

ECC INTERNATIONAL CORP

Form 10-Q

May 15, 2003

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UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION

Washington, DC 20549

**FORM 10-Q**

(Mark One)

☒ QUARTERLY REPORT PURSUANT TO SECTION 13 or 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended March 31, 2003

or

☐ TRANSITION REPORT PURSUANT TO SECTION 13 or 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the transition period from      to

Commission File Number: 001-8988

**ECC International Corp.**

(Exact name of registrant as specified in its charter)

Delaware  
(State or other jurisdiction of incorporation or organization)

23-1714658  
(I.R.S. Employer Identification No.)

2001 West Oak Ridge Road, Orlando, FL  
(Address of principal executive offices)

32809-3803  
(Zip Code)

(407) 859-7410  
(Registrant's telephone number, including area code)

Not Applicable  
(Former name, former address and former fiscal year, if changed since last report)

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 twelve months (or for such shorter period that the Registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

☒ Yes ☐ No

Indicate by check mark whether the Registrant is an accelerated filer as defined in Rule 12b-2 of the Securities Exchange Act of 1934.

☐ Yes ☒ No

As of May 13, 2003, there were 7,902,197 shares of the Registrant's Common Stock, \$.10 par value per share, outstanding.

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ECC INTERNATIONAL CORP. AND SUBSIDIARIES  
CONSOLIDATED STATEMENTS OF OPERATIONS  
NINE MONTHS ENDED MARCH 31, 2003 AND 2002  
(In Thousands Except Per Share Data)  
(Unaudited)

|                                           | Nine Months<br>Ended<br>3/31/2003 | Nine Months<br>Ended<br>3/31/2002 |
|-------------------------------------------|-----------------------------------|-----------------------------------|
| Sales                                     | \$23,177                          | \$22,035                          |
| Cost of Sales                             | 15,425                            | 14,998                            |
| Gross Profit                              | 7,752                             | 7,037                             |
| Expenses:                                 |                                   |                                   |
| Selling, General & Administrative         | 4,396                             | 4,574                             |
| Independent Research and Development      | 961                               | 1,201                             |
| Total Expenses                            | 5,357                             | 5,775                             |
| Operating Income                          | 2,395                             | 1,262                             |
| Other Income/(Expense):                   |                                   |                                   |
| Interest Income                           | 64                                | 171                               |
| Interest Expense                          | (63)                              | (132)                             |
| Other Net                                 | (3)                               | 58                                |
| Total Other Income/(Expense)              | (2)                               | 97                                |
| Income Before Income Taxes                | 2,393                             | 1,359                             |
| (Benefit)/Provision for Income Taxes      |                                   | (215)                             |
| Net Income                                | \$ 2,393                          | \$ 1,574                          |
| Net Income Per Common Share-Basic/Diluted | \$ 0.30                           | \$ 0.20                           |

See accompanying notes to the consolidated financial statements.

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ECC INTERNATIONAL CORP. AND SUBSIDIARIES  
CONSOLIDATED STATEMENTS OF OPERATIONS  
THREE MONTHS ENDED MARCH 31, 2003 AND 2002  
(In Thousands Except Per Share Data)  
(Unaudited)

|                                      | Three<br>Months<br>Ended<br>3/31/2003 | Three<br>Months<br>Ended<br>3/31/2002 |
|--------------------------------------|---------------------------------------|---------------------------------------|
| Sales                                | \$ 8,851                              | \$ 9,139                              |
| Cost of Sales                        | 6,151                                 | 5,995                                 |
| Gross Profit                         | 2,700                                 | 3,144                                 |
| Expenses:                            |                                       |                                       |
| Selling, General & Administrative    | 1,723                                 | 1,410                                 |
| Independent Research and Development | 333                                   | 320                                   |
| Total Expenses                       | 2,056                                 | 1,730                                 |
| Operating Income                     | 644                                   | 1,414                                 |
| Other Income/(Expense):              |                                       |                                       |
| Interest Income                      | 17                                    | 137                                   |
| Interest Expense                     | (21)                                  | (44)                                  |
| Other Net                            | (2)                                   | 12                                    |
| Total Other Income/(Expense)         | (6)                                   | 105                                   |
| Income Before Income Taxes           | 638                                   | 1,519                                 |
| (Benefit)/Provision for Income Taxes |                                       | (215)                                 |
| Net Income                           | \$ 638                                | \$ 1,734                              |

See accompanying notes to the consolidated financial statements.

