

ECC INTERNATIONAL CORP

Form 10-Q

February 14, 2003

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 December 31, 2002

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.

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(Exact name of registrant as specified in its charter)

Delaware

23-1714658

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(State or other jurisdiction of incorporation or organization)

(I.R.S. Employer Identification No.)

2001 West Oak Ridge Road, Orlando, FL

32809-3803

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(Address of principal executive offices)

(Zip Code)

(407) 859-7410

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(Registrant's telephone number, including area code)

Not Applicable

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(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

As of February 3, 2003 there were 7,881,197 shares of the Registrant's Common Stock, \$.10 par value per share outstanding.

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PART I. FINANCIAL STATEMENTS  
 ITEM 1. FINANCIAL STATEMENTS  
 ECC INTERNATIONAL CORP. AND SUBSIDIARIES  
 CONSOLIDATED STATEMENTS OF OPERATIONS  
 SIX MONTHS ENDED DECEMBER 31, 2002 AND 2001  
 (In Thousands Except Per Share Data)  
 (Unaudited)

|   | <b>Six Months<br/>Ended<br/>12/31/2002</b> | <b>Six Months<br/>Ended<br/>12/31/2001</b> |
|---|--|--|
|   | <u>          </u>                          | <u>          </u>                          |
| Sales   | \$ 14,325                                  | \$ 12,897                                  |
| Cost of Sales                                     | 9,273                                      | 9,004                                      |
|   | <u>          </u>                          | <u>          </u>                          |
| Gross Profit                                      | 5,052                                      | 3,893                                      |
| Expenses:   |  |  |
| Selling, General & Administrative                 | 2,673                                      | 3,164                                      |
| Independent Research and Development              | 628  | 881  |
|   | <u>          </u>                          | <u>          </u>                          |
| Total Expenses                                    | 3,301                                      | 4,045                                      |
|   | <u>          </u>                          | <u>          </u>                          |
| Operating Income/(Loss)                           | 1,751                                      | (152)                                      |
| Other Income/(Expense):                           |  |  |
| Interest Income                                   | 47   | 34   |
| Interest Expense                                  | (43)                                       | (88)                                       |
| Other Net   |  | 45   |
|   | <u>          </u>                          | <u>          </u>                          |
| Total Other Income/(Expense)                      | 4  | (9)  |
|   | <u>          </u>                          | <u>          </u>                          |
| Income/(Loss) Before Income Taxes                 | 1,755                                      | (161)                                      |
| Provision for Income Taxes                        |  |  |
|   | <u>          </u>                          | <u>          </u>                          |
| Net Income/(Loss)                                 | \$ 1,755                                   | \$ (161)                                   |
|   | <u>          </u>                          | <u>          </u>                          |
| Income/(Loss) Per Common Share Basic and Diluted: |  |  |
| Net Income/(Loss) Per Common Share Basic/Diluted  | \$ 0.22                                    | \$ (0.02)                                  |
|   | <u>          </u>                          | <u>          </u>                          |

See accompanying notes to the consolidated financial statements.

ECC INTERNATIONAL CORP. AND SUBSIDIARIES  
 CONSOLIDATED STATEMENTS OF OPERATIONS  
 THREE MONTHS ENDED DECEMBER 31, 2002 AND 2001  
 (In Thousands Except Per Share Data)  
 (Unaudited)

|   | <b>Three<br/>Months<br/>Ended<br/>12/31/2002</b> | <b>Three<br/>Months<br/>Ended<br/>12/31/2001</b> |
|---|--|--|
| Sales   | \$ 6,973   | \$ 6,749   |
| Cost of Sales                                     | 4,701  | 4,573  |
| Gross Profit                                      | 2,272  | 2,176  |
| Expenses:   |  |  |
| Selling, General & Administrative                 | 1,087  | 1,367  |
| Independent Research and Development              | 345  | 397  |
| Total Expenses                                    | 1,432  | 1,764  |
| Operating Income/(Loss)                           | 840  | 412  |
| Other Income/(Expense):                           |  |  |
| Interest Income                                   | 20   | 26   |
| Interest Expense                                  | (21)   | (64)   |
| Other Net   | 19   | 1  |
| Total Other Income/(Expense)                      | 18   | (37)   |
| Income/(Loss) Before Income Taxes                 | 858  | 375  |
| Provision for Income Taxes                        |  |  |
| Net Income/(Loss)                                 | \$ 858   | \$ 375   |
| Income/(Loss) Per Common Share Basic and Diluted: |  |  |
| Net Income/(Loss) Per Common Share Basic/Diluted  | \$ 0.11  | \$ 0.05  |

See accompanying notes to the consolidated financial statements.

