

AEROSONIC CORP /DE/  
Form 10-Q  
September 13, 2010

UNITED STATES SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 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 July 30, 2010

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 1-11750

AEROSONIC CORPORATION

(Exact name of registrant as specified in its charter)

Delaware

74-1668471

(State or other jurisdiction of incorporation or organization)

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

1212 North Hercules Avenue

Clearwater, Florida 33765

(Address of principal executive offices and Zip Code)

Registrant's telephone number, including area code: (727) 461-3000

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 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes  No

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

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Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer or a smaller reporting company (as defined in Rule 12b-2 of the Exchange Act).

Large accelerated filer  Accelerated filer  Non-accelerated filer  Smaller reporting company

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

As of September 13, 2010, the issuer had 3,743,189 shares of Common Stock outstanding, net of treasury shares.

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<b>PART I</b>		<b>FINANCIAL INFORMATION</b>	
Item 1	Financial Statements		
	Consolidated Balance Sheets as of July 30, 2010 (unaudited) and January 31, 2010		4
	Consolidated Statements of Operations for the three and six months ended July 30, 2010 and July 31, 2009 (unaudited)		5
	Consolidated Statements of Cash Flows for the six months ended July 30, 2010 and July 31, 2009 (unaudited)		6
	Notes to Consolidated Financial Statements (unaudited)		7
Item 2	Management's Discussion and Analysis of Financial Condition and Results of Operations		14
Item 3	Quantitative and Qualitative Disclosures About Market Risk		20
Item 4	Controls and Procedures		21
<b>PART II</b>		<b>OTHER INFORMATION</b>	
Item 1	Legal Proceedings		22
Item 1A	Risk Factors		22
Item 2	Unregistered Sale of Equity Securities and Use of Proceeds		22
Item 3	Defaults Upon Senior Securities		22
Item 5	Other Information		22
Item 6	Exhibits		22
	Signatures		23

PART I - FINANCIAL INFORMATION

Cautionary Note on Forward-Looking Statements

Certain statements made in this Quarterly Report on Form 10-Q that are not statements of historical or current facts are forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. Forward-looking statements may involve known and unknown risks, uncertainties and other factors that may cause our actual results, performance or achievements to be materially different from historical results or from any future results expressed or implied by such forward-looking statements.

In addition to statements that explicitly describe such risks and uncertainties, readers are urged to consider statements in future or conditional tenses or, include terms such as “believes,” “belief,” “expects,” “intends,” “anticipates” or “plans” uncertain and forward-looking. Forward-looking statements are based on management’s beliefs and assumptions, using information currently available to us as to current expectations concerning future events and trends and are necessarily subject to uncertainties, many of which are outside of the Company’s control.

We claim the protection of the safe harbor for forward-looking statements provided for in the Private Securities Litigation Reform Act of 1995, Section 27A of the Securities Act of 1933, as amended (the “Securities Act”), and Section 21E of the Securities Exchange Act of 1934, as amended (the “Exchange Act”). Except as required by applicable law, we undertake no obligation, and do not intend, to update these forward-looking statements to reflect events or circumstances that arise after the date they are made. Furthermore, as a matter of policy, we do not generally make any specific projections as to future earnings, nor do we endorse any projections regarding future performance, which may be made by others outside our company.

All subsequent written and oral forward-looking statements attributable to the Company or individuals acting on its behalf are expressly qualified in their entirety by this Cautionary Note on Forward-Looking Statements.

## PART I - FINANCIAL INFORMATION

## ITEM 1. FINANCIAL STATEMENTS

AEROSONIC CORPORATION AND SUBSIDIARIES  
CONSOLIDATED BALANCE SHEETS

	July 30, 2010 (unaudited)	January 31, 2010
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents	\$ 74,000	\$ -
Accounts receivable, net	4,113,000	3,421,000
Inventories, net	7,535,000	7,743,000
Prepaid expenses and other current assets, net	1,232,000	1,035,000
Property held for sale, net	2,062,000	2,062,000
Deferred income taxes	1,413,000	1,613,000
<b>Total current assets</b>	<b>16,429,000</b>	<b>15,874,000</b>
Property, plant and equipment, net	3,446,000	2,917,000
Deferred income taxes	1,833,000	1,831,000
Intangible assets, net	340,000	450,000
Goodwill	366,000	366,000
Other assets, net	104,000	38,000
<b>Total assets</b>	<b>\$ 22,518,000</b>	<b>\$ 21,476,000</b>
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>		
Current liabilities:		
Revolving credit facility	\$ 3,057,000	\$ 2,165,000
Current maturities of long-term debt	1,776,000	5,768,000
Accounts payable, trade	1,775,000	2,717,000
Customer advances	101,000	452,000
Compensation and benefits	595,000	720,000
Income taxes payable	-	67,000
Accrued sales commissions	149,000	42,000
Accrued expenses and other liabilities	1,821,000	1,617,000
<b>Total current liabilities</b>	<b>9,274,000</b>	<b>13,548,000</b>
Long-term debt	4,684,000	-
Unrecognized tax benefits	40,000	40,000
Deferred income taxes	168,000	168,000
<b>Total liabilities</b>	<b>14,166,000</b>	<b>13,756,000</b>
Commitments and contingencies (Note 11)		
Stockholders' equity:		
Common stock, \$.40 par value: authorized 8,000,000 shares; issued 4,166,096 shares and 4,162,289 shares at July 30, 2010 and January 31, 2010, respectively; outstanding 3,735,329 and 3,731,522 shares at July 30, 2010 and January 31, 2010, respectively.	1,666,000	1,665,000
Additional paid-in capital	6,103,000	5,749,000
Retained earnings	3,746,000	3,469,000

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Less treasury stock: 430,767 shares at both July 30, 2010 and January 31, 2010, at cost	(3,163,000)	(3,163,000)
Total stockholders' equity	8,352,000	7,720,000
Total liabilities and stockholders' equity	\$ 22,518,000	\$ 21,476,000

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

AEROSONIC CORPORATION AND SUBSIDIARIES  
CONSOLIDATED STATEMENTS OF OPERATIONS (Unaudited)

	Three Months Ended		Six Months Ended	
	July 30, 2010	July 31, 2009	July 30, 2010	July 31, 2009
Sales, net	\$ 6,813,000	\$ 8,114,000	\$ 13,744,000	\$ 16,888,000
Cost of sales	4,714,000	4,951,000	9,491,000	10,415,000
Gross profit	2,099,000	3,163,000	4,253,000	6,473,000
Selling, general and administrative expenses	1,819,000	2,159,000	3,574,000	3,738,000
Operating income	280,000	1,004,000	679,000	2,735,000
Other income (expense):				
Interest expense, net	(211,000)	(151,000)	(361,000)	(207,000)
Gain from casualty	-	50,000	235,000	550,000
Other income (expense)	-	1,000	(47,000)	(7,000)
Loss on extinguishment of debt	(31,000)	-	(31,000)	-
	(242,000)	(100,000)	(204,000)	336,000
Income before income taxes	38,000	904,000	475,000	3,071,000
Income tax provision	(20,000)	(348,000)	(198,000)	(1,140,000)
Net income	\$ 18,000	\$ 556,000	\$ 277,000	\$ 1,931,000
Basic earnings per share	\$ 0.00	\$ 0.15	\$ 0.07	\$ 0.53
Diluted earnings per share	\$ 0.00	\$ 0.14	\$ 0.07	\$ 0.51
Weighted average shares outstanding basic	3,735,329	3,683,033	3,733,447	3,651,861
Weighted average shares outstanding diluted	4,059,410	3,932,205	4,065,823	3,779,280

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

AEROSONIC CORPORATION AND SUBSIDIARIES  
CONSOLIDATED STATEMENTS OF CASH FLOWS (Unaudited)