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ECC INTERNATIONAL CORP. AND SUBSIDIARIES  
CONSOLIDATED BALANCE SHEETS  
(In Thousands)

|                                                                                | (Unaudited)<br>3/31/2003 | (Audited)<br>6/30/2002 |
|--------------------------------------------------------------------------------|--------------------------|------------------------|
| <b>ASSETS</b>                                                                  |                          |                        |
| Current Assets:                                                                |                          |                        |
| Cash                                                                           | \$ 6,759                 | \$ 6,280               |
| Accounts Receivable                                                            | 2,286                    | 2,152                  |
| Costs and Estimated Earnings in Excess of Billings<br>on Uncompleted Contracts | 13,408                   | 9,458                  |
| Inventories                                                                    | 605                      | 920                    |
| Prepaid Expenses and Other                                                     | 164                      | 274                    |
|                                                                                | <hr/>                    | <hr/>                  |
| Total Current Assets                                                           | 23,222                   | 19,084                 |
|                                                                                | <hr/>                    | <hr/>                  |
| Property, Plant and Equipment Net                                              | 11,137                   | 11,823                 |
|                                                                                | <hr/>                    | <hr/>                  |
| Other Assets                                                                   | 28                       | 32                     |
|                                                                                | <hr/>                    | <hr/>                  |
| Total Assets                                                                   | \$34,387                 | \$30,939               |
|                                                                                | <hr/>                    | <hr/>                  |

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ECC INTERNATIONAL CORP. AND SUBSIDIARIES  
CONSOLIDATED BALANCE SHEETS (Continued)  
(In Thousands Except Share and Per Share Data)

|                                                                                                                                             | (Unaudited)<br>3/31/2003 | (Audited)<br>6/30/2002 |
|---------------------------------------------------------------------------------------------------------------------------------------------|--------------------------|------------------------|
| <b>LIABILITIES &amp; STOCKHOLDERS EQUITY</b>                                                                                                |                          |                        |
| Current Liabilities:                                                                                                                        |                          |                        |
| Accounts Payable                                                                                                                            | \$ 3,209                 | \$ 2,121               |
| Accrued Expenses and Other                                                                                                                  | 1,680                    | 1,972                  |
|                                                                                                                                             | <u>          </u>        | <u>          </u>      |
| Total Current Liabilities                                                                                                                   | 4,889                    | 4,093                  |
| Deferred Income Taxes                                                                                                                       | 61                       | 61                     |
|                                                                                                                                             | <u>          </u>        | <u>          </u>      |
| Total Liabilities                                                                                                                           | 4,950                    | 4,154                  |
|                                                                                                                                             | <u>          </u>        | <u>          </u>      |
| <b>COMMITMENTS AND CONTINGENCIES</b>                                                                                                        |                          |                        |
| Stockholders Equity:                                                                                                                        |                          |                        |
| Preferred Stock, \$.10 par; 1,000,000 shares authorized; none issued and outstanding                                                        |                          |                        |
| Common Stock, \$.10 par; 20,000,000 shares authorized; issued and outstanding, 8,621,197 and 7,894,197 (8,577,608 and 7,850,608 at 6/30/02) | 862                      | 858                    |
| Note Receivable from Stockholder                                                                                                            |                          | (168)                  |
| Capital in Excess of Par                                                                                                                    | 25,580                   | 25,493                 |
| Retained Earnings                                                                                                                           | 5,904                    | 3,511                  |
| Treasury Stock, at cost (727,000 shares)                                                                                                    | (2,909)                  | (2,909)                |
|                                                                                                                                             | <u>          </u>        | <u>          </u>      |
| Total Stockholders Equity                                                                                                                   | 29,437                   | 26,785                 |
|                                                                                                                                             | <u>          </u>        | <u>          </u>      |
| Total Liabilities & Stockholders Equity                                                                                                     | \$ 34,387                | \$ 30,939              |
|                                                                                                                                             | <u>          </u>        | <u>          </u>      |

See accompanying notes to the consolidated financial statements.

