ENVIRONMENTAL TECTONICS CORP
Form 10-Q
May 29, 2008

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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, DC 20549

FORM 10-Q
QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF
THE SECURITIES EXCHANGE ACT OF 1934
For the quarterly period ended August 24, 2007
Commission File Number 1-10655
ENVIRONMENTAL TECTONICS CORPORATION

Pennsylvania	23-1714256
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

County Line Industrial Park
Southampton, Pennsylvania 18966

(Address of principal executive offices, Zip Code)
Registrant s telephone number, including area code (215) 355-9100

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes o No þ

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

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

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

Yes o No þ

As of May 13, 2008, there were 9,035,355 shares of the registrant s common stock issued and outstanding.

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Explanatory Statement

Restatement of previously issued financial statements

Environmental Tectonics Corporation (ETC or the Company) has restated its previously issued financial statements for the fiscal year ended February 23, 2007 and the 13 and 39 week-periods ended November 24, 2006.

Settlement with U.S. Navy

History of the Claim Receivable

In May 2003, the Company filed a certified claim with the Department of the Navy (the Government) seeking costs totaling in excess of $5.0 million in connection with a contract for submarine rescue decompression chambers.

In accordance with accounting principles generally accepted in the United States of America, recognizing revenue on contract claims and disputes related to customer caused delays, errors in specifications and designs, and other unanticipated causes, and for amounts in excess of contract value, is generally appropriate if it is probable that the claim will result in additional contract revenue and if the Company can reliably estimate the amount of additional contract revenue the Company may receive. However, revenue recorded on a contract claim cannot exceed the incurred contract costs related to that claim. Since 2004, the Company had a claim receivable recorded for $3,004,000. The Company s Form 10-K as originally filed for February 23, 2007 included this claim receivable. This claim receivable was subsequently deemed to be impaired and reserved in full (see below).

Litigation of the Certified Claim

On July 22, 2004, the Navy s contracting officer issued a final decision denying the claim in full. In July 2005, the Company converted this claim into a complaint which the Company filed in the United States Court of Federal Claims. On June 14, 2007, the Government amended its filings to add counterclaims pursuant to the anti-fraud provisions of the Contract Disputes Act, the False Claims Act, and the forfeiture statute.

Settlement of Litigation and Subsequent Funding

On June 27, 2007, the Company and the Government filed a Joint Motion to Dismiss with prejudice all of the Company s claims against the Government, which was granted on June 28, 2007. Additionally, the Company agreed to pay to the Government $3.55 million to reimburse the Government for estimated work to complete the chambers and for litigation expenses ($3.3 million recorded in the first quarter of fiscal 2008 and $250,000 recorded in the second quarter of fiscal 2008) and transfer the submarine rescue decompression chambers to the Navy. As of May 14, 2008, the Company had made all payments required under this settlement agreement and had transferred the chambers to the Government.

To partially fund the settlement, on August 23, 2007 the Company entered into the Series C Preferred Stock Purchase Agreement with Lenfest, pursuant to which, among other things, ETC issued and sold 3,300 shares of its newly-created class of Series C Cumulative Convertible Participating Preferred Stock (the Series C Preferred Stock) to H.F. Lenfest (Lenfest), a member of ETC s Board of Directors and a significant shareholder for $3,300,000. The proceeds from the issuance of the Series C Preferred Stock were restricted solely for use to partially fund the settlement with the Government.

Audit Committee Review and Regulatory Compliance Matters

In July 2007 the Company s Audit Committee retained independent counsel to review the Government claim issue. While this review was being conducted, the Company could not file its Quarterly Reports on Form 10-Q (Quarterly Reports), although preliminary financial results were released and filed on Form 8-K s for each of the fiscal quarters ended May 25, 2007, August 24, 2007 and November 23, 2007. Since the Company could not file its Quarterly Reports, the Company was notified by the American Stock Exchange (AMEX) that it was not in compliance with AMEX s continued listing standards and in August 2007 the Company submitted a plan to regain compliance. On January 30, 2008, the Company was notified by AMEX that, due to continuing non-compliance with listing standards, they were initiating delisting proceedings. The Company appealed that decision and, on April 9, 2008 representatives of the Company participated in an appeal hearing. As a result of that hearing, on April 16, 2008 the Company was granted a stay of delisting proceedings until May 29, 2008.

As a result of the allegations made by the Department of Justice in connection with the Navy matter, on October 12, 2007, pursuant to the Federal Acquisition Regulations, the Government placed the Company on suspension, which barred the Company from soliciting contract work with any Government agency. On December 12, 2007, the Company executed an Administrative Agreement, which included a program of compliance reviews, audits and reports, and the Government lifted the suspension.

Change in Independent Registered Public Accounting Firm

Following the independent counsel s review, the Company s auditors, Grant Thornton LLP, resigned from the Company and rescinded their audit opinion for the fiscal years 2003 through 2007. On January 30, 2008, the Company s Audit Committee engaged Friedman LLP as the Company s registered public accounting firm.

Restatement of Previously Filed Financial Statements

Settlement with U.S. Navy

In November 2007, the independent counsel completed its review. Subsequently, the Company s Audit Committee, in conjunction with management, concluded that as of November 2006 the claim receivable of $3,004,000 had been impaired.