	Six Months Ended	
	July 30, 2010	July 31, 2009
<b>Cash flows from operating activities:</b>		
Net income	\$ 277,000	\$ 1,931,000
<b>Adjustments to reconcile net income to net cash used in operating activities:</b>		
Depreciation	143,000	139,000
Amortization	122,000	123,000
Accretion on long-term debt	124,000	67,000
Loss on early extinguishment of debt	31,000	-
Recovery of previously written off bad debt	(71,000)	-
Provision for obsolete and slow-moving inventory	192,000	-
Stock-based compensation	106,000	122,000
Gain from casualty	(235,000)	(550,000)
Proceeds from insurance	235,000	550,000
Provision for deferred income taxes	198,000	1,140,000
<b>Changes in assets and liabilities:</b>		
Accounts receivable, net	(621,000)	(1,496,000)
Inventories, net	16,000	(381,000)
Prepaid expenses and other current assets, net	(197,000)	(179,000)
Other assets	(109,000)	226,000
Accounts payable, trade	(942,000)	(587,000)
Customer advances	(351,000)	(2,343,000)
Compensation and benefits	(125,000)	68,000
Income taxes payable	(67,000)	-
Accrued expenses and other liabilities	311,000	(174,000)
Net cash used in operating activities	(963,000)	(1,344,000)
<b>Cash flows from investing activities:</b>		
Capital expenditures	(672,000)	(761,000)
Net cash used in investing activities	(672,000)	(761,000)
<b>Cash flows from financing activities:</b>		
Net increase in revolving credit facility	892,000	1,503,000
Proceeds from issuance of notes payable	600,000	800,000
Principal payments on long-term debt	(5,195,000)	(198,000)
Proceeds from refinancing of long-term debt	5,412,000	-
Net cash provided by financing activities	1,709,000	2,105,000
Change in cash and cash equivalents	74,000	-
Cash and cash equivalents, beginning of period	-	-
Cash and cash equivalents, end of period	\$ 74,000	\$ -
<b>Supplemental disclosures of cash flow information:</b>		
Net cash paid during the year for:		
Interest	\$ 222,000	\$ 116,000
Income taxes	\$ 67,000	\$ -



Non-cash financing and other transactions:

Common stock issued	\$	-	\$	123,000
Common stock warrants issued	\$	249,000	\$	283,000

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

AEROSONIC CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Unaudited)

1. Description of Business, Basis of Presentation and Recent Accounting Pronouncements

Description of Business

Aerosonic Corporation (“Aerosonic”) and its wholly-owned subsidiaries, Avionics Specialties, Inc. and OP Technologies, Inc. (collectively referred to herein as the “Company”) manufacture and sell aircraft instrumentation and sensors systems including integrated cockpit displays, digital and mechanical standby displays, sensors and probes. Our customers include government and commercial users located worldwide. The Company’s production facilities are located in Florida and Virginia.

Financial Condition and Management’s Plans

On April 30, 2010, the Company refinanced its Wachovia Bank, N.A. (“Wachovia”) debt totaling \$7,481,000 with new debt facilities from M&I Marshall & Ilsley Bank (“M&I”) with a maximum credit availability of \$10,100,000. On May 1, 2010, the Wachovia debt was repaid with proceeds available under the M&I facilities. Accordingly, the Company has presented its current and long-term debt on the July 30, 2010 balance sheet in accordance with the repayment terms of the M&I facilities. As of July 30, 2010, the Company was in compliance with all of M&I’s financial and other restrictive covenants.

Prior to the debt refinancing, and as of January 31, 2010, the Company was not in compliance with certain debt covenants with Wachovia. As a result, the Company’s total debt with Wachovia, which was \$7,245,000 at January 31, 2010, was subject to acceleration and was classified as current on the consolidated balance sheet at January 31, 2010. The Company maintained a written waiver from Wachovia through April 30, 2010 relating to its covenant for noncompliance.

Basis of Presentation

The Company prepares its consolidated financial statements in conformity with accounting principles generally accepted in the United States of America (“U.S. GAAP”). These principles require management to make estimates and judgments that affect reported and contingent amounts of assets, liabilities, revenues and expenses, including such items as (i) inventory, restructuring and environmental costs, (ii) other miscellaneous accruals and, (iii) valuation allowances for accounts receivable, inventory and deferred tax assets. Actual results may differ from these estimates under different assumptions or conditions, and such differences could be material.

The accompanying consolidated financial statements include the accounts of the Company. All significant intercompany balances and transactions have been eliminated in consolidation. The Company operates on a fiscal year that ends on January 31, consisting of four quarters, each of the first three quarters ending on the Friday of each successive 13 week period. Accordingly, all references to the second quarter mean the second quarter ended on the 26th Friday of the fiscal year. For example, references to the second quarter of fiscal year 2011 mean the quarter ended July 30, 2010.

Reclassifications

Certain amounts in the three and six months ended July 31, 2009 financial statements and balance sheet dated January 31, 2010 have been reclassified to conform to the three and six months ended July 30, 2010 presentation. Such

reclassifications had no effect on net income or stockholders' equity as previously reported.

#### Unaudited Interim Financial Information

The accompanying consolidated balance sheet as of July 30, 2010, the consolidated statements of operations for the three and six months ended July 30, 2010 and July 31, 2009, and the consolidated statements of cash flows for the six months ended July 30, 2010 and July 31, 2009 are unaudited but include all adjustments (consisting of normal recurring adjustments) that are, in the opinion of management, necessary for a fair presentation of our financial position at such dates and our results of operations and cash flows for the periods then ended, in conformity with U.S. GAAP. The consolidated balance sheet as of January 31, 2010 has been derived from the audited consolidated financial statements at that date but, in accordance with the rules and regulations of the United States Securities and Exchange Commission ("SEC"), does not include all of the information and notes required by U.S. GAAP for complete financial statements. Operating results for the three months ended July 30, 2010 are not necessarily indicative of results that may be expected for the fiscal year ending January 31, 2011. The consolidated financial statements are prepared on a basis consistent with, and should be read in conjunction with, the consolidated financial statements and related notes for the fiscal year ended January 31, 2010 included in the Company's Annual Report on Form 10-K filed with the SEC on May 3, 2010.

## Adoption of New Accounting Pronouncements

In April 2010, the FASB issued new authoritative guidance surrounding revenue recognition, specifically addressing the criteria for recognizing revenue tied to research and development efforts. The guidance adds the milestone method to the list of acceptable methods of revenue recognition when accounting for multiple element arrangements within research and development efforts. The guidance is effective for milestones achieved in fiscal years beginning on or after June 15, 2010, unless early adoption is elected. The Company adopted the guidance beginning the quarter ended July 30, 2010, which required retrospective application from the beginning of the fiscal year. The adoption of this guidance did not have a material impact on the Company's financial statements.

## Milestone method of revenue recognition

The Company has been engaged by three separate customers for the design and development of prototypical hardware components or software programs. All three contracts are short term in nature and not expected to extend beyond twelve months. Each contract provides for interim payments upon achievement of specifically defined milestones, consisting of the delivery of hardware, software or documentation.

The Company has deemed all milestone payments within each contract to be either substantive or non-substantive. That conclusion was determined based upon a thorough review of each contract and the Company's deliverables committed to in each such contract. For substantive milestones, the Company has concluded that upon achievement of each milestone, the amount of the corresponding defined payment is commensurate with the effort required to achieve such milestone or the value of the delivered item. The payment associated with each milestone relates solely to past performance and is deemed reasonable upon consideration of the deliverables and the payment terms within the contract. For non-substantive milestones, including advance payments, the recognition of such payments are pro-rated to the substantive milestones. During the three and six months ended July 30, 2010, revenue recognized through the achievement of two milestones, relating to one of the three contracts, both during the quarter ended July 30, 2010, amounted to \$108,000, respectively.