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ECC INTERNATIONAL CORP. AND SUBSIDIARIES  
CONSOLIDATED STATEMENTS OF CASH FLOWS  
NINE MONTHS ENDED MARCH 31, 2003 AND 2002  
(In Thousands)  
(Unaudited)

|                                                                                | Nine Months<br>Ended<br>3/31/2003 | Nine Months<br>Ended<br>3/31/2002 |
|--------------------------------------------------------------------------------|-----------------------------------|-----------------------------------|
| Cash Flows From Operating Activities:                                          |                                   |                                   |
| Net Income                                                                     | \$ 2,393                          | \$ 1,574                          |
| Items Not Requiring Cash:                                                      |                                   |                                   |
| Depreciation                                                                   | 931                               | 1,466                             |
| Amortization                                                                   | 48                                | 75                                |
| Loss/(Gain) on Disposal of Equipment                                           | 150                               | (5)                               |
| Changes in Certain Assets and Liabilities:                                     |                                   |                                   |
| Accounts Receivable                                                            | (134)                             | (907)                             |
| Costs and Estimated Earnings in Excess of Billings on<br>Uncompleted Contracts | (3,949)                           | 652                               |
| Inventories                                                                    | 315                               | 84                                |
| Prepaid Expenses and Other                                                     | 66                                | (8)                               |
| Accounts Payable                                                               | 1,088                             | (525)                             |
| Accrued Expenses and Other Long-Term Liabilities                               | (293)                             | (348)                             |
| Net Cash Provided By Operating Activities                                      | 615                               | 2,058                             |
| Cash Flows From Investing Activities:                                          |                                   |                                   |
| Proceeds from Sales of Assets                                                  | 27                                | 5                                 |
| Additions to Property, Plant and Equipment                                     | (422)                             | (302)                             |
| Net Cash Used In Investing Activities                                          | (395)                             | (297)                             |
| Cash Flows From Financing Activities:                                          |                                   |                                   |
| Proceeds From Issuance of Common Stock and Options Exercised                   | 91                                | 10                                |
| Note Receivable from Stockholder                                               | 168                               |                                   |
| Borrowings Under Revolving Credit Facility                                     |                                   | 4,873                             |
| Repayments Under Revolving Credit Facility                                     |                                   | (5,030)                           |
| Net Cash Provided By/(Used In) Financing Activities                            | 259                               | (147)                             |
| Net Increase in Cash                                                           | 479                               | 1,614                             |
| Cash at Beginning of the Period                                                | 6,280                             | 39                                |
| Cash at End of the Period                                                      | \$ 6,759                          | \$ 1,653                          |

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ECC INTERNATIONAL CORP. AND SUBSIDIARIES  
CONSOLIDATED STATEMENTS OF CASH FLOWS  
NINE MONTHS ENDED MARCH 31, 2003 AND 2002 (Continued)  
(In Thousands)  
(Unaudited)

|                                                         | <b>Nine<br/>Months<br/>Ended<br/>3/31/2003</b> | <b>Nine<br/>Months<br/>Ended<br/>3/31/2002</b> |
|---------------------------------------------------------|------------------------------------------------|------------------------------------------------|
| Supplemental Disclosure of Cash Flow Information:       |                                                |                                                |
| Cash Paid During the Year For:                          |                                                |                                                |
| Interest                                                | \$ 63                                          | \$ 145                                         |
| Supplemental Schedule of Non Cash Financing Activities: |                                                |                                                |
| Issuance of Director Equity Compensation                | \$                                             | \$ 8                                           |

See accompanying notes to the consolidated financial statements.

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## ECC INTERNATIONAL CORP. AND SUBSIDIARIES NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Unaudited)

- The accompanying consolidated financial statements are unaudited and have been prepared by ECC International Corp. (the Company) pursuant to the rules and regulations of the Securities and Exchange Commission. The June 30, 2002 consolidated balance sheet was derived from audited consolidated financial statements but does not include all disclosures required by generally accepted accounting principles. In the opinion of management, the accompanying unaudited consolidated financial statements contain all adjustments, consisting of only normal recurring adjustments, necessary to present fairly the consolidated financial position, results of operations, comprehensive income and cash flows for the interim presented. These unaudited consolidated financial statements should be read in conjunction with the consolidated financial statements and footnotes thereto in the Company's Annual Report on Form 10-K for the fiscal year ended June 30, 2002.

The Company has no Comprehensive Income other than Net Income.

### 2. New Accounting Pronouncements

Effective January 1, 2003, the Company adopted SFAS No. 146, "Accounting for costs associated with Exit or Disposal Activities", which addresses the recognition, measurement and reporting of costs that are associated with exit and disposal costs. SFAS 146 is effective for exit or disposal activities that are initiated after December 31, 2002. Severance costs incurred during the quarter ended March 31, 2003 have been recorded as incurred in accordance with the Standard.