On April 24, 2008, the Company announced that it was restating results for the 13 and 39 week-periods ended November 24, 2006 and the fiscal year ended February 23, 2007. This restatement reflected the formal investigation which concluded that the carrying value of the $3,004,000 claim receivable had been impaired during the third quarter of fiscal 2007. This impairment resulted from certain allegations made by the Government during that period which resulted in the counterclaim which was filed by the Government against the Company in June 2007.

The restatement for the 13 and 39 week-periods ended November 24, 2006 and the fiscal year ended February 23, 2007 involves one change, namely the recording of a reserve against a claim receivable for the full amount of the carrying value of $3,004,000 of the claim receivable. The effect of this adjustment results in a corresponding reduction in accounts receivable, an increase in net loss and a reduction in stockholder s equity.

Preferred Stock

In connection with the restatement of the Company s previously issued financial statements for the year ended February 23, 2007, the Company has reclassified the Series B and C Preferred Stock (the instruments) from equity to mezzanine. The reclassification is due to the preferential redemption feature of the instruments, which provides that a change in ownership would result in a forced liquidation. A forced liquidation is considered outside the control of the Company. Therefore, the preferential treatment upon an act outside the control of the Company precluded equity treatment under the Securities and Exchange Commission Accounting Series Release (ASR) 268 and Topic D98. Prior year s financial statements have been adjusted to reflect this change.

Due to the Company s accumulated deficit, all dividends accruing for the Series B and Series C Preferred Stock have been recorded in the accompanying financial statements as a reduction in additional paid-in capital.

For the discussion of the restatement adjustments, see Note 1 Restatement of Previously Issued Financial Statements in the accompanying Notes to the Consolidated Financial Statements. All amounts referenced in this Quarterly Report for the 13 and 39 week-periods ended November 24, 2006 and the fiscal year ended February 23, 2007 reflect the amounts on a restated basis.

Previously Filed Reports

The Company will not amend its Annual Report on Form 10-K for the fiscal year ended February 23, 2007 or its Quarterly Report on Form 10-Q for the quarterly period ended November 24, 2006. The previously issued financial statements for the fiscal year ended February 23, 2007 and quarterly period ended November 24, 2006 should no longer be relied upon.

Additional Matters Regarding H.F. Lenfest

Lenfest Acquisition Proposal

On February 20, 2008, ETC received a proposal from an affiliate of Lenfest to purchase all of the publicly traded shares of the common stock of the Company not owned by Lenfest at the time the acquisition is consummated. The Board of Directors of the Company has formed a committee (the Transaction Committee) comprised of independent directors to evaluate the proposal. The Transaction Committee has engaged a financial advisor to assist the Transaction Committee in evaluating the proposal. The Transaction Committee is evaluating the proposal and will make a recommendation with respect to the proposal to the Company s Board of Directors.

Lenfest Letter Agreement

On May 20, 2008, Lenfest agreed to fund all requests by ETC for funds to support its operations through June 30, 2009, on terms and conditions to be mutually agreed upon by Lenfest and ETC, provided that ETC may not request more than $10 million in the aggregate. All agreements will be subject to any required approvals including the approval of ETC s shareholders and in accordance with the rules and regulations of AMEX, if required. ETC s

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objective will be to either replace or supplant any financing provided by Lenfest with third party commitments on a best efforts basis.

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When used in this Quarterly Report on Form 10-Q, except where the context otherwise requires, the terms we , us , our , ETC and the Company refer to Environmental Tectonics Corporation.

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PART I FINANCIAL INFORMATION

Item 1. Financial Statements (unaudited)

Environmental Tectonics Corporation
Condensed Consolidated Statements of Operations
(unaudited)
(in thousands, except share and per share information)

	Thirteen weeks ended		Twenty-six weeks ended	
	August 24, 2007	August 25, 2006	August 24, 2007	August 25, 2006
Net sales	$ 4,247	$ 4,329	$ 8,594	$ 8,904
Cost of goods sold	3,704	3,835	7,156	7,396
Gross profit	543	494	1,438	1,508
Operating expenses:				
Selling and administrative	2,635	2,144	5,434	4,636
Claim settlement costs	250		3,639	
Research and development	237	263	291	486
	3,122	2,407	9,364	5,122
Operating loss	(2,579)	(1,913)	(7,926)	(3,614)
Other expenses:				
Interest expense	386	284	740	566
Other expense (income), net	11	(43)	41	7
	397	241	781	573
Loss before income taxes	(2,976)	(2,154)	(8,707)	(4,187)
Provision for income taxes		4		9
Loss before minority interest	(2,976)	(2,158)	(8,707)	(4,196)
Loss attributable to minority interest	(6)	(10)	(12)	(17)
Net loss	$ (2,970)	$ (2,148)	$ (8,695)	$ (4,179)
Preferred stock dividend	(90)	(55)	(180)	(79)
Loss applicable to common shareholders	$ (3,060)	$ (2,203)	$ (8,875)	$ (4,258)

Per share information:				
Basic and diluted loss per share applicable to common shareholders	$ (0.34)	$ (0.24)	$ (0.98)	$ (0.47)
Basic and diluted weighted average number of common shares	9,030,000	9,029,000	9,029,000	9,033,000

The accompanying notes are an integral part of the consolidated financial statements.