	Milestone consideration	Milestone recognition
Milestone 1 (non-substantive)	218,000	-
Milestone 2	32,000	53,000
Milestone 3	33,000	55,000
Milestone 4	65,000	108,000
Milestone 5	65,000	108,000
Milestone 6	65,000	108,000
Milestone 7	66,000	112,000
	544,000	544,000

This table excludes two research and development contracts for which milestone revenue has not yet been recognized.

## 2. Accounts Receivable – Allowance for Doubtful Accounts

The allowance for doubtful accounts activity for the six months ended July 30, 2010 and July 31, 2009 was as follows:

	Six Months Ended	
	July 30, 2010	July 31, 2009
Beginning balance	\$ 653,000	\$ 551,000
Recoveries of amounts provided for	(71,000)	(116,000)
Ending balance	\$ 582,000	\$ 435,000



## 3. Inventories

Inventories at July 30, 2010 and January 31, 2010 consisted of the following:

	July 30, 2010	January 31, 2010
Raw materials	\$ 6,376,000	\$ 6,622,000
Work in process	2,944,000	2,758,000
Finished goods	432,000	388,000
Reserve for obsolete and slow moving inventory	(2,217,000)	(2,025,000)
Inventories, net	\$ 7,535,000	\$ 7,743,000

The reserve for obsolete and slow moving inventory activity for the six months ended July 30, 2010 and July 31, 2009 was as follows:

	July 30, 2010	Six Months Ended July 31, 2009
Beginning balance	\$ 2,025,000	\$ 1,795,000
Amounts charged to operations	192,000	-
Ending balance	\$ 2,217,000	\$ 1,795,000

## 4. Prepaid Expenses

Included in, and making up the majority of, prepaid expenses and other current assets is \$958,000 of deferred charges related to several current engineering contracts as of July 30, 2010. The Company has been retained for the development of customer specific engineering projects. All the contracts are short-term in nature and not expected to extend beyond twelve months. The deferred charges consist of \$1,004,000 of internal engineering labor, including overhead, and \$327,000 of external engineering contract labor. The deferred charges are offset by interim payments from customers of \$373,000. Included in accrued expenses and other liabilities are \$559,000 and \$273,000 of accrued contract losses at July 30, 2010 and January 31, 2010.

## 5. Intangible Assets and Other Assets

Amortization expense related to intangible assets for the three and six months ended July 30, 2010 was \$55,000 and \$110,000, respectively. Amortization expense related to capitalized debt issue costs for the three and six months ended July 30, 2010 was \$5,000 and \$12,000, respectively. Unamortized debt issue costs in the amount of \$31,000, related to the extinguished Wachovia debt, was expensed in the quarter ended July 30, 2010. Debt issue costs in the amount of \$109,000, related to the M&I debt, was capitalized and is being amortized over the three-year term of the debt.

Amortization expense related to intangible assets and capitalized debt issue costs is included in selling, general and administrative expenses.

## 6. Short-Term Notes

On May 14, 2009, the Company entered into three separate unsecured notes payable, herein referred to as "Notes Payable", with three separate private lenders, Bruce J. Stone, Redmond Family Investments, LLLP and Martin L. Schaffel, herein referred to as "the Investors", each containing a drawdown provision allowing the Company to borrow up to an aggregate of \$2,000,000. The loan agreements provide for the issuance of warrants with an exercise price of \$0.64 per warrant issued at the rate of one warrant for every four dollars loaned to the Company and common shares at the rate of one share for every ten dollars loaned to the Company. Additionally, any amounts borrowed are subject to 14% interest per annum, payable monthly.

On May 21, 2009, the Company borrowed an aggregate principal amount of \$800,000 based upon the cash drawdown provision of each of the three unsecured loan agreements. The 200,000 warrants issued to the Investors pursuant to the \$800,000 drawdown are exercisable at any time during the period after May 21, 2010 and before the warrant expiration date of April 10, 2015. Aerosonic's 80,000 common shares issued in connection with the \$800,000 cash drawdown were not registered under the Securities Act of 1933 and therefore, are restricted securities as that term is defined in Rule 144 under the Securities Act. The aggregate amount borrowed of \$800,000 was payable in full under each of the three notes on or before April 10, 2010.

On February 19, 2010, the Company entered into amendments to each of the three unsecured loan agreements with the Investors. The note modifications (a) extended the maturity date of the subordinated notes for a period of one year from April 10, 2010 to April 10, 2011, (b) removed Aerosonic's obligation to issue shares of its common stock upon each cash drawdown made on or after February 19, 2010, (c) revised the ratio of common shares underlying warrants issuable per each \$1.00 of principal amount borrowed from ".25 shares per \$1.00 of principal amount" to ".20 shares per \$1.00 of principal amount" with respect to cash draw downs made on or after February 19, 2010 and (d) deleted certain negative covenants relating to the issuance of securities. The warrant modifications (a) extended the expiration date of any warrants issued prior to February 19, 2010 for a period of five years from April 10, 2015 to April 10, 2020, (b) extended the expiration date of any warrants issued on or after February 19, 2010 from April 10, 2015 to the sixth anniversary date of the issuance of the warrant certificate and (c) revised the purchase price for any warrants issued on or after February 19, 2010 from \$0.64 per share to a price equal to 50% of the volume weighted average of the selling price of Aerosonic's common stock on February 12, 2010 and for the 19 trading days prior to February 12, 2010, or \$1.98 per share. On that date, the Company borrowed an additional \$600,000 from the Investors under the three unsecured loan agreements entered into on May 14, 2009 and amended on February 19, 2010. The related warrants (120,000 issued to the Investors pursuant to the additional \$600,000 loan) are exercisable at any time during the period after February 19, 2011 but before the expiration date of February 19, 2016.

The warrants and common shares are recorded as a separate component of interest and are being accreted into the loan balance over the term of the loan. For the three and six months ended July 30, 2010, the Company had recognized accretion of \$73,000 and \$124,000, respectively, presented as additional interest expense.

#### 7. Customer Advances

From September 2008 through January 2009, the Company received advances totaling approximately \$4,965,000 from certain customers for unbilled product orders. Such advances were used to fund production, thus alleviating some of the Company's liquidity challenges resulting from the business interruption caused by the August 2008 fire at our Florida facility. These advances represent non-interest bearing prepayments and have been offset against the resulting accounts receivable at the time of product shipments. Remaining advances from customers total approximately \$101,000 at July 30, 2010.

#### 8. Accrued Expenses and Other Liabilities

Accrued expenses and other liabilities as of July 30, 2010 and January 31, 2010 consisted of the following:

	July 30, 2010	January 31, 2010
Environmental liability	\$ 912,000	\$ 932,000
Contract loss provision	559,000	273,000
Warranty liability	119,000	167,000
Other	231,000	245,000
Accrued expenses and other liabilities	\$ 1,821,000	\$ 1,617,000

#### 9. Long-Term Debt and Notes Payable and Revolving Credit Facility

On April 30, 2010, the Company entered into a Loan Agreement (the "Loan Agreement") with M&I with a maximum amount of credit facilities available to us of \$10,100,000. The Loan Agreement provides for (a) a \$4,000,000 revolving line of credit (the "Revolving Credit Line Note"), (b) a \$3,500,000 first real estate mortgage loan (the "Real Estate Mortgage Note"), (c) a \$1,900,000 term loan (the "Equipment Term Note" and together with the Real Estate Mortgage Note, the "Bank Notes"), and (d) a \$700,000 equipment line of credit (the "Equipment Credit Line Note" and together with the Revolving Credit Line Note, the "Credit Line Notes"). The proceeds from the M&I facilities were



used, in part, to fully satisfy the outstanding debt and fees with Wachovia of \$7,521,830. The available funds received and financing available under the Loan Agreement will be used for new product development, working capital and capital expenditure needs.