In December 2002, the Financial Accounting Standards Board issued SFAS No. 148 "Accounting for Costs Associated with Stock Based Compensation - Transition and Disclosure - an Amendment of FAS 123" which amends SFAS No. 123 "Accounting for Stock Based Compensation", to provide alternative methods of transition for a voluntary change to the fair value method of accounting for stock-based employee compensation. In addition, this statement amends the disclosure requirements of SFAS 123 to require prominent disclosure of the method of accounting for stock based compensation and the effect of the method on reported results. The interim disclosure requirements are effective for quarters beginning after December 15, 2002 and have been included in the following table:

|                                                                                                                             | Three<br>Months<br>Ended<br>3/31/2003 | Nine<br>Months<br>Ended<br>3/31/2002 |
|-----------------------------------------------------------------------------------------------------------------------------|---------------------------------------|--------------------------------------|
| Net Income, as reported                                                                                                     | \$ 638                                | \$2,393                              |
| Deduct:                                                                                                                     |                                       |                                      |
| Total stock-based employee compensation expense determined under fair value based method for all awards, net of related tax | 7                                     | 61                                   |
| Pro Forma Net Income                                                                                                        | \$ 631                                | \$2,332                              |
| Earnings Per Share:                                                                                                         |                                       |                                      |
| Basic- as reported                                                                                                          | \$ 0.08                               | \$ 0.30                              |
| Basic pro forma                                                                                                             | \$ 0.08                               | \$ 0.30                              |
| Diluted as reported                                                                                                         | \$ 0.08                               | \$ 0.30                              |
| Diluted pro forma                                                                                                           | \$ 0.08                               | \$ 0.29                              |

|                   | (In Thousands)<br>3/31/2003 | 6/30/2002 |
|-------------------|-----------------------------|-----------|
| Work in Process   | \$ 101                      | \$ 187    |
| Raw Materials     | 566                         | 1,343     |
| Total Gross Value | 667                         | 1,530     |
| Reserves          | (62)                        | (610)     |

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|           |        |        |
|-----------|--------|--------|
| Net Value | \$ 605 | \$ 920 |
|-----------|--------|--------|

Due to the recent reconfiguration of the Company operations into a smaller area, the Company disposed of a portion of its excess and obsolete raw materials inventory which had been fully reserved in prior years.

Work in process inventory is valued using the specific identification cost method, but not in excess of net realizable value. The Company values raw materials at the lower of average cost or market. On a quarterly basis, inventory items are evaluated to identify slow-moving, excess or obsolete parts. An assessment of potential use on future programs including spare parts orders, repairs and warranty work, is the basis for the establishment of a reserve for excess and obsolete inventory.

#### 4. Debt

On June 24, 1999, the Company entered into a revolving credit facility ( Credit Facility ) with Mellon Bank, N.A., which was subsequently purchased by LaSalle Business Credit, totaling \$12.5 million and expires on June 24, 2003. The Credit Facility was amended in November 2001 to reduce the line of credit to \$5.0 million. Available borrowings are based on a formula of receivables and property, as defined in the Credit Facility. As of March 31, 2003, there was no outstanding balance under the Credit Facility and the Company is in compliance with the covenants. Based on the positive cash balance since July 13, 2001 and the positive cash

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projections for the balance of fiscal year 2003, management believes that operational cash requirements can be funded internally through the next fiscal year. The Company is in discussions with several banks regarding a new Credit Facility.

The Credit Facility includes a subjective acceleration clause as well as a lockbox requirement under the control of the lender, whereby all collections of trade receivables are used to immediately reduce any outstanding balance under the Credit Facility.

### **5. Income Taxes**

The Company has approximately \$12.3 million of cumulative federal net operating loss carryforwards, which expire between 2019 and 2022. In addition, the Company had available at June 30, 2002, cumulative net operating loss carryforwards of \$18.0 million for Florida state income tax purposes, which expire between 2019 and 2022. This amount is prior to an adjustment resulting from current year profit. A 100% valuation allowance is recorded against these deferred tax assets due to the uncertainty of their ultimate realization.

### **6. Unusual Expenses**

Dr. James C. Garrett, former President and Chief Executive Officer of the Company resigned in June 2002. Severance costs totaling approximately \$255,000 were recorded in June 2002, and are included in Accrued Expenses and Other. These costs are being paid during fiscal year 2003. On July 1, 2002, Dr. Garrett repaid in full an outstanding Promissory Note owed the Company, which included the principal balance of \$146,250 and accrued interest through June 30, 2002 of \$33,000 for a total of \$179,250.

In July 2002, the Company reduced its operating cost by eliminating 15 employees or 11% of the employees. The employee termination benefits associated with the reductions were approximately \$202,000 and were recorded in the first quarter of fiscal year 2003. Annual compensation savings associated with these actions were approximately \$1.2 million.