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

|  | <u>(Unaudited)</u><br><u>12/31/2002</u> | <u>(Audited)</u><br><u>6/30/2002</u> |
|--|---|--------------------------------------|
| <b>ASSETS</b>  |   |                                      |
| Current Assets:  |   |                                      |
| Cash   | \$ 6,812                                | \$ 6,280                             |
| Accounts Receivable  | 2,421                                   | 2,152                                |
| Costs and Estimated Earnings in Excess of Billings<br>on Uncompleted Contracts | 10,868                                  | 9,458                                |
| Inventories  | 675                                     | 920                                  |
| Prepaid Expenses and Other   | 183                                     | 274                                  |
|  | <u>20,959</u>                           | <u>19,084</u>                        |
| Property, Plant and Equipment Net  | 11,536                                  | 11,823                               |
| Other Assets   | 22                                      | 32                                   |
|  | <u>32,517</u>                           | <u>30,939</u>                        |
| Total Assets   | <u>\$ 32,517</u>                        | <u>\$ 30,939</u>                     |

Continued . . .

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

|   | <u>(Unaudited)</u><br><u>12/31/2002</u> | <u>(Audited)</u><br><u>6/30/2002</u> |
|---|---|--------------------------------------|
| <b>LIABILITIES &amp; STOCKHOLDERS EQUITY</b>  |   |                                      |
| Current Liabilities:  |   |                                      |
| Accounts Payable  | 2,253                                   | 2,121                                |
| Accrued Expenses and Other  | 1,438                                   | 1,972                                |
|   | <u>          </u>                       | <u>          </u>                    |
| Total Current Liabilities   | 3,691                                   | 4,093                                |
| <br>  |   |                                      |
| Deferred Income Taxes   | 61                                      | 61                                   |
|   | <u>          </u>                       | <u>          </u>                    |
| Total Liabilities   | 3,752                                   | 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, 8,608,197 and 7,881,197 (8,577,608 and 7,850,608 at 6/30/02) | 861                                     | 858                                  |
| Note Receivable from Stockholder  |   | (168)                                |
| Capital in Excess of Par  | 25,547                                  | 25,493                               |
| Retained Earnings   | 5,266                                   | 3,511                                |
| Treasury Stock, at cost (727,000 shares)  | (2,909)                                 | (2,909)                              |
|   | <u>          </u>                       | <u>          </u>                    |
| Total Stockholders Equity   | 28,765                                  | 26,785                               |
|   | <u>          </u>                       | <u>          </u>                    |
| Total Liabilities & Stockholders Equity   | \$32,517                                | \$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  
SIX MONTHS ENDED DECEMBER 31, 2002 AND 2001

(In Thousands)  
(Unaudited)

|  | <b>Six Months<br/>Ended<br/>12/31/2002</b> | <b>Six Months<br/>Ended<br/>12/31/2001</b> |
|--|--|--|
| <b>Cash Flows From Operating Activities:</b>                                   |  |  |
| Net Income/(Loss)  | \$ 1,755                                   | \$ (161)                                   |
| <b>Items Not Requiring Cash:</b>   |  |  |
| Depreciation   | 744  | 1,015                                      |
| Amortization   |  | 50   |
| (Gain)/Loss on Disposal of Equipment   | 48   | (5)  |
| <b>Changes in Certain Assets and Liabilities:</b>                              |  |  |
| Accounts Receivable  | (269)                                      | 1,174                                      |
| Costs and Estimated Earnings in Excess of Billings on<br>Uncompleted Contracts | (1,410)                                    | 2,078                                      |
| Inventories  | 245  | 7  |
| Prepaid Expenses and Other   | 54   | 44   |
| Accounts Payable   | 132  | (315)                                      |
| Accrued Expenses and Other Long-Term Liabilities                               | (534)                                      | (445)                                      |
| <b>Net Cash Provided By/(Used In) Operating Activities</b>                     | <b>765</b>                                 | <b>3,442</b>                               |
| <b>Cash Flows From Investing Activities:</b>                                   |  |  |
| Proceeds from Sales of Assets  | 27   | 5  |
| Additions to Property, Plant and Equipment                                     | (485)                                      | (276)                                      |
| <b>Net Cash Provided by/(Used In) Investing Activities</b>                     | <b>(458)</b>                               | <b>(271)</b>                               |
| <b>Cash Flows From Financing Activities:</b>                                   |  |  |
| Proceeds From Issuance of Common Stock and Options Exercised                   | 57   | 10   |
| Note Receivable from Stockholder   | 168  |  |
| Borrowings Under Revolving Credit Facility                                     |  | 4,873                                      |
| Repayments Under Revolving Credit Facility                                     |  | (5,030)                                    |
| <b>Net Cash Used In Financing Activities</b>                                   | <b>225</b>                                 | <b>(147)</b>                               |
| <b>Net Increase/(Decrease) in Cash</b>   | <b>532</b>                                 | <b>3,024</b>                               |
| Cash at Beginning of the Period  | 6,280                                      | 39   |
| <b>Cash at End of the Period</b>   | <b>\$ 6,812</b>                            | <b>\$ 3,063</b>                            |

Continued...