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Environmental Tectonics Corporation
Condensed Consolidated Balance Sheets
(in thousands, except share information)

	August 24, 2007 (unaudited)	February 23, 2007 (restated)
Assets		
Current assets:		
Cash	$ 427	$ 2,215
Restricted cash	3,322	20
Accounts receivable, net of allowance for bad debts of $385 and $3,372	4,041	2,094
Costs and estimated earnings in excess of billings on uncompleted long-term contracts	1,466	2,816
Inventories	5,471	4,739
Deferred tax asset	74	71
Prepaid expenses and other current assets	421	213
Total current assets	15,222	12,168
Property, plant and equipment, at cost, net of accumulated depreciation of $13,120 and $12,760	3,761	4,054
Construction in progress	11,176	8,460
Software development costs, net of accumulated amortization of $11,495 and $10,949	2,047	2,158
Goodwill	455	455
Other assets	16	30
Total assets	$ 32,677	$ 27,325
Liabilities and Stockholders Deficiency		
Liabilities		
Current liabilities:		
Accounts payable trade	2,210	2,254
Billings in excess of costs and estimated earnings on uncompleted long-term contracts	1,251	1,400
Customer deposits	2,378	794
Accrued claim settlement costs	3,550	
Accrued interest and dividends	1,357	668
Accrued liabilities	1,510	1,539
Total current liabilities	12,256	6,655
Long-term obligations:		
Credit facility payable to bank	5,000	
Subordinated convertible debt	9,087	8,830
	14,087	8,830

Total liabilities	26,343	15,485
Commitments and contingencies		
Minority interest	41	53
Cumulative convertible participating preferred stock, Series B, $.05 par value, 15,000 shares authorized; 6,000 shares issued and outstanding at August 24, 2007 and February 23, 2007, respectively	6,000	6,000
Cumulative convertible participating preferred stock, Series C, $.05 par value, 3,300 shares authorized, issued and outstanding at August 24, 2007	3,300	
Stockholders Deficiency		
Common stock; $.05 par value; 20,000,000 shares authorized; 9,028,459 shares issued and outstanding at August 24, 2007 and February 23, 2007, respectively	451	451
Additional paid-in capital	16,539	16,662
Accumulated other comprehensive loss	(125)	(149)
Accumulated deficit	(19,872)	(11,177)
Total stockholders (deficiency) equity	(3,007)	5,787
Total liabilities and stockholders deficiency	$ 32,677	$ 27,325

The accompanying notes are an integral part of the consolidated financial statements.

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Environmental Tectonics Corporation
Condensed Consolidated Statements of Cash Flows
(unaudited)
(in thousands)

	Twenty-six weeks ended	
	August 24, 2007	**August 25, 2006**
Cash flows from operating activities:		
Net loss	$ (8,695)	$ (4,179)
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation and amortization	906	920
Accretion of debt discount	257	217
Increase (decrease) in allowance for accounts receivable and inventories	433	(407)
Loss attributable to minority interest	(12)	(17)
Stock compensation expense	57	274
Deferred income taxes	(3)	
Changes in operating assets and liabilities:		
Accounts receivable	(2,049)	1,353
Costs and estimated earnings in excess of billings on uncompleted long-term contracts	1,350	(2,256)
Inventories	(1,063)	(1,376)
Prepaid expenses and other current assets	(208)	236
Other assets	14	(1)
Accounts payable	(44)	(776)
Billings in excess of costs and estimated earnings on uncompleted long-term contracts	(149)	429
Customer deposits	1,584	79
Accrued claim settlement costs	3,550	
Other accrued liabilities	480	(380)
Net cash used in operating activities	(3,592)	(5,884)
Cash flows from investing activities:		
Acquisition of equipment	(67)	(158)
Capitalized software development costs	(435)	(66)
Payments for construction in progress	(2,716)	
Net cash used in investing activities	(3,218)	(224)
Cash flows from financing activities:		
Proceeds from borrowings under line of credit	5,000	
Proceeds from notes payable, Lenfest	4,000	
Repayment of notes payable, Lenfest	(4,000)	
Proceeds from issuance of common stock / warrants		3

Increase in restricted cash	(3,302)	(2)
Proceeds from issuance of preferred stock	3,300	6,000
Net cash provided by financing activities	4,998	6,001
Other comprehensive losses	24	61
Net decrease in cash and cash equivalents	(1,788)	(46)
Cash at beginning of period	2,215	3,566
Cash at end of period	$ 427	$ 3,520
Supplemental schedule of cash flow information:		
Interest paid	113	207
Income taxes paid		4

Supplemental information on non-cash operating and investing activities:
None

The accompanying notes are an integral part of the consolidated financial statements.

Environmental Tectonics Corporation
Notes to the Condensed Consolidated Financial Statements
1. Restatement of Previously Issued Financial Statements and Subsequent Events

Environmental Tectonics Corporation (ETC or the Company) has restated its previously issued financial statements for the fiscal year ended February 23, 2007 and the 13 and 39 week-periods ended November 24, 2006.