During the first quarter of fiscal year 2003, retention agreements were implemented in order to temporarily retain 11 key employees whose jobs will be outsourced due to the consolidation of the workforce into a smaller space. Severance payments and retention bonuses will be earned as the employees are terminated based on the employees remaining with the Company through completion dates ranging from November 2002 through March 2003. As of March 31, 2003, all of these key employees left the Company and severance payments and retention bonuses totaling \$100,000 were paid.

Effective January 1, 2003, the Company adopted SFAS No. 146, *Accounting for Exit or Disposal Activities*, which addresses the recognition, measurement and reporting of costs that are associated with exit and disposal costs. SFAS 146 is effective for exit or disposal activities that are initiated after December 31, 2002. Severance costs incurred during the quarter ended March 31, 2003 have been recorded as incurred in accordance with the Standard.

The following table sets forth the details and the cumulative activity associated with the accrual of these termination costs (In Thousands):

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|                                                   |        |
|---------------------------------------------------|--------|
| Accrued Employee Termination Benefits at 6/30/02  | \$ 255 |
| Cash Payments                                     | (193)  |
| Employee Termination Benefits Incurred            | 202    |
|                                                   | <hr/>  |
| Accrued Employee Termination Benefits at 9/30/02  | 264    |
| Cash Payments                                     | (129)  |
|                                                   | <hr/>  |
| Accrued Employee Termination Benefits at 12/31/02 | 135    |
| Cash Payments                                     | (108)  |
| Employee Termination Benefits Incurred            | 45     |
|                                                   | <hr/>  |
| Accrued Employee Termination Benefits at 3/31/03  | \$ 72  |
|                                                   | <hr/>  |

## 7. Business Segment Information

The Company operates only in the training segment which includes the design and manufacture of training simulators.

Sales by Class of Customer (In Thousands):

|                            | Nine Months Ended |           | Three Months Ended |           |
|----------------------------|-------------------|-----------|--------------------|-----------|
|                            | 3/31/2003         | 3/31/2002 | 3/31/2003          | 3/31/2002 |
| U.S. Department of Defense | \$12,112          | \$ 4,479  | \$ 6,040           | \$ 975    |
| Direct Subcontract         | 11,064            | 17,556    | 2,811              | 8,164     |
|                            | <hr/>             | <hr/>     | <hr/>              | <hr/>     |
| Total Sales                | \$23,176          | \$ 22,035 | \$ 8,851           | \$ 9,139  |
|                            | <hr/>             | <hr/>     | <hr/>              | <hr/>     |

Export Sales from the U.S. were not material for the three-month and nine-month periods ended March 31, 2003 and March 31, 2002. Export sales do not include Foreign Military Sales through U.S. Government Agencies and prime contractors of \$454,755 and \$694,849 during the three-month and nine-month periods ended March 31, 2003, respectively.

Since a substantial portion of the Company's revenues are attributable to long-term contracts with various government agencies, any factor affecting procurement of long-term government contracts such as changes in government spending, cancellation of weapons programs and delays in contract awards could have a material impact on the Company's financial condition and results of operations.

Sales by Geographic Area

All of the Company's Revenues, Operating Income and Long-Lived Assets are within the United States.

## 8. Earnings Per Share

Basic earnings per common share is computed by dividing net earnings available to common stockholders by the weighted-average number of common shares outstanding during the period. Diluted earnings per share is computed by dividing net earnings available to common

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stockholders by the weighted-average number of common shares outstanding during the period adjusted for the number of shares that would have been outstanding if the dilutive potential common shares resulting from the exercise of stock options had been issued. The diluted earnings per share does not assume the exercise of stock options that would have an antidilutive effect on earnings per share.

The Company's dilutive potential common shares consist of stock options. In calculating diluted earnings per share, 110,012 and 42,998 dilutive potential common shares were included for the three-month and the nine-month periods ended March 31, 2003, respectively. For the three-month and nine-month periods ended March 31, 2002, the calculation of diluted earnings per share included 9,934 and 16,987 dilutive potential common shares, respectively.

The weighted-average number of common shares outstanding for each period presented is as follows:

|         | Nine Months Ended |           | Three Months Ended |           |
|---------|-------------------|-----------|--------------------|-----------|
|         | 3/31/2003         | 3/31/2002 | 3/31/2003          | 3/31/2002 |
| Basic   | 7,870,643         | 7,832,896 | 7,883,064          | 7,836,844 |
| Diluted | 7,913,641         | 7,849,883 | 7,993,076          | 7,846,778 |

9. Commitments and Contingencies

During the first quarter of fiscal year 2003, retention agreements were implemented in order to temporarily retain 11 key employees whose jobs will be outsourced due to the consolidation of the workforce into a smaller space. See Note 5 of the Notes to Consolidated Financial Statements.