ECC INTERNATIONAL CORP. AND SUBSIDIARIES  
 CONSOLIDATED STATEMENTS OF CASH FLOWS  
 SIX MONTHS ENDED DECEMBER 31, 2002 AND 2001 (Continued)  
 (In Thousands)  
 (Unaudited)

|  | <b>Six<br/>Months<br/>Ended<br/>12/31/2002</b> | <b>Six<br/>Months<br/>Ended<br/>12/31/2001</b> |
|--|--|--|
| <b>Supplemental Disclosure of Cash Flow Information:</b>       |  |  |
| <b>Cash Paid During the Year For:</b>                          |  |  |
| Interest   | \$ 42  | \$ 88  |
| <b>Supplemental Schedule of Non Cash Financing Activities:</b> |  |  |
| Issuance of Director Equity Compensation                       | \$   | \$ 8   |

See accompanying notes to the consolidated financial statements.



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

1. 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 United States of America. 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. Inventories

|                              | (In Thousands) |           |
|------------------------------|----------------|-----------|
|                              | 12/31/2002     | 6/30/2002 |
| Work in Process              | \$ 101         | \$ 187    |
| Raw Materials                | 631            | 1,343     |
| Total Gross Value            | 732            | 1,530     |
| Reserves for Excess/Obsolete | (57)           | (610)     |
| Net Value                    | \$ 675         | \$ 920    |

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.

3. 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 expiring 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 December 31, 2002, 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

projections for the balance of fiscal year 2003, management believes that operational cash requirements can be funded internally.

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.

4. 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 impact due to current year profit. A 100% valuation allowance is recorded against these deferred tax assets due to the uncertainty of their ultimate realization.

5. 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 will be 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 totaling \$106,400 will be recorded 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 December 31, 2002, five of these key employees left the Company and severance payments and retention bonuses totaling \$44,374 were paid.

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

|   |                            |
|---|----------------------------|
| Accrued Employee Termination Benefits at 6/30/02  | \$ 255                     |
| Cash Payments                                     | (193)                      |
| Employee Termination Benefits Incurred            | 202                        |
|   | <hr style="width: 100%;"/> |
| Accrued Employee Termination Benefits at 9/30/02  | 264                        |
| Cash Payments                                     | (129)                      |
|   | <hr style="width: 100%;"/> |
| Accrued Employee Termination Benefits at 12/31/02 | \$ 135                     |
|   | <hr style="width: 100%;"/> |

### 6. Business Segment Information

The Company operates in one segment-training. This segment includes the design and manufacture of training simulators.

Sales by Class of Customer (In Thousands):

|                            | Six Months Ended           |                            | Three Months Ended         |                            |
|----------------------------|----------------------------|----------------------------|----------------------------|----------------------------|
|                            | 12/31/2002                 | 12/31/2001                 | 12/31/2002                 | 12/31/2001                 |
| U.S. Department of Defense |                            |                            |                            |                            |
| Direct                     | \$ 6,072                   | \$ 3,250                   | \$ 3,695                   | \$ 1,679                   |
| Subcontract                | 8,253                      | 9,647                      | 3,278                      | 5,070                      |
|                            | <hr style="width: 100%;"/> | <hr style="width: 100%;"/> | <hr style="width: 100%;"/> | <hr style="width: 100%;"/> |
| Total Sales                | \$ 14,325                  | \$ 12,897                  | \$ 6,973                   | \$ 6,749                   |
|                            | <hr style="width: 100%;"/> | <hr style="width: 100%;"/> | <hr style="width: 100%;"/> | <hr style="width: 100%;"/> |

Export Sales from the U.S. were not material for the three-month and six-month periods ended December 31, 2002 and December 31, 2001. Export sales do not include Foreign Military Sales through U.S. Government Agencies and prime contractors of \$157,000 and \$240,000 during the three-month and six-month periods ended December 31, 2002, 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.

### 7. Earnings/(Loss) Per Share

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

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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/(loss) per share does not assume the exercise of stock options that would have an antidilutive effect on earnings/(loss) per share.

The Company's dilutive potential common shares consist of stock options. In calculating diluted earnings per share, 49,363 and 20,680 dilutive potential common shares were included for the three-month and the six-month periods ended December 31, 2002, respectively, and 16,397 dilutive potential common shares were included for the three-month period ended December 31, 2001, respectively. The number of potentially dilutive common shares for the six-month period ended December 31, 2001 was 29,817. These shares were not included in computing earnings per share since they would have an anti-dilutive effect.