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History of the Claim Receivable

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Subsequent Events

Additional Matters Regarding H.F. Lenfest

Lenfest Acquisition Proposal

On February 20, 2008, ETC received a proposal from an affiliate of Lenfest to purchase all of the publicly traded shares of the common stock of the Company not owned by Lenfest at the time the acquisition is consummated. The Board of Directors of the Company has formed a committee (the Transaction Committee) comprised of independent directors to evaluate the proposal. The Transaction Committee has engaged a financial advisor to assist the Transaction Committee in evaluating the proposal. The Transaction Committee is evaluating the proposal and will make a recommendation with respect to the proposal to the Company s Board of Directors.

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Environmental Tectonics Corporation
Notes to the Condensed Consolidated Financial Statements, continued

The following financial schedules reflect the impact of these restatements.

Restated Statements of Operations amounts:

The table below sets forth the effect of the adjustment on the Condensed Consolidated Statement of Operations for the 13 week period ended November 24, 2006.

(unaudited)
(in thousands, except share and per share information)

	As Originally Reported	Claim Receivable Impairment	As Restated
Net sales	$ 4,718	$	$ 4,718
Cost of goods sold	3,688		3,688
Gross profit	1,030		1,030
Operating expenses:			
Selling and administrative	2,568		2,568
Claim settlement costs		3,004	3,004
Research and development	43		43
	2,611	3,004	5,615
Operating loss	(1,581)	(3,004)	(4,585)
Other expenses:			
Interest expense	291		291
Other income, net	(43)		(43)
	248		248
Loss before income taxes	(1,829)	(3,004)	(4,833)
Provision for income taxes	4		4
Loss before minority interest	(1,833)	(3,004)	(4,837)
Income attributable to minority interest			

Working capital was $187.3 million as of June 30, 2001 and $154.5 million as of December 30, 2000. The increase was primarily due to increases in inventory related to the opening of fifteen additional stores during the first six months of 2001, as well as seasonal, forward buy and owned pharmacy inventory purchases, combined with a reduction in the current portion of outstanding term loans payable under the Senior Credit Agreement resulting from the Offering and increased cash balances generated after the repayment of all amounts outstanding under the revolving credit facility under the Senior Credit Agreement. This was partially offset by a reduction in the current portion of the deferred tax asset related to the current year's tax provision and an increase in accounts payable related to the additional inventory purchased during the period.

For the first six months of 2001, net cash provided by operating activities was $5.8 million, as compared to net cash provided by operating activities of $7.8 million in the first six months of 2000. The decrease was due to the higher investment in working capital described above.

For the 26 weeks ended June 30, 2001, our EBITDA (earnings before interest, taxes, depreciation, amortization and deferred rent charges) increased by 14.9% to $49.6 million, or 8.8% of sales, compared to $43.2 million, or 9.2% of sales, in the first six months of 2000.

Net cash used in investing activities was $22.5 million during the first six months of 2001, compared to $13.2 million during the first six months of 2000. In the first six months of 2001, capital expenditures, primarily related to new store openings and the remodeling of existing locations, amounted to $21.4 million, while lease acquisition costs accounted for $1.1 million of cash used in investing activities. In the first six months of 2000, $12.8 million was spent on capital expenditures and $0.4 million on lease acquisition costs.

Net cash provided by financing activities was $21.0 million for the first six months of 2001, compared to $5.5 million for the first six months of 2000. The increase reflects the higher level of capital expenditures and increase in working capital investment over the prior year.

Our capital requirements primarily result from opening and stocking new stores, remodeling and renovating existing retail locations and from the continuing development of management information systems. We believe that there are significant opportunities to open additional stores, and currently plan to open approximately 55 to 65 stores through year-end 2002, including the fifteen stores opened during the first six months of 2001. We expect to spend approximately $35.0 million in 2001 on capital expenditures, primarily for new, renovated and replacement stores and an additional $6.0 million for lease and pharmacy file acquisition costs. We also require working capital to support inventory for our existing stores. Historically, we have been able to lease our store locations.

We believe that, based on current levels of operations and anticipated growth, cash flow from operations, together with other available sources of funds, including revolving and term loan borrowings under our Senior Credit Agreement, will be adequate for at least the next two years to make required payments of principal and interest on our indebtedness, to fund anticipated capital expenditures and working capital requirements, and to comply with the terms of our debt agreement. As of June 30, 2001, we had no borrowings under the revolving portion of our Senior Credit Agreement and had $54.2 million of remaining availability. Our ability to meet our debt service obligations and reduce our total debt will be dependent upon our future performance, which, in turn, will be subject to general economic, financial, business, competitive, legislative, regulatory, and other conditions, many of which are beyond our control. In addition, we cannot assure you that our operating results, cash flow and capital resources will be sufficient to repay our indebtedness in the future. Substantially all of our future revolving and outstanding term loan borrowings under our Senior Credit Agreement bear interest at floating rates. There was approximately $160.0 million of floating rate debt outstanding on June 30, 2001. Therefore, our financial condition will be affected by changes in prevailing interest rates. On December 20, 2000, we entered into a two-year interest rate swap in the notional amount of $150.0 million. This swap had an effective date of January 12, 2001, and represented a hedging transaction whereby we would receive interest at a floating rate and pay interest at a fixed LIBOR rate. The effect of this swap is to fix our interest obligations on $150.0 million of floating rate debt for two years at a LIBOR rate of 5.8075% plus the applicable margins as defined in the Senior Credit Agreement. See "   Market Risk."

