equity Agreement.

Item 3. Defaults Upon Senior Securities

None.

Item 4. Submission of Matters to Vote of Security Holders

On September 21, 2006, the Company held its Annual Meeting to vote on proposals to elect five directors. The results of voting are as follows:

I.	Election of Directors	FOR	WITHHELD
	William F. Mitchell	9,038,801	224,264
	Alan Mark Gemmill	9,244,785	18,280
	Howard W. Kelley	9,244,785	18,280
	George K. Anderson, M.D.	9,038,889	224,176
	H. F. Lenfest	9,038,889	224,176

Item 5. Other Information

None.

Item 6. Exhibits

Number	Item
3.1	Registrant s Articles of Incorporation, as amended, were filed as Exhibit 3.1 to Registrant s Form 10-K for the year ended February 28, 1997 and are incorporated herein by reference.
3.2	Registrant s amended and restated By-Laws were filed as Exhibit 3.2 to Registrant s Form 8-K dated May 25, 2005, and are incorporated herein by reference.
31.1	Certification dated January 8, 2007 pursuant to 18 U.S.C. Section 1350 as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 made by William F. Mitchell, Chief Executive Officer.
31.2	Certification dated January 8, 2007 pursuant to 18 U.S.C. Section 1350 as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 made by Duane D. Deaner, Chief Financial Officer.
32	Certification dated January 8, 2007 pursuant to 18 U.S.C. Section 1350 as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 made by William F. Mitchell, Chief Executive Officer, and Duane D. Deaner, Chief Financial Officer.

Signatures

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

	ENVIRONMENTAL TECTONICS CORPORATION (Registrant)
Date: January 8, 2007	By: /s/ William F. Mitchell
	William F. Mitchell President and Chief Executive Officer (Principal Executive Officer)
Date: January 8, 2007	By: /s/ Duane Deaner
	Duane Deaner Chief Financial Officer (Principal Financial and Accounting Officer)