Repayment of the loans and all obligations to M&I under the Loan Agreement, the Bank Notes and Credit Line Notes are collateralized by the personal property and real property of the Company. Details of loan facilities are as follows:

- The Revolving Credit Line Note, which supports a \$4,000,000 revolving line of credit, has a 364 day term and provides a line of credit in an amount equal to the lesser of (a) the Revolving Credit Limit of \$4,000,000; or (b) the Borrowing Base, which is the sum of (i) up to eighty percent (80%) of the aggregate amount of Eligible Accounts, which is represented by all of the Company's accounts, which contain selling terms and conditions acceptable to M&I; plus (ii) eighty percent (80%) of the aggregate amount of Finished Goods Inventory, which is represented, at any time, by all of the Company's inventory, except: (a) inventory which is not subject to a perfected first priority security interest in favor of M&I and not otherwise free and clear of all other liens; (b) inventory which M&I, in its sole discretion, deems to be obsolete, unsalable, damaged, defective or unfit for further processing; (c) work in progress; (d) inventory stored offsite for which M&I cannot obtain a landlord waiver or which is not insured by the Company; and (e) inventory in transit from vendor/supplier if such inventory is uninsured; plus (iii) fifty percent (50%) of the aggregate amount of Raw Materials Inventory, which is represented by materials used to assemble inventory, including purchased and manufactured components and subassemblies, with the aggregate total inventory of (ii) and (iii) not to exceed \$1,500,000. The interest rate on the Revolving Credit Line Note is one month LIBOR plus 300 basis points with a 4% floor. Interest is paid monthly.
- The Real Estate Mortgage Note, which supports a \$3,500,000 first real estate mortgage loan, has a 3 year term, a 15 year amortization period, and the interest rate is one month LIBOR plus 340 basis points with a 4% floor. Interest and principal are paid monthly. The proceeds of the Real Estate Mortgage Note were used for refinancing an existing loan relating to the Clearwater, Florida property and for working capital and capital expenditure needs.
- The Equipment Term Note, which supports a \$1,900,000 term loan, has a 3 year term, a 5 year amortization period, and the interest rate is one month LIBOR plus 340 basis points with a 4% floor. Interest and principal are paid monthly. The proceeds of the Equipment Term Note were used for refinancing an existing loan relating to the Earlysville, Virginia property and for working capital and capital expenditure needs. In the event the Company receives any proceeds from the sale of the Earlysville, Virginia property, the Company shall immediately remit such proceeds to M&I and such proceeds shall be applied as a principal payment under the Equipment Term Note.
- The Equipment Credit Line Note, which supports a \$700,000 equipment line of credit, has a 3 year term, a 5 year amortization period, and the interest rate is one month LIBOR plus 325 basis points with a 4% floor. Interest and principal are paid monthly. Proceeds are used to purchase equipment for use in the Company's business.

The Loan Agreement with M&I contains certain financial and other restrictive covenants, including the requirement to maintain: (i) on a consolidated basis, Total Stockholders' Equity, defined as the value of total assets less total liabilities, equal to at least \$7,419,000, which amount shall increase on a quarterly basis in an amount equal to ninety percent (90%) of the Company's net income (calculated on a consolidated basis) for such quarter; (ii) on a consolidated basis, a ratio of Funded Debt, defined as all outstanding liabilities for borrowed money and other interest-bearing liabilities, including current and long term debt, less the non-current portion of Subordinated Liabilities, defined as liabilities subordinated to the Company's obligations to M&I in a manner acceptable to M&I in its sole discretion, to EBITDA not exceeding 3.0:1.0; and (iii) on a consolidated basis, a Fixed Charge Coverage Ratio, defined as the ratio of (a) the sum of EBITDA plus lease expense and rent expense, minus income tax, minus dividends, withdrawals, and other distributions, to (b) the sum of cash interest expense, lease expense, rent expense, scheduled principal amortization actually paid to M&I during the measuring period (excluding any principal payments under the Revolving Credit Line Note and the Investors' Notes Payable), and scheduled payments on capitalized lease obligations during the measuring period, of at least 1.20:1.0. These three covenant amounts shall be calculated at the end of each quarterly reporting period for which M&I will require financial statements. As of July 30, 2010 the Company was in compliance with all of M&I's financial and other restrictive covenants.

Prior to the refinancing with M&I on April 30, 2010, the Company's credit facilities were with Wachovia. In fiscal year 2008, the Company increased the maximum amount available to the Company under its credit facilities with

Wachovia to \$8,420,000 and delivered to Wachovia two replacement promissory notes as follows: (i) a Renewal and Future Advance Promissory Note in the amount of \$3,920,000 (the “Future Advance Note”), and (ii) a Renewal and Amended Term Promissory Note in the amount of \$2,000,000 (the “Term Note” and together with the Future Advance Note, the “Notes”). Additionally, the Company’s revolving credit facility of \$2,500,000 was continued under the original terms of the revolving promissory note. The Future Advance Note was collateralized by the Company’s real estate in Clearwater, Florida. The revolving credit facility was collateralized by the Company’s assets, with the exception of the Company’s real estate located in Earlysville, Virginia and Clearwater, Florida. The Term Note was collateralized by the Company’s real estate in Earlysville, Virginia. The Notes were scheduled to mature on: (i) with respect to the Future Advance Note, September 1, 2022, and (ii) with respect to the Term Note, June 1, 2011. The interest rate on the Wachovia revolving credit facility, as well as on the Notes was one-month LIBOR (which was 0.25% and 0.23% at April 30, 2010, the date of refinancing, and January 31, 2010, respectively), plus 300 basis points.

The Company's long-term debt agreements with Wachovia contained certain financial and other restrictive covenants, including the requirement to maintain: (i) at all times, a ratio of total liabilities to tangible net worth that does not exceed 1.30 to 1.00; and (ii) at the end of each fiscal quarter, a cash flow coverage ratio (with regard to the debt service) of at least 1.25 to 1.00.

As of January 31, 2010, the Company was not in compliance with Wachovia's cash flow coverage ratio covenant and the total liability to tangible net worth covenant. Wachovia provided a written waiver of the non-compliance to the Company through April 30, 2010. Consequently, the entire amount of long-term debt was classified as current maturities at January 31, 2010.

Wachovia's other restrictive covenants, among other things, required the Company to obtain consent from the lender prior to making a material change of management, guarantee or otherwise become responsible for obligations of any other person or entity or assuming or becoming liable for any debt, contingent or direct, in excess of \$100,000.

The interest rate on the M&I Revolving Credit Line Note was one-month LIBOR (which was 0.31% at July 30, 2010), plus 300 basis points with a 4% floor. Available borrowings on the Revolving Credit Line Note at July 30, 2010 were \$943,000.

Long-term debt and notes payable at July 30, 2010 and January 31, 2010 consisted of the following:

	July 30, 2010	January 31, 2010
Future Advance Note	\$ -	\$ 3,294,000
Term Note	-	1,786,000
Real Estate Mortgage Note	3,461,000	-
Equipment Term Note	1,837,000	-
Notes Payable	1,162,000	688,000
	6,460,000	5,768,000
Less: current maturities	(1,776,000)	(5,768,000)
Long-term debt, less current maturities	\$ 4,684,000	\$ -

Interest expense on long-term debt, notes payable and the revolving credit line for the three months ended July 30, 2010 and July 31, 2009 was \$211,000 and \$151,000, respectively. Included in interest expense, net is accretion of discount on notes payable of \$73,000 and \$67,000 for the three months ended July 30, 2010 and July 31, 2009, respectively. Interest expense on long-term debt, notes payable and the revolving credit line for the six months ended July 30, 2010 and July 31, 2009 was \$361,000 and \$207,000, respectively. Included in interest expense, net is accretion of discount on notes payable of \$124,000 and \$67,000 for the six months ended July 30, 2010 and July 31, 2009, respectively.