The Company is party to various legal proceedings arising from normal business activity. Management believes that the ultimate resolution of these matters will not have an adverse material effect on the Company's financial condition, cash flow, or results of operations.

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ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

Overview

This Quarterly Report on Form 10-Q contains forward-looking statements within the meaning of Section 21E of the Securities Exchange Act of 1934, as amended, and Section 27A of the Securities Act of 1933, as amended. For this purpose, any statements contained herein that are not statements of historical fact may be deemed to be forward-looking statements. Without limiting the foregoing, the words believes, anticipates, plans, expects, and similar expressions are intended to identify forward-looking statements. There are a number of factors that could cause the Company's actual results to differ materially from those indicated by such forward-looking statements. These factors include, without limitation, those set forth below under the caption Certain Factors That May Affect Future Operating Results.

a) Material Changes in Financial Condition

During the nine-month period ended March 31, 2003, the Company's principal source of cash was from operations. The Company's cash balance increased by \$479,000 to \$6,759,000 since fiscal year end 2002 due primarily to lower working capital requirements to support operations. The Company's working capital increased \$3,342,000 since fiscal year end 2002 primarily due to an increase in the unbilled receivables (costs and estimated earnings in excess of billings on uncompleted contracts.)

Liquidity and Capital Resources

As of March 31, 2003, the Company is in compliance with the Credit Facility covenants. See Note 3 of the Notes to Consolidated Financial Statements for more information on the Credit Facility. Based on the positive cash balance since July 13, 2001 and the positive cash projections for the balance of fiscal year 2003, management believes that operational cash requirements can be funded internally through the next fiscal year. The current Credit Facility expires on June 24, 2003. The Company is in discussions with several banks regarding a new Credit Facility.

During the nine-month period ended March 31, 2003, the Company spent approximately \$400,000 to consolidate into 90,000 square feet of the Orlando facility and to purchase new machinery and equipment. No material additional funds are expected to be spent on this effort during the remainder of the fiscal year. The Company is continuing to offer the real estate for sale with a partial leaseback and is also evaluating the prospect of upgrading the vacant portion of the facility and leasing it to potential tenants.

In July 2002, the Company reduced its operating cost by eliminating 15 employees or 11% of the employees. The employee termination benefits associated with the reductions were approximately \$202,000 and were recorded in the first quarter of fiscal year 2002. Annual compensation savings associated with these actions were approximately \$1.2 million.

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During the first quarter of fiscal year 2003, retention agreements were implemented in order to temporarily retain 11 key employees whose jobs will be outsourced due to the consolidation of the workforce into a smaller space. Severance payments and retention bonuses will be earned as the employees are terminated based on the employees remaining with the Company through completion dates ranging from November 2002 through March 2003. As of March 31, 2003, all of these key employees left the Company and severance payments and retention bonuses totaling \$100,000 were paid.

Management's plans to improve future profitability include: (1) a continuation of both direct and indirect cost reduction initiatives and improvement of operating performance, (2) an aggressive focus on obtaining follow-on awards to existing business, and (3) the implementation of strategies to procure new business and penetrate new markets.

Other than as stated above, the Company currently has no other material commitments for capital expenditures. Management believes that with the funds available under its projected cash flows, the Company will have sufficient resources to meet planned operating commitments through the next fiscal year.

**b) Material Changes in Results of Operations**

Sales increased 5% or \$1,142,000 for the nine-month period ended March 31, 2003, compared to the same period a year ago due primarily to increased revenues resulting from EST Lot 3 and the SIMNET Visuals program awards.

Gross margin as a percentage of sales was 31% for the three-month period ended March 31, 2003 compared to 34% for the same period a year ago. This difference in gross margin results primarily from higher volume on the EST and SIMNET programs which have lower margins compared to the Javelin programs. Gross margin for the nine-month periods ended March 31, 2003 and 2002 was 33% and 32%, respectively.

Selling, general and administrative expenses increased 22% or \$313,000 for the three-month period ended March 31, 2003, compared to the same period a year ago due primarily to increased bid and proposal activities to pursue new contracts. Selling, general and administrative expense decreased 4% or \$178,000 during the nine-month period ended March 31, 2003 compared to the same period a year ago due primarily to the aggressive cost reduction actions.