The number of shares outstanding for each period presented is as follows:

|         | Six Months Ended |            | Three Months Ended |            |
|---------|------------------|------------|--------------------|------------|
|         | 12/31/2002       | 12/31/2001 | 12/31/2002         | 12/31/2001 |
| Basic   | 7,864,567        | 7,830,965  | 7,878,227          | 7,831,630  |
| Diluted | 7,885,247        | 7,830,965  | 7,927,590          | 7,848,027  |

8. Commitments and Contingencies

During fiscal year 2001, the Company announced the formation of a strategic planning committee to evaluate various strategic alternatives for enhancing stockholder value including a potential sale of the Company. In order to retain critical employees, retention agreements were implemented with 28 key employees whereby an incentive of 15-20% of their salaries would be payable in two increments: half at the date of the sale of the Company and half six months after the close of the sale. These payments totaling \$420,000 will be recorded in the event the Company is sold on or before March 11, 2003.

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 totaling \$106,400 will be recorded 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 December 31, 2002, five of these key employees left the Company and severance payments and retention bonuses totaling \$44,374 were paid.

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 or results of operations.

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 six-month period ended December 31, 2002, the Company's principal source of cash was from operations. The Company's cash balance increased by \$0.5 million since fiscal year end 2002 due primarily to lower working capital requirements to support operations.

Liquidity and Capital Resources

As of December 31, 2002, 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.

During the six-month period ended December 31, 2002, the Company spent approximately \$350,000 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.

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 will be paid during fiscal year 2003.

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.

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 totaling \$106,400 will be recorded 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 December 31, 2002, five of these key employees left the Company and severance payments and retention bonuses totaling \$44,374 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 for the foreseeable future.

b) Material Changes in Results of Operations.

Sales increased 3% or \$223,000 and 11% or 1.4 million, respectively, for the three-month and six month periods ended December 31, 2002, compared to the same periods ended December 31, 2001 due primarily to higher volume on the Javelin and EST 2000 programs, and the sales from the two new SIMNET contracts. These increases were partially offset by less volume on the CCTT and C-17 programs.

Gross margins for the three-month periods were relatively consistent at 33% and 32% in fiscal year 2003 and 2002, respectively. For the six-month periods, gross margins improved from 30% in fiscal year 2002 to 35% in fiscal year 2003 due primarily to the higher sales volume as well as continuing aggressive cost reduction actions.

Selling, general and administrative expenses decreased 20% or \$280,000 and 16% or \$491,000, respectively, during the three-month and six month periods ended December 31, 2002, compared to the same period ended December 31, 2001, due primarily to the recovery of a previously reserved receivable that reduced bad debt expense by \$153,000 and to workforce and other costs reduction actions that took place during fiscal year 2002 and early fiscal year 2003.

Independent research and development expenses decreased 13% or \$52,000 and 29% or \$252,000, respectively, for the three-month and six month periods ended December 31, 2002, compared to the same periods ended December 31, 2001, due primarily to reduced activities related to the EST 2000 program.

c) Certain Factors That May Affect Future Operating Results

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 our 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. 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.



PART II. OTHER INFORMATION  
ECC INTERNATIONAL CORP.

ITEM 4. Submission of Matters to a Vote of Security Holders

At the Company's Annual Meeting of Stockholders held on December 13, 2002, the following proposals were adopted by the vote specified below:

| Proposal  | Votes<br>For | Votes<br>Against | Abstain | Broker<br>Non Votes |
|---|--------------|------------------|---------|---------------------|
| (1) To elect the Board of Directors   |              |                  |         |                     |
| Julian J. Demora  | 7,447,500    | 3,419            |         | 37,760              |
| James R. Henderson  | 6,943,852    | 507,067          |         | 541,408             |
| Jesse L. Krasnow  | 7,449,550    | 1,369            |         | 35,710              |
| Warren G. Lichtenstein  | 7,449,951    | 968              |         | 35,309              |
| Merrill A. McPeak   | 7,447,901    | 3,018            |         | 37,359              |
| Robert F. Mehmel  | 6,944,849    | 506,070          |         | 540,411             |
| (2) To approve the Company's 2002 Employee Stock Purchase Plan  |              |                  |         |                     |
|   | 7,359,577    | 79,432           | 46,251  | 392,970             |
| (3) To ratify the appointment of PricewaterhouseCoopers, LLP as the Company's independent certified public accountants for the fiscal year ending June 30, 2003 |              |                  |         |                     |
|   | 7,427,404    | 36,267           | 21,589  | 392,970             |

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 Certification of Principal Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
- 99.4 Certification of Principal Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002

b. Reports on Form 8-K

None

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.

Date: February 14, 2003

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ECC INTERNATIONAL CORP.

/s/ Melissa Van Valkenburgh

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Melissa Van Valkenburgh  
Chief Financial Officer