## 10. Stockholders' Equity

### Earnings Per Share

Basic earnings per share are based upon the Company's weighted average number of common shares outstanding during each period. Diluted earnings per share is based upon the weighted average number of common shares outstanding during each period, assuming the issuance of common shares for all dilutive potential common shares outstanding during the period. Some potential common stock shares resulting from stock options were not included in the computation of diluted earnings per share for the three months ended July 30, 2010 as the exercise price of those options were greater than the market value of the common stock and inclusion of the potential common stock would be anti-dilutive and increase earnings per share. Potential common stock shares from stock options and warrants,

which were included in the computation of diluted earnings per share for the three months ended July 30, 2010, were accounted for using the treasury stock method.

11. Commitments and Contingencies

Litigation

From time to time, the Company may be involved in certain claims and legal actions arising in the ordinary course of business. As of July 30, 2010, there were no claims or legal actions that management believes will have a material adverse effect on the Company's financial position, results of operations, or liquidity.

12

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## Environmental

In preparation for the sale of the Earlysville, Virginia facility, the Company engaged an environmental consulting firm to survey the property for possible soil or groundwater contamination. This survey revealed impacts to both shallow soils and groundwater that may have resulted from the accidental loss of solvents. As a result of the initial and subsequent surveys, contamination treatment was determined to be necessary for an estimated total cost of \$912,000 as of July 30, 2010, as determined by an environmental compliance specialist, and which is included in the environmental liability. Thus, in accordance with U.S. GAAP, the Company capitalized these contamination treatment costs in its fiscal year 2008 financial statements as an increase to property held for sale, net, since such costs will be incurred in preparation for the sale of the Earlysville, Virginia facility. Costs incurred totaled \$9,000 and \$2,000 for the three months ended July 30, 2010 and July 31, 2009, respectively. Costs incurred totaled \$20,000 and \$2,000 for the six months ended July 30, 2010 and July 31, 2009, respectively.

The Company has solicited proposals from highly qualified environmental consulting firms and received proposals from which management estimates the cost of contamination treatment to be approximately \$597,000. Additionally, \$98,000 is required to pay an environmental consulting firm to characterize any contamination that may be present in the ground between the Company's property and nearby homes. Depending on the findings of this additional study, the scope and cost of the contamination treatment may change. Current estimates of future monitoring, oversight and other related costs are \$217,000. The Company is proceeding with the final characterization of the site as well as the resulting treatment actions required under the Voluntary Remediation Program (VRP) program administered by the Virginia DEQ. We will reassess the accrued liability and record any appropriate adjustments in our financial statements following completion of the characterization process.

After the August 8, 2008 fire at our Florida facility, during a routine investigation by the Florida Department of Environmental Protection ("Florida DEP"), the Company was cited with violations, and potential civil penalties estimated at \$100,000, relating to the storage, handling and disposal of normal chemicals, solvents and paints used in our production facility. The Company's remediation plan, to avoid future violations and the payment of the above civil penalties, was submitted and subsequently approved by the Florida DEP. During the three months ended April 30, 2010, the Company completed the construction of a materials handling building at a cost of \$116,000. On June 7, 2010, the Company received a release of said violations and civil penalties from the Florida DEP.

## Commitments

There have been no material changes to our purchase and lease commitments from those disclosed in our Annual Report on Form 10-K for the year ended January 31, 2010. Total rent expense under the facility lease in Charlottesville, Virginia for the three months ended July 30, 2010 and July 31, 2009, was \$42,000 and \$24,000, respectively, which are both included in cost of sales. Rent expense for the six months ended July 30, 2010 and July 31, 2009, was \$70,000 and \$66,000, respectively, which are both included in cost of sales.

ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS ("MD&A")

Explanatory Note

We begin Management's Discussion and Analysis of Financial Condition and Results of Operations ("MD&A") of Aerosonic Corporation with a business overview followed by the "Results of Operations." We then provide an analysis of cash flows under "Liquidity and Capital Resources" as well as a discussion on working capital and capital expenditures. This is followed by a discussion of the critical accounting estimates that we believe are important to understanding the assumptions and judgments incorporated in our reported financial results and in the discussion provided within the MD&A. This MD&A should be read in conjunction with our unaudited Consolidated Financial Statements, the notes thereto, the other unaudited financial data included elsewhere in this Quarterly Report on Form 10-Q and our 2010 Annual Report on Form 10-K filed with the SEC on May 3, 2010.

Overview

We are an aerospace industry leader in the design and manufacturing of aircraft instrumentation and sensor systems. These products are used for both primary flight data as well as standby instrumentation in cockpits where electronic displays are used for primary flight data. As cockpit panel space becomes more valuable in the new age of glass displays, we have maintained a strong position with OEMs as a premier supplier of quality aircraft instrumentation in both the military and commercial aircraft marketplace. This allows us to offer a fully integrated avionics package from air data to display and backup instrumentation thus reducing the number of suppliers required on the aircraft. The Company's unique capabilities in air data products continue to expand with the development of a flush port air data system for a leading international aircraft manufacturer for use on a new Unmanned Combat Air Vehicle and Level A certification of a Stall Warning Transmitter (SWT) for a major US manufacturer of business and military aircraft.

Building on our expertise with mechanical instrumentation, we have successfully developed and marketed digital instrumentation and displays for both primary flight data systems as well as standby redundant systems to complement our mechanical line of business. In addition, we have also made considerable progress in developing electronic air data collection instrumentation for military and commercial aircraft.

Our current market focus has been and will continue to be the design, development and supply of electronic and mechanical primary and standby flight control systems components and instruments. These include altimeters, airspeed indicators, angle of attack indicators, stall warning systems, air data measurement systems and flight display systems. All of these products are critical to aircraft operation, performance and safety.

In conjunction with our development and production activities, Aerosonic has developed expertise in the build, test and validation of critical test equipment including ESS chambers and wind tunnels. Aerosonic is expanding that knowledge to offer customers the ability to order turnkey solutions for their test needs.

The trend in the aerospace industry continues toward digital cockpits as the aerospace industry moves away from mechanical cockpit instrumentation that was our foundation. During the first two quarters of fiscal year 2011, we continued to make progress in our ability to design and manufacture digital instrumentation that is integrated into cockpit flight management systems. We have maintained and strengthened our commitment to research and development to further enhance our product line as we anticipate continued movement toward digital cockpits in the aerospace industry. We plan to position ourselves such that we have the ability to offer both digital and mechanical instrumentation. While we believe that this strategy will, over time, strengthen our position in the aerospace industry, we cannot guarantee that this strategy will be successful or that we will have access to the capital resources needed to fully support this strategy.

We also have significant business tied to military programs. As a consequence, our business can fluctuate depending on government spending on military programs for which we supply our products. While we have been successful in obtaining contracts to supply military needs in recent years, changes in government spending could have a favorable or unfavorable impact on our future military business. While we cannot fully predict the outcome of the U.S. government's budget process, we expect that the majority of the military programs we supply will be sustained at current or near current levels.

Likewise, changes in the commercial sector of the aerospace industry can have a favorable or unfavorable impact on our future business. While we have historically invested heavily in product development for both funded and unfunded programs, OEM requirements may change such that additional product development efforts will be necessary to maintain or increase our revenue in the aerospace industry. With the recent economic conditions, several of our commercial customers continue to operate with reduced operations and manufacturing. While this may be offset by additional increases in aftermarket support, it is likely that our business will continue to be negatively affected until the economy recovers and our customers resume prior levels of production and growth.



## Results of Operations

Our senior management regularly reviews the performance of our operations including reviews of key performance metrics and the status of operating initiatives. We review information on the financial performance of the operations, new business opportunities, customer relationships and initiatives, IR&D activities, human resources, manufacturing effectiveness, cost reduction activities, as well as other subjects. We compare performance against budget, against prior comparable periods and against our most recent internal forecasts.