The Senior Credit Agreement and the indenture relating to our senior subordinated notes contain various covenants that limit or restrict, among other things, subject to specified exceptions, our ability to make capital expenditures, incur indebtedness, permit liens on our property, enter into transactions with affiliates, make restricted payments, investments or acquisitions, enter into mergers, consolidations or dissolutions, conduct assets sales, pay dividends or distributions and enter into other specified transactions and business activities. Financial performance covenants included in our Senior Credit Agreement include interest coverage, leverage ratios, minimum net worth requirements and fixed charge coverage requirements. At June 30, 2001, we were in compliance with all financial performance covenants.

Tax Benefits from Net Operating Losses

At December 30, 2000, we had net operating loss carryforwards, or NOLs, of approximately $23.0 million, which are due to expire in the years 2007 through 2018. These NOLs may be used to offset future taxable income through 2018 and thereby reduce or eliminate our federal income taxes otherwise payable. The Internal Revenue Code of 1986, as amended, imposes significant limitations on the utilization of NOLs in the event of an "ownership change," as defined in Section 382 of the Code. This Section 382 limitation is an annual limitation on the amount of pre-ownership change NOLs that a corporation may use to offset its post-ownership change income. The Section 382 limitation is calculated by multiplying the value of a corporation's stock immediately before an ownership change by the long-term tax-exempt rate (as published by the Internal Revenue Service). Generally, an ownership change occurs with respect to a corporation if the aggregate increase in the percentage of stock ownership by value of that corporation by one or more 5% shareholders, including specified groups of shareholders who in the aggregate own at least 5% of that corporation's stock, exceeds 50 percentage points over a three-year testing period. Our recapitalization in 1997 caused us to experience an ownership change. As a result, we are currently subject to an annual Section 382 limitation of approximately $8.5 million in 2001 and approximately $5.1 million from 2002 to 2007 on the amount of NOLs generated prior to the recapitalization that we may use to offset future taxable income. At December 30, 2000, all of the existing NOLs were subject to this limitation. We cannot assure you that we will be able to use any NOLs to offset future taxable income or that the NOLs will not become subject to limitation due to future ownership changes. Based on our recent and projected performance, however, management believes that it is more likely than not that the full value of the NOLs will be realized.

Seasonality

In general, sales of drugstore items such as prescription drugs, over-the-counter drugs and health and beauty care products exhibit limited seasonality in the aggregate, but do vary by product category. Quarterly results are primarily affected by the timing of new store openings and the sale of seasonal products, with the Christmas holiday season generating a higher proportion of sales and earnings than other periods.

Recently Issued Accounting Pronouncements

FASB Statement No. 133 "Accounting for Derivative Instruments and Hedging Activities" requires that derivative instruments such as interest rate swaps be recorded as assets and liabilities at fair value and provides guidance for recognition of changes in fair value depending on the reason for holding the derivative. As discussed in "Newly Adopted Accounting Standards" on page 8, we adopted Statement No. 133 during the first quarter of 2001, but this action did not have a material impact on our consolidated financial statements.

Market Risk

Our financial results are subject to risk from interest rate fluctuations on debt, which carries variable interest rates. Variable rate debt outstanding under our Senior Credit Agreement was approximately $160.0 million at June 30, 2001. During 1998, in connection with Senior Credit Agreement requirements, we entered into an interest rate protection agreement, which capped the LIBOR rate at 6.5% on $65.0 million of our floating rate debt. This agreement expired in November 2000. On December 20, 2000, we purchased a two-year interest rate swap in the notional amount of $150.0 million. This swap had an effective date of January 12, 2001, and represented a hedging transaction to effectively convert $150.0 million of floating rate debt to a fixed rate. This fixed rate is equivalent to a LIBOR rate of 5.8075% plus the applicable margins described in our Senior Credit Agreement. At June 30, 2001, the 90-day LIBOR rate in effect on the $10.0 million balance of the floating rate term debt was 4.8125%. A 0.50% change in interest rates applied to the $10.0 million balance of floating rate debt would affect pre-tax annual results of operations by approximately $0.1 million. We also have $80.0 million of senior subordinated notes outstanding at June 30, 2001, which bear interest payable semi-annually at a fixed rate of 9.25%, and are therefore not subject to risk from interest rate fluctuations.

The principal objective of our investment management activities is to maintain acceptable levels of interest rate and liquidity risk to facilitate our funding needs. As part of our risk management, we may use additional derivative financial products such as interest rate hedges and interest rate swaps in the future.

PART II

OTHER INFORMATION

ITEM 1. Legal Proceedings

We are a party to legal actions arising in the ordinary course of business. Based on information presently available to us, we believe that we have adequate legal defenses or insurance coverage for these actions and that the ultimate outcome of these actions will not have a material adverse effect on us.