Independent research and development expenses decreased 20% or \$240,000 during the nine-month period ended March 31, 2003, compared to the same period a year ago primarily due to reduced activities related to the EST 2000 product.

The Company has approximately \$12.3 million of cumulative federal net operating loss carryforwards, which expire between 2019 and 2022. A full valuation allowance has been provided for these net operating loss carryforwards which were subject to uncertainty as to their ultimate realization. No tax provision was recorded for the three-month period ended March 31, 2003, as the Company anticipates utilization of the net operating loss carryforwards with a reduction in the valuation allowance.

Certain Factors That May Affect Future Operating Results

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The following important factors, among others, could cause actual results to differ materially from those indicated by forward-looking statements made in this Quarterly Report on Form 10-Q and presented elsewhere by management from time to time. All forward-looking statements included in this Form 10-Q are based on information available to the Company on the date hereof, and the Company assumes no obligation to update such forward-looking statements.

A number of uncertainties exist that could affect the Company's future operating results including, without limitation, general economic conditions, changes in government spending, borrowing availability under and compliance with the Credit Facility, cancellation of weapons programs, delays in contract awards, delays in the acceptance process of contract deliverables, the Company's continued ability to develop and introduce products, the introduction of new products by competitors, pricing practices of competitors, the cost and availability of parts and the Company's ability to control costs.

To date, a substantial portion of the Company's revenues have been attributable to long-term contracts with various government agencies. As a result, any factor adversely affecting procurement of long-term government contracts could have a material adverse effect on the Company's financial condition and results of operations.

Because of these and other factors, past financial performance should not be considered an indication of future performance. The Company's future quarterly operating results may vary significantly. Investors should not use historical trends to anticipate future results and should be aware that the trading price of the Company's Common Stock may be subject to wide fluctuations in response to quarterly variations in operating results and other factors, including those discussed above.

### **Critical Accounting Policies**

The Company considers that certain accounting policies are critical due to the estimation process involved in each of them. The assumptions and judgement utilized in developing these estimates are based on the information available at the time including an assessment of the risks and uncertainties. These estimates and assumptions affect the reported amounts of assets and liabilities at the date of the financial statements and the reported amounts of revenue and expenses during the periods presented. The significant accounting policies, which the Company believes are the most critical to aid in fully understanding and evaluating its reported financial results, include the following:

### **Revenue Recognition**

Contract sales and anticipated profits are recognized using the percentage of completion method measured by the ratio of costs incurred to date to estimated total costs. The Company reevaluates the estimated costs to complete on the entire contract on a quarterly basis. Any revisions in estimated costs or contract value during the progress of the work may affect the estimated gross margin percentage for the contract. Estimated costs may be adjusted favorably or unfavorably based on projected changes in areas such as labor efficiencies, material price negotiations, supplier delivery schedules, design and development progress and overhead rate projections.

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Changes in gross margin percentages have the effect of adjusting the current period earnings applicable to performance in prior periods.

Anticipated losses on contracts in progress are recorded in the period in which the losses are identified. Claims would be included as a component of contract value for purposes of revenue recognition at such time as the amount is reasonably determinable and probable.

**Inventories**

The Company values raw materials at the lower of average cost or market. On a quarterly basis, inventory items are evaluated to identify slow-moving, excess or obsolete parts. An assessment of potential use on future programs including spare parts orders, repairs and warranty work, is the basis for the establishment of a reserve for excess and obsolete inventory. Potential usage assessments may be impacted favorably or unfavorably by changes in the Company's projected contracts, parts obsolescence and level of spares and repairs.

**Deferred Tax Assets**

The Company has provided a full valuation reserve against its deferred tax assets. In the future, if sufficient evidence of the Company's ability to generate future taxable income becomes apparent, the Company may reduce its valuation allowances resulting in income tax benefits in the Company's consolidated statement of operations. Management evaluates the realizability of the deferred tax assets quarterly and assesses the valuation allowance quarterly.

**ITEM 3. Quantitative and Qualitative Disclosures About Market Risk**

The Company is subject to interest rate risk on its borrowings under the Credit Facility. The Credit Facility has a floating interest rate based on prevailing market rates. Accordingly, the carrying value of the debt is generally not affected by fluctuations in interest rates. However, such changes in interest rates could affect future interest expense and hence earnings and cash flows.