Three months ended July 30, 2010 and July 31, 2009:

Net sales for the second quarter of fiscal year 2011 decreased \$1,301,000, or 16%, to \$6,813,000 when compared to \$8,114,000 for the second quarter of fiscal year 2010. During the second quarter of fiscal year 2011, the sales volume decreased from the prior year by approximately \$2.4 million on reduced demand for transmitter products, sensor products and spares, offset by approximately \$1.3 million of increased sales volume of mechanical instruments, contributing to the net decrease of \$1.3 million. The sales volume for the second quarter of fiscal year 2010 was enhanced through the fulfillment of backlogged sales caused by the August 8, 2008 fire offsetting the initial impacts of the recession.

Cost of sales for the second quarter of fiscal year 2011 decreased \$237,000, or 5%, to \$4,714,000 when compared to \$4,951,000 for the second quarter of fiscal year 2010 as a result of the lower sales volume. Gross profit for the second quarter of fiscal year 2011 was 30.8% versus 39.0% for the second quarter of fiscal year 2010. The three month comparative decrease in gross profit, as a percent of sales, reflects (a) the effects of a significantly higher mix of mechanical products which historically produce lower gross margins and (b) contract loss provisions of approximately \$286,000 on two customer funded development contracts. Management views these costs as investments in technology and capabilities that are expected to benefit future business opportunities. Future enhancement of gross profit will require continuously improving throughput in our manufacturing processes while reducing costs and inefficiencies in our operations through better resource management. We are well engaged with the implementation of lean manufacturing principles, supported by training programs to further develop a consistent, disciplined, and innovative engineering and production culture. These initiatives are complemented by a marketing and sales strategy that builds on our market presence and core competencies in sensor, air data computation, and display technologies.

Selling, general and administrative expenses for the second quarter of fiscal year 2011 was \$1,819,000 and was a decrease of approximately \$340,000 from the second quarter of fiscal 2010 of \$2,159,000. The net decrease was primarily due to (a) a decrease in legal and consulting expenses, offset by (b) increases in sales commissions relating to international sales and (c) increases in internally funded research and development (IR&D) costs. Our investment in IR&D was immaterial during the second quarter of fiscal 2010 when our engineering resources were focused on the operational recovery from August 2008 fire.

We reported operating income during the second quarter of fiscal 2011 of \$280,000, or 4.1% of net sales, compared to \$1,004,000, or 12.4% of net sales, in the prior year's second quarter, a decrease of \$724,000. This decrease in operating income is primarily attributable to (a) the comparatively lower net sales and (b) the lower gross margin percentage as described above, offset by (c) the reduced level of selling, general, and administrative expenses.

Interest expense, net, increased \$60,000 for the second quarter of fiscal year 2011 when compared to the second quarter of fiscal year 2010 primarily as a result of accretion expense relating to the \$1,400,000 Investors notes payable presented in other income. The prior year second quarter included a gain from casualty of \$50,000 relating to the claim as a result of the August 8, 2008 fire.

Income before income taxes was approximately \$38,000 in the second quarter of fiscal year 2011 versus \$904,000 in the second quarter of fiscal year 2010. The provision for income taxes was \$20,000 as our estimated effective income tax rate for fiscal 2011 is approximately 41.7% compared to an effective income tax rate of 37.1% last year. The fiscal 2011 estimated effective tax rate is higher than the statutory rate of approximately 37% primarily due to the permanent tax difference relating to the accretion expense associated with the Investors notes payable. For the quarter ended July 30, 2010, net income was approximately \$18,000 or \$0.00 basic and diluted earnings per share, versus net income of approximately \$556,000, or \$0.15 basic and \$0.14 diluted earnings per share for the quarter ended July 31, 2009.

Six months ended July 30, 2010 and July 31, 2009:

Net sales for the six months ended July 30, 2010 decreased \$3,144,000, or 18.6%, to \$13,744,000 when compared to \$16,888,000 for the six months ended July 31, 2009. During the six months of fiscal year 2011, the sales volume decreased from the prior year by approximately \$4.5 million on reduced demand for transmitter products, sensor products and spares, offset by approximately \$2.1 million of increased sales volume of mechanical instruments, contributing to the net decrease of \$3.1 million.

Cost of sales for six months of fiscal year 2011 decreased \$924,000, or 9%, to \$9,491,000 when compared to \$10,415,000 for the six months of fiscal year 2010. Gross profit for the six months of fiscal year 2011 was 30.9% versus 38.3% for the six months of fiscal year 2010. The six month comparative decrease in gross profit, as a percent of sales, reflects (a) the effects of a significantly higher mix of mechanical products which historically produce lower gross margins and (b) contract loss provisions of approximately \$286,000 on two customer funded development contracts. Management views these costs as investments in technology and capabilities that are expected to benefit future business opportunities. Selling, general and administrative expenses for the six months of fiscal year 2011 was \$3,605,000 and was a decrease of approximately \$133,000 over the six months of fiscal 2010 at \$3,738,000. The net decrease was primarily due to (a) decreases in legal and consulting expenses, offset by (b) increases in sales commissions relating to international sales and (c) increases in internally funded research and development (IR&D) costs. Our investment in IR&D was immaterial during the six months of fiscal 2010 when our engineering resources were focused on the operational recovery from August 2008 fire.

Selling, general and administrative expenses for the six months of fiscal year 2011 was \$3,574,000 and was a decrease of approximately \$164,000 over the six months of fiscal 2010 at \$3,738,000. The net decrease was primarily due to (a) decreases in legal and consulting expenses, offset by (b) increases in sales commissions relating to international sales and (c) increases in internally funded research and development (IR&D) costs. Our investment in IR&D was immaterial during the six months of fiscal 2010 when our engineering resources were focused on the operational recovery from August 2008 fire.

We reported operating income during the six months of fiscal 2011 of \$679,000, or 4.9% of net sales, compared to \$2,735,000, or 16.2% of net sales, in the prior year's six months period, a decrease of \$2,056,000. This decrease in operating income is primarily attributable to (a) the comparatively lower net sales and (b) the lower gross margin percentage as described above, offset by (c) the reduced level of selling, general, and administrative expenses.

Interest expense, net, increased \$154,000 for the six months of fiscal year 2011 when compared to the six months of fiscal year 2010 primarily as a result of accretion expense relating to the \$1,400,000 Investors notes payable presented in other income. The prior year six months period included a gain from casualty of \$550,000 relating to the claim as a result of the August 8, 2008 fire.

Income before income taxes was approximately \$475,000 in the six months of fiscal year 2011 versus \$3,071,000 in the six months of fiscal year 2010. The provision for income taxes was \$198,000 as our estimated effective income tax rate for fiscal 2011 is approximately 41.7% compared to an effective income tax rate of 37.1% last year. The fiscal 2011 estimated effective tax rate is higher than the statutory rate of approximately 37% primarily due to the permanent tax difference relating to the accretion expense associated with the Investors notes payable. For the six month period ended July 30, 2010, net income was approximately \$277,000 or \$0.07 basic and \$0.07 diluted earnings per share, versus net income of approximately \$1,931,000, or \$0.53 basic and \$0.51 diluted earnings per share for the six month period ended July 31, 2009.

Liquidity and Capital Resources

We believe that anticipated cash flows from operations, together with existing cash and cash equivalents and our new M&I facilities will be adequate to finance presently anticipated working capital, capital expenditure requirements and other contractual obligations and to repay our short and long-term debt as it matures.

Cash used in operating activities was \$1,073,000 and \$1,344,000 for the six months ended July 30, 2010 and July 31, 2009, respectively. This reduction in cash usage was attributable, in part, to a \$1,992,000 reduction in the Company's repayment of customer cash advances for prospective shipment of Company products. The cash advances were made to the Company subsequent to the August 2008 fire for the purpose of supporting our loss recovery efforts. In addition, improved collection of customer accounts, as well as better management of inventory and expenses, resulted in additional favorable cash flow variances when compared to the same period of the prior year. The unfavorable cash flow impacts for the six months ended July 30, 2010, when compared to the six months ended July 31, 2009, stem from less net income and a reduction to the prior year favorable cash flow adjustment relating to the income tax provision. Additionally, increased payments to vendors, comparing year over year, resulted in further unfavorable variances.