In addition, we are currently party to arbitration proceedings arising out of disputes over the Rock Bottom acquisition. In this arbitration, RB Holdings Corporation (formerly known as Rock Bottom Stores, Inc.) claims that it is owed approximately $1.2 million for rent and other proration payments allegedly made by RB Holdings prior to the closing. We have not disputed this claim, but we have filed counterclaims against RB Holdings seeking to recover several million dollars based on an assertion of several breaches by RB Holdings of the asset purchase agreement for the acquisition and tortious interference with a business relationship by RB Holdings. In RB Holdings' reply to our counterclaims, RB Holdings has asserted that it is entitled to recover unspecified amounts from us in connection with certain trade payables owed to our vendors. This matter is subject to the jurisdiction of an impartial arbitrator. The parties to the arbitration have both disputed the preliminary findings of the arbitrator and as of the date of this filing, no final resolution has yet been determined. Final resolution of the matter is expected in the near future. We believe that the ultimate outcome of this action will not have a material adverse effect on our financial position or results of operations.

Also in connection with the Rock Bottom acquisition, we were awarded a purchase price adjustment of approximately $2.15 million with respect to an inventory shortfall at the closing.

ITEM 2. Changes in Securities and Use of Proceeds

Not applicable

ITEM 3. Defaults Upon Senior Securities

Not applicable

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

The Company's annual meeting of stockholders was held on May 14, 2001. At the meeting, the shareholders re-elected the Board of Directors slate of nominees (Nicole S. Arnaboldi, Anthony J. Cuti, David L. Jaffe, David W. Johnson, Carl M. Pradelli, Kevin Roberg and William Simon) to serve as members of the Board of Directors through the 2002 meeting. All of the members had served on the Board since the last shareholder's meeting except Mr. Simon. Mr. Simon was first appointed to the Board of Directors on February 13, 2001. In addition, the shareholders approved the proposal to increase by 1,000,000 the number of shares available for issuance under the Company's 1997 Equity Participation Plan.

ITEM 5. Other Information

Not applicable

ITEM 6. Exhibits, Financial Statement Schedules and Reports on Form 8-K

(a) The following documents are filed as a part of this report:

(i) Financial Statements

(ii) Exhibits:

3.1(i)	Amended and Restated Certificate of Incorporation of the Company (incorporated by reference to Exhibit 3.1(i) to the Company's Registration Statement No. 333-41239 (the "Common Stock S-1")).
3.1(ii)	Form of Amended and Restated By-laws of the Company (incorporated by reference to Exhibit 3.1(i) to the Common Stock S-1).
3.2(i)	Certificate of Incorporation of DRI I Inc. (incorporated by reference to Exhibit 3.2(i) to the S-1 Registration Statement No. 333-43313 with respect to the Company's $9\frac{1}{4}$% Senior Subordinated Notes due 2008 (the "Notes S-1")).
3.2(ii)	By-laws of DRI I Inc. (incorporated by reference to Exhibit 3.2(ii) to the Notes S-1).
3.3	Second Amended and Restated Partnership Agreement of Duane Reade (incorporated by reference to Exhibit 3.3 to the Notes S-1)

3.4(i)	Certificate of Incorporation of Duane Reade International, Inc. (incorporated by reference to Exhibit 3.4(i) to the Company's Annual Report on Form 10-K for the year ended December 26, 1999 (the "1999 10-K")).
3.4(ii)	By-laws of Duane Reade International, Inc. (incorporated by reference to exhibit 3.4(ii) to the 1999 10-K).
3.5(i)	Certificate of Incorporation of Duane Reade Realty, Inc. (incorporated by reference to Exhibit 3.5(i) to the 1999 10-K).
3.5(ii)	By-laws of Duane Reade Realty, Inc. (incorporated by reference to Exhibit 3.5(ii) to the 1999 10-K).
4.1	Form of Indenture (incorporated by reference to Exhibit 4.1 to the Notes S-1)
10.1	Duane Reade Inc. 1997 Equity Participation Plan (incorporated by reference to Exhibit 10.1 to the Common Stock S-1).
10.2	Duane Reade Inc. Holding Corp. 1992 Stock Incentive Plan (incorporated by reference to Exhibit 10.2 to the Common Stock S-1).
10.3	Employment Agreement, dated as of October 27, 1997, between the Company and Anthony J. Cuti (incorporated by reference to Exhibit 10.3 to the Common Stock S-1).
10.4	Employment Agreement, dated as of February 22, 1993, as amended, between the Company and Gary Charboneau (incorporated by reference to Exhibit 10.4 to the Common Stock S-1).
10.5	Employment Agreement, dated as of April 10, 1995, as amended, between Duane Reade and Jerry M. Ray (incorporated by reference to Exhibit 10.5 to the Common Stock S-1).
10.6	Employment Letter Agreement, dated as of October 9, 1996, between Duane Reade and Joseph Lacko (incorporated by reference to Exhibit 10.6 to the Common Stock S-1).
10.7	Employment Letter Agreement, dated as of February 12, 1997, between the Company and William Tennant (incorporated by reference to Exhibit 10.7 to the Common Stock S-1).