**ITEM 4. Controls and Procedures**

Based on their evaluation, as of a date within 90 days of the filing of this Form 10-Q, the Company's Chief Executive Officer and Chief Financial Officer have concluded the Company's disclosure controls and procedures (as defined in Rules 13a-14 and 15d-14 under the Securities Exchange Act of 1934) are effective. There have been no significant changes in internal controls or in other factors that could significantly affect these controls subsequent to the date of their evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

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PART II. OTHER INFORMATION  
ITEM 5. OTHER INFORMATION  
ECC INTERNATIONAL CORP. AND SUBSIDIARIES

ITEM 5. Other Information

On March 6, 2003, the Company announced the appointment of Robert L. Collins as Chief Executive Officer at an annual salary of \$200,000. He also received an option to purchase 50,000 shares of common stock which will vest over a four year period at 25% per year.

ITEM 6. Exhibits and Reports on Form 8-K

a. Exhibits

- |      |                                                                                                         |
|------|---------------------------------------------------------------------------------------------------------|
| 99.1 | Certification of Chief Executive Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002      |
| 99.2 | Certification of Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002      |
| 99.3 | Letter Agreement dated February 20, 2003 by and between ECC International Corp., and Robert L. Collins. |

b. Reports on Form 8-K

A Current Report on Form 8-K under Item 5 was filed on March 6, 2003, announcing the appointment of Robert L. Collins as Chief Executive Officer. In addition, the Form 8-K included a letter agreement between the Company and Mr. Collins regarding his offer of employment.

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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.

ECC INTERNATIONAL CORP.

Date: May 14, 2003

/s/ Melissa Van Valkenburgh

Melissa Van Valkenburgh  
Chief Financial Officer

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**ECC INTERNATIONAL CORP.**

**a Delaware corporation**

**CERTIFICATION OF PRINCIPAL EXECUTIVE OFFICER**

**Section 302 Certification**

I, Robert L. Collins certify that:

1. I have reviewed this quarterly report on Form 10-Q of ECC International Corp.;
2. Based on my knowledge, this quarterly report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this quarterly report;
3. Based on my knowledge, the financial statements, and other financial information included in this quarterly report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this quarterly report;
4. The registrant's other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-14 and 15d-14) for the registrant and we have:
  - a) designed such disclosure controls and procedures to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this quarterly report is being prepared;
  - b) evaluated the effectiveness of the registrant's disclosure controls and procedures as of a date within 90 days prior to the filing date of this quarterly report (the "Evaluation Date"); and
  - c) presented in this quarterly report our conclusions about the effectiveness of the disclosure controls and procedures based on our evaluation as of the Evaluation Date;
5. The registrant's other certifying officers and I have disclosed, based on our most recent evaluation, to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent function):
  - a) all significant deficiencies in the design or operation of internal controls which could adversely affect the registrant's ability to record, process, summarize and report financial data and have identified for the registrant's auditors any material weaknesses in internal controls; and
  - b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal controls; and

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6. The registrant's other certifying officers and I have indicated in this quarterly report whether or not there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of our most recent evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

Date: May 14, 2003

/s/ Robert L. Collins

Robert L. Collins  
Principal Executive Officer

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**ECC INTERNATIONAL CORP.**

**a Delaware corporation**

**CERTIFICATION OF PRINCIPAL FINANCIAL OFFICER**

**Section 302 Certification**

I, Melissa Van Valkenburgh, certify that:

1. I have reviewed this quarterly report on Form 10-Q of ECC International Corp.;
2. Based on my knowledge, this quarterly report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this quarterly report;
3. Based on my knowledge, the financial statements, and other financial information included in this quarterly report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this quarterly report;
4. The registrant's other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-14 and 15d-14) for the registrant and we have:
  - a) designed such disclosure controls and procedures to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this quarterly report is being prepared;
  - b) evaluated the effectiveness of the registrant's disclosure controls and procedures as of a date within 90 days prior to the filing date of this quarterly report (the "Evaluation Date"); and
  - c) presented in this quarterly report our conclusions about the effectiveness of the disclosure controls and procedures based on our evaluation as of the Evaluation Date;
5. The registrant's other certifying officers and I have disclosed, based on our most recent evaluation, to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent function):
  - a) all significant deficiencies in the design or operation of internal controls which could adversely affect the registrant's ability to record, process, summarize and report financial data and have identified for the registrant's auditors any material weaknesses in internal controls; and
  - b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal controls; and

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6. The registrant's other certifying officers and I have indicated in this quarterly report whether or not there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of our most recent evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

Date: May 14, 2003

/s/ Melissa Van Valkenburgh

Melissa Van Valkenburgh  
Principal Financial Officer