Cash used in investing activities was \$672,000 for the six months ended July 30, 2010, compared to cash used in investing activities of \$761,000 for the six months ended July 31, 2009. In both quarters, the cash used was attributable to the purchase of new, as well as the internal development of, production and testing equipment, most of which was destroyed in the August 2008 fire.

Cash provided by financing activities was \$1,819,000 for the six months ended July 30, 2010, compared to cash provided by financing activities of \$2,105,000 for the six months ended July 31, 2009. When compared to the six months ended July 31, 2009, the unfavorable variance in cash provided by financing activities for the six months ended July 30, 2010 was due primarily to positive cash flows from the refinancing of long-term debt, offset by reduced comparable Investor debt proceeds and the reduced borrowings on the revolving line of credit

#### Working Capital and Capital Expenditures

Our working capital at July 30, 2010 was \$7,155,000 compared to \$2,326,000 at January 31, 2010, an increase of \$4,829,000. The increase in working capital during the six months ended July 30, 2010 related primarily to the reclassification of debt from current to noncurrent, sourced by the April 30, 2010 debt refinancing with M&I which accounted for \$3,992,000 of the increase. Additional increases in working capital were created by an increase to deferred charges of \$197,000 related to ongoing engineering contract costs, an increase to accounts receivable of \$692,000, due primarily to the timing of collections and a decrease to trade and accrued liabilities of \$1,174,000, a by-product of the Company's effort to improve vendor credit terms. The decreases to working capital stem from a reduction of inventory of \$208,000, a result of the Company's efforts to improve the management of inventory, additional draw-downs on the Revolving Credit Line Note of \$892,000 and a reduction to the deferred tax asset of \$198,000, a direct result of the current income tax provision.

Future capital requirements depend on numerous factors, including unforeseen costs associated with production and testing requirements, research and development, expansion of product lines and other factors. Furthermore, we may need to develop and introduce new or enhanced products, respond to competitive pressures, invest or acquire businesses or technologies or respond to unanticipated requirements or developments, which would require additional resources.

#### Critical Accounting Policies

The discussion and analysis of our financial condition and results of operations are based upon the accompanying unaudited consolidated financial statements, which have been prepared in accordance with U.S. GAAP. The preparation of those financial statements and this Quarterly Report on Form 10-Q requires us to make estimates and judgments that affect the reported amount of assets and liabilities, revenues and expenses, and related disclosure items, including disclosure of contingent assets and liabilities, at the date of our financial statements. Actual results may differ from these estimates under different assumptions or conditions, and as a result of trends and uncertainties identified previously under "Results of Operations" and "Liquidity and Capital Resources". Such differences could be material.

Set forth below is a discussion of the Company's critical accounting policies. The Company considers critical accounting policies to be those (i) that require the Company to make estimates that are highly uncertain at the time the estimate is made, (ii) for which a different estimate which could have been made would have a material impact on the Company's financial statements, (iii) that are the most important and pervasive policies utilized, and (iv) that are the most sensitive to material change from external factors. Additionally, the policies discussed below are critical to an understanding of the financial statements because their application places the most significant demands on management's judgment, with financial reporting results relying on estimates about the effect of matters that are highly uncertain. Specific risks for these critical accounting policies are described in the following paragraphs. The impact

and any associated risks related to these policies on business operations is discussed throughout this MD&A where such policies affect reported and expected financial results.

Senior management has discussed the development and selection of the critical accounting estimates and the related disclosure included herein with the Audit Committee of the Board of Directors.

#### Revenue Recognition

The Company generally recognizes revenue from sales of its products when the following have occurred: evidence of a sale arrangement exists; delivery or shipment has occurred or services have been rendered; the price to the buyer is fixed or determinable; and collectability is reasonably assured.

For fixed-price contracts, the Company recognizes revenue on a completed contract “units of delivery” basis. The units-of-delivery method recognizes as revenue the contract price of units of a basic production product delivered during a period and as the cost of earned revenue the costs allocable to the delivered units; costs allocable to undelivered units are reported in the balance sheet as inventory or work in progress. Revenue is recorded when title to the goods passes to the customer, generally upon shipment. The Company recognizes most of its revenue under the completed contract method.

For long-term, fixed-price contracts meeting certain criteria, the Company may elect to follow the percentage-of-completion method of accounting for revenue recognition. Under this method, contract revenue is computed as that percentage of estimated total revenue that costs incurred to date bear to total estimated costs, after giving effect to the most recent estimates of costs to complete. From time to time, the Company will record costs and estimated profits in excess of billings for a contract. Revisions in costs and revenue estimates are reflected in the period in which the revisions are determined. Provisions for estimated losses on uncompleted contracts are made in the period in which such losses are determined without regard to the percentage-of-completion.

Occasionally, the Company enters into research and development contracts with customers. When the contracts provide for milestone or other interim payments, generally, the Company will follow the milestone method, which recognizes revenue upon achievement of each milestone. Milestones are commensurate with the effort required to achieve the milestone or the value of the delivered item. Additionally, the payment associated with each milestone relates solely to past performance and is deemed reasonable upon consideration of the deliverables and the payment terms within the contract. When there is no milestone or other interim payments, revenue is generally recognized at completion. The Company adopted the use of the milestone method for the quarter ended July 30, 2010.

As a general matter, the terms specified in customer purchase orders determine whether the Company or the customer bears the obligation for payment of freight charges. While customers pay for freight in most transactions, the Company does occasionally pay freight charges on behalf of customers and may bill all or a portion to customers.

#### Accounts Receivable, Allowance for Doubtful Accounts and Credit Losses

The Company continuously evaluates its customers and provides specific reserves for anticipated credit losses as soon as collection becomes compromised. Measurement of such losses requires consideration of historical loss experience, including the need to adjust for current conditions, and judgments about the probable effects of relevant observable data, including present economic conditions such as delinquency rates and financial health of specific customers.

#### Inventories

The Company values inventory at the lower of cost using a method that approximates the first-in, first-out method (“FIFO”), or net realizable value. The reserve for obsolete and slow moving inventory is based upon reviews of inventory quantities on hand, usage and sales history.

During production, the Company uses standards to estimate product costs. These standards are reviewed and updated periodically by management and approximate costing under the FIFO method.

#### Property Held for Sale

Property held for sale is reported at the lower of its carrying amount or fair value less cost to sell. Depreciation on property held for sale is discontinued at the time the criteria, established by U.S. GAAP, are met. The Earlysville, Virginia property is presently held for sale. The property consists of a 53,000 square foot manufacturing facility on approximately 12 acres of land. In preparation for the sale of the Earlysville, Virginia facility, we engaged an

environmental consulting firm to survey the property for any possible soil or groundwater contamination. This survey revealed impacts to both shallow soils and groundwater that may have resulted from the accidental loss of solvents by a former owner of the property. As a result of the initial and subsequent surveys, the remaining contamination treatment costs are estimated at \$912,000. The Company has capitalized these contamination treatment costs as an increase to property held for sale, net, since such costs will be incurred in preparation for the sale of the Earlysville, Virginia facility and will not result in a carrying value in excess of the estimated fair value less cost to sell. Costs incurred during the three months ended July 30, 2010 and July 31, 2009, totaled \$9,000 and \$2,000, respectively. Costs incurred during the six months ended July 30, 2010 and July 31, 2009, totaled \$20,000 and \$2,000, respectively.



## Goodwill and Intangible Assets

The carrying value of goodwill is reviewed at least annually for impairment and will be reviewed more frequently if current events and circumstances indicate a possible impairment. An impairment loss is charged to expense in the period identified. As current events and circumstances warrant, the Company examines the carrying value of its intangible assets with finite lives, such as capitalized software and development costs, purchased intangibles, and other long-lived assets, to determine whether there are any impairment losses. If indicators of impairment are present and future cash flows are not expected to be sufficient to recover the asset's carrying amount, an impairment loss is charged to expense in the period identified. Factors that may cause impairment include negative industry or economic trends or significant underperformance relative to historical or projected future operating results.