10.8	Agreement, dated as of November 22, 1996, as amended, between Duane Reade and Drug, Chemical, Cosmetic, Plastics and Affiliated Industries Warehouse Employees Local 815 (incorporated by reference to Exhibit 10.8 to the Common Stock S-1).
10.9	Agreement, dated July 16, 1992, as amended, between Duane Reade and Allied Trades Council (incorporated by reference to Exhibit 10.9 to the Common Stock S-1).
10.10	Stockholders and Registration Rights Agreement, dated as of June 18, 1997, among the Company, DLJMB Funding II, Inc., DLJ Merchant Banking Partners II, L.P., DLJ Diversified Partners, L.P., DLJ First ESC L.L.C., DLJ Offshore Partners, II, C.V., DLJ EAB Partners, L.P., UK Investment Plan 1997 Partners, Bankers Trust New York Corporation, Conac & Co., Muico & Co., Roton & Co., Putnam High Yield Trust, PaineWebber Managed Investment Trust on behalf of PaineWebber High Income Fund, USL Capital Corporation, Pearlman Family Partners, The Marion Trust, Bruce L. Weitz, BCIP Associates, BCIP Trust Associates, L.P., Tyler Capital Fund L.P., Tyler International, L.P.-II, and Tyler Massachusetts, L.P. (incorporated by reference to Exhibit 10.13 to the Common Stock S-1).
10.11	Amended and Restated Partnership Security Agreement, dated as of September 11, 1998, among Duane Reade Inc. and DRI I Inc. and Fleet National Bank, as Administrative Agent (incorporated by reference to Exhibit 10.15 to the Company's Current Report on Form 8-K dated September 24, 1998).
10.12	Amended and Restated Borrower Security Agreement, dated as of September 11, 1998, between Duane Reade and Fleet National Bank as Administrative Agent (incorporated by reference to Exhibit 10.16 to the Company's Current Report on Form 8-K dated September 24, 1998).
10.13	Amended and Restated Holdings Pledge Agreement, dated as of September 11, 1998, among Duane Reade Inc. and Fleet National Bank, as Administrative Agent (incorporated by reference to Exhibit 10.17 to the Company's Current Report on Form 8-K dated September 24, 1998).
10.14	Promissory Note, dated as of November 9, 1998, between the Company and Anthony J. Cuti (incorporated by reference to Exhibit 10.16 to the Company' 1998 Annual Report on Form 10-K).
10.15	Employment Letter, dated June 10, 1999, between the Company and John K. Henry (incorporated by reference to Exhibit 10.18 to the 1999 10-K).
10.16	Promissory Note, dated as of June 7, 1999, between the Company and Anthony J. Cuti (incorporated by reference to Exhibit 10.19 to the 1999 10-K).

10.17	Promissory Note, dated as of December 30, 1999, between the Company and Anthony J. Cuti (incorporated by reference to Exhibit 10.20 to the 1999 10-K).
10.18	Third Amended and Restated Credit Agreement, dated as of March 17, 2000, among Duane Reade, as the Borrower, Duane Reade Inc. and DRI I Inc., as the Parent Guarantors, Various Financial Institutions set forth therein, as the Lenders, DLJ Capital Funding, Inc., as the Syndication Agent for the Lenders, and Credit Lyonnais New York Branch, as the Documentation Agent for the Lenders (incorporated by reference to Exhibit 10.21 to the 1999 10-K).
10.19	Amendment Agreement to Credit Agreement, dated as of March 17, 2000 among Duane Reade, Duane Reade Inc., DRI I Inc., Various Financial Institutions as Lenders, DLJ Capital Funding, Inc. as Syndication Agent, Fleet National Bank as Administrative Agent and Credit Lyonnais New York Branch as Documentation Agent (incorporated by reference to Exhibit 10.22 to the 1999 10-K).
10.20	First Amendment to Employment Agreement, dated March 13, 2000, between the Company and Anthony J. Cuti. (incorporated by reference to Exhibit 10.23 to the 1999 10-K).

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10.21	Agreement, dated April 1, 1999, between Duane Reade and Local 340A/340B, New York (incorporated by reference to Exhibit 10.21 to the Company's Quarterly Report on Form 10-Q for the period ended September 23, 2000).
10.22	First Amendment to the Third Amended and Restated Credit Agreement, dated as of September 5, 2000, by and among Duane Reade, each designated Guarantor, Duane Reade Inc., DRI I, Inc., DLJ Capital Funding, Inc. as Syndication Agent and Fleet National Bank as Administrative Agent (incorporated by reference to Exhibit 10.22 to the Company's Quarterly Report on Form 10-Q for the period ended September 23, 2000).
10.23	Second Amendment to the Third Amended and Restated Credit Agreement, dated as of October 31, 2000, among Duane Reade, Duane Reade Inc., DRI I, Inc., Various Financial Institutions as Lenders, DLJ Capital Funding, Inc. as Syndication Agent, Fleet National Bank as Administrative Agent and Credit Lyonnais New York Branch as Documentation Agent (incorporated by reference to Exhibit 10.23 to the Company's Quarterly Report on Form 10-Q for the period ended September 23, 2000).
10.24	Promissory Note, dated as of January 10, 2001, between the Company and Anthony J. Cuti (incorporated by reference to Exhibit 10.24 to the 2000 10-K).
10.25	Second Amendment to Employment Agreement, dated May 1, 2001, between the Company and Anthony J. Cuti (incorporated by reference to Exhibit 10.25 to the Company's Quarterly Report on Form 10-Q for the period ended March 31, 2001).
10.26	Second Amendment to Employment Agreement, as amended, dated May 21, 2001, between the Company, Credit Suisse First Boston Ltd. and Anthony J. Cuti (incorporated by reference to Exhibit 10.1 to Amendment No. 1 to the Company's Registration Statement on Form S-3 dated July 22, 2001).
10.27	Certificate of Amendment of Amended and Restated Certificate of Incorporation (incorporated by reference to Exhibit 3.1 to Amendment No. 1 to the Company's Registration Statement on Form S-3 dated July 22, 2001).
10.28*	Employment Letter, dated June 14, 2001, between the Company and Bruce E. Schwallie.
10.29*	Fourth Amended and Restated Credit Agreement, dated as of July 10, 2001, among Duane Reade, as the Borrower, Duane Reade Inc. and DRI I Inc., as the Parent Guarantors, Various Financial Institutions set forth therein, as the Lenders, Credit Suisse First Boston, as the Syndication Agent for the Lenders, and Credit Lyonnais New York Branch, as the Documentation Agent for the Lenders.
21.1	Subsidiaries of the Company (incorporated by reference to Exhibit 21.1 to the 1999 10-K).

* Filed herewith

(b) Reports on Form 8-K:

The Company filed a report on Form 8-K, dated July 27, 2001, related to the issuance of the Company's press release detailing the second quarter and six-month cumulative financial performance.

(c) Financial Statement Schedules: None

Schedules for which provision is made in the applicable accounting regulations of the Commission are either not required under the related instructions, are inapplicable or not material, or the information called for thereby is otherwise included in the financial statements and therefore has been omitted.

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SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) 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.

Dated: August 14, 2001

DUANE READE, INC.
(Registrant)

By: /s/ JOHN K. HENRY

Name: John K. Henry
Title: *Senior Vice President and Chief Financial Officer*

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the registrant in the capacities indicated on August 14, 2001

Signatures	Titles
/s/ ANTHONY J. CUTI Anthony J. Cuti	President and Chief Executive Officer and Director (Principal Executive Officer)
/s/ JOHN K. HENRY John K. Henry	Senior Vice President and Chief Financial Officer (Principal Accounting and Financial Officer)

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SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) 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.

Dated: August 14, 2001

DRI INC.

By: /s/ JOHN K. HENRY

Name: John K. Henry
Title: *Senior Vice President and Chief Financial Officer*

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed on August 14, 2001 by:

Signatures	Titles
/s/ ANTHONY J. CUTI Anthony J. Cuti	President and Chief Executive Officer and Director (Principal Executive Officer)
/s/ JOHN K. HENRY John K. Henry	Senior Vice President and Chief Financial Officer (Principal Accounting and Financial Officer)

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SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) 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.

Dated: August 14, 2001

DUANE READE

By: DRI I Inc., a general partner

/s/ JOHN K. HENRY

Name: John K. Henry
Title: *Senior Vice President and Chief Financial Officer*

By: Duane Reade Inc., a general partner

/s/ JOHN K. HENRY

Name: John K. Henry
Title: *Senior Vice President and Chief Financial Officer*

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below on August 14, 2001 by the following persons in the capacities indicated with respect to Duane Reade Inc. and DRI I Inc., the general partners of Duane Reade, on behalf of Duane Reade (except as otherwise indicated):

Signatures	Titles
/s/ ANTHONY J. CUTI Anthony J. Cuti	President and Chief Executive Officer and Director (Principal Executive Officer)
/s/ JOHN K. HENRY John K. Henry	Senior Vice President and Chief Financial Officer (Principal Accounting and Financial Officer)

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SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) 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.

Dated: August 14, 2001

DUANE READE REALTY, INC.

By: /s/ JOHN K. HENRY

Name: John K. Henry
Title: *Senior Vice President and Chief Financial Officer*

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed on August 14, 2001 by:

Signatures	Titles
/s/ ANTHONY J. CUTI Anthony J. Cuti	President and Chief Executive Officer and Director (Principal Executive Officer)
/s/ JOHN K. HENRY John K. Henry	Senior Vice President and Chief Financial Officer (Principal Accounting and Financial Officer)

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SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) 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.

Dated: August 14, 2001

DUANE READE INTERNATIONAL, INC.

By: /s/ JOHN K. HENRY

Name: John K. Henry
Title: *Senior Vice President and Chief Financial Officer*

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed on August 14, 2001 by:

Signatures	Titles
/s/ ANTHONY J. CUTI Anthony J. Cuti	President and Chief Executive Officer and Director (Principal Executive Officer)

Signatures	Titles
/s/ JOHN K. HENRY John K. Henry	Senior Vice President and Chief Financial Officer (Principal Accounting and Financial Officer)

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