## Long-Lived Assets

Management periodically evaluates long-lived assets for potential impairment. Upon indication of possible impairment, management evaluates the recoverability of such asset. When an evaluation indicates that the impairment is unrecoverable, the asset is written down to its estimated fair value.

## Income Taxes

Aerosonic and its includable subsidiaries file a consolidated U.S. federal income tax return in accordance with the provisions of the Internal Revenue Code of 1986, as amended.

The Company's accounting for income taxes represents management's best estimate of various events and transactions.

Deferred tax assets and liabilities resulting from temporary differences between the financial reporting and tax bases of assets and liabilities are measured at the balance sheet date using enacted tax rates expected to apply to taxable income in the years the temporary differences are expected to reverse.

The realization of deferred tax assets depends upon the existence of sufficient taxable income within the carryback or carryforward periods under the tax law in the applicable tax jurisdiction. Valuation allowances are established when management determines, based on available information, that it is more likely than not that deferred income tax assets will not be realized. Significant judgment is required in determining whether valuation allowances should be established as well as the amount of such allowances. When making such determination, consideration is given to, among other things, the following:

- future taxable income exclusive of reversing temporary differences and carryforwards;
- future reversals of existing taxable temporary differences;
- taxable income in prior carryback years; and
- tax planning strategies.

The Company classifies tax related interest as interest expense and tax related penalties as a component of income taxes.

## Research and Development

Research and development costs are expensed in the period incurred.

## Environmental Expenditures

The Company assesses its property held for sale, along with any property that is being taken out of its initially intended use, for the presence of hazardous or toxic substances that would result in an environmental liability.

Liabilities for environmental remediation costs not related to retirements of tangible long-lived assets, and arising from claims, assessments, litigation, fines, and penalties and other sources, are recorded when it is probable that a liability has been incurred and the amount of the assessment and/or remediation can be reasonably estimated.

Legal costs incurred in connection with environmental remediation are expensed as incurred. Recoveries of environmental remediation costs from third parties, which are probable of realization, are separately recorded as assets, and are not offset against the related environmental liability, in accordance with U.S. GAAP.

### Stock-Based Compensation

U.S. GAAP requires that all stock-based compensation be recognized as an expense in the financial statements and that such cost be measured at the fair value of the award. Under this method, in addition to reflecting compensation for new share-based awards, expense is also recognized to reflect the remaining service period of awards. U.S. GAAP requires that the cost of all share-based transactions be measured at fair value and recognized over the period during which a grantee is required to provide goods or services in exchange for the award. Although the terms of the Company's share-based plans do not accelerate vesting upon retirement, or the attainment of retirement eligibility, the requisite service period subsequent to attaining such eligibility is considered non-substantive. Accordingly, the Company recognizes compensation expense related to share-based awards over the shorter of the requisite service period or the period to attainment of retirement eligibility. U.S. GAAP also requires an estimation of future forfeitures of share-based awards to be incorporated into the determination of compensation expense when recognizing expense over the requisite service period.

During the three months ended July 30, 2010 and July 31, 2009, the Company recorded approximately \$46,000 and \$45,000, respectively, of stock-based compensation expenses. During the six months ended July 30, 2010 and July 31, 2009, the Company recorded approximately \$91,000 and \$93,000, respectively, of stock-based compensation expenses.

Stock issued in payment for services provided by members of the board of directors is expensed in the period the services are provided. During the three months ended July 30, 2010 and July 31, 2009, the Company recorded director compensation expense, relating to stock-based compensation, in the amount of \$15,000, respectively. During the six months ended July 30, 2010 and July 31, 2009, the Company recorded director compensation expense, relating to stock-based compensation, in the amount of \$30,000, respectively.

### Off-Balance Sheet Arrangements

The Company does not maintain off-balance sheet arrangements except as disclosed in our Annual Report on Form 10-K for the fiscal year ended January 31, 2010 nor does it participate in non-exchange traded contracts requiring fair value accounting treatment.

### Contractual Obligations

There have been no material changes to our commitments and contingencies from that disclosed in our Annual Report on Form 10-K for the year ended January 31, 2010.

### Adoption of New Accounting Pronouncements

In April 2010, the FASB issued new authoritative guidance surrounding revenue recognition, specifically addressing the criteria for recognizing revenue tied to research and development efforts. The guidance adds the milestone method to the list of acceptable methods of revenue recognition when accounting for multiple element arrangements within research and development efforts. The guidance is effective for milestones achieved in fiscal years beginning on or after June 15, 2010, unless early adoption is elected. The Company adopted the guidance beginning the quarter ended July 30, 2010, which required retrospective application from the beginning of the fiscal year. The adoption of this guidance did not have a material impact on the Company's financial statements.

### ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

We do not issue or invest in financial instruments or their derivatives for trading or speculative purposes. Our market risk is limited to fluctuations in interest rates pertaining to our borrowings under our existing credit facilities which require the payment of interest at variable rates equal to one-month LIBOR plus 300 to 340 basis points, with a minimum rate of 4%. We therefore are exposed to market risk from changes in interest rates on certain of our funded debt. Any increase in these rates could adversely affect our interest expense. The extent of market rate risk associated with fluctuations in interest rates is not quantifiable or predictable because of the volatility of future interest rates and business financing requirements. We use no derivative products to hedge or mitigate interest rate risk.

Based on the outstanding balance on our credit facilities with M&I as of July 30, 2010, a 1% increase in interest rates would cost the Company approximately \$28,000 annually.

ITEM 4.

CONTROLS AND PROCEDURES

We evaluated the effectiveness of the design and operation of our disclosure controls and procedures, as defined in Rules 13a-15(e) and 15d-15(e) of the Exchange Act, as of July 30, 2010. Our principal executive and financial officers supervised and participated in the evaluation. Based on the evaluation, and in light of the previously identified material weakness as of January 31, 2010, described within the 2010 Annual Report on Form 10-K, our principal executive and financial officers each concluded that, as of July 30, 2010, our disclosure controls and procedures were not effective in providing reasonable assurance that information required to be disclosed by us in the reports we file or submit under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the SEC's form and rules and accumulated and communicated to our management, including our principal executive and principal financial officer, as appropriate, to allow timely decisions regarding required disclosures.

Given the identification of the above material weakness, we are continuing on a course of action that we anticipate will remediate the material weakness. Management completed a standard cost accounting analysis and developed a plan of actions deemed necessary to provide reasonable assurance that controls are adequate to detect or prevent a material misstatement in our financial statements in a timely manner. Implementation of remediation actions is progressing as planned and will continue through fiscal year 2011.

Changes in Internal Control Over Financial Reporting

There were no changes in the Company's internal controls over financial reporting (as such term is defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act) during the fiscal quarter ended July 30, 2010 that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

PART II – OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

None

ITEM 1A. RISK FACTORS

None

ITEM 2. UNREGISTERED SALE OF EQUITY SECURITIES AND USE OF PROCEEDS

None

ITEM 3. DEFAULTS UPON SENIOR SECURITIES

None

ITEM 5. OTHER INFORMATION

None

ITEM 6. EXHIBITS

Exhibit No.	Description of Exhibit
31.1	Section 302 Certification
31.2	Section 302 Certification
32.1	Section 906 Certification
32.2	Section 906 Certification

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: September 13, 2010

AEROSONIC CORPORATION

/s/ Douglas J. Hillman  
Douglas J. Hillman  
President and Chief Executive Officer

Date: September 13, 2010

AEROSONIC CORPORATION

/s/ Kevin J. Purcell  
Kevin J. Purcell  
Executive Vice President and  
Chief Financial Officer