FLIGHT SAFETY TECHNOLOGIES INC
Form 10KSB
August 26, 2005

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

Form 10-KSB

ANNUAL REPORT UNDER SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the fiscal year ended May 31, 2005
Commission file number 000-33305

FLIGHT SAFETY TECHNOLOGIES, INC.

(Name of small business issuer in its charter)

Nevada	95-4863690
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
28 Cottrell Street, Mystic, Connecticut 06355	(860) 245-0191
(Address of principal executive offices and Zip Code)	(Issuer's telephone number)

Securities registered under Section 12(b) of the Exchange Act:

(Title of class)	(Name of each exchange on which registered)
Common Stock, par value $0.001 per share	AMEX
Common Stock Purchase Warrants	AMEX

Securities registered under Section 12(g) of the Exchange Act: None

Check whether the issuer (1) filed all reports required to be filed by Section 13 or 15(d) of the Exchange Act during the past 12 months (or for such shorter period that the issuer was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes x No o

Check if there is no disclosure of delinquent filers in response to Item 405 of Regulation S-B is not contained in this form, and no disclosure will be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-KSB or any amendment to this Form 10-KSB. o

Registrant's revenues for its most recent fiscal year: $3,310,871

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

The aggregate market value of the common stock held by non-affiliates of the registrant, based on the last sale price of $1.60 per share on August 25, 2005, as reported on the American Stock Exchange, was approximately $11,257,304. In determining the market value of non-affiliate voting stock, shares of common stock beneficially owned by each executive officer and director have been excluded. This determination of affiliate status is not necessarily a conclusive determination for other purposes.

There were 8,215,110 shares of common stock outstanding as of August 25, 2005.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the registrant's Proxy Statement relating to the registrant's 2005 Annual Meeting of Stockholders are incorporated by reference into Part III of this Report.

Transitional Small Business Disclosure Format (Check one): Yes o ; No x

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Preliminary Note: Cautionary Statement Pursuant to Safe Harbor Provisions of the Private Securities Litigation Reform Act of 1995:

Except for the historical information presented in this document, the matters discussed in this annual report on Form 10-KSB for the fiscal year ending May 31, 2005 or otherwise incorporated by reference into this document, contain "forward-looking statements" (as such term is defined in the Private Securities Litigation Reform Act of 1995). These statements are identified by the use of forward-looking terminology such as "believes", "plans", "intend", "scheduled", "potential", "continue", "estimates", "hopes", "goal", "objective", expects", "may", "will", "should" or "anticipates" or the negative thereof or other variations thereon or comparable terminology, or by discussions of strategy that involve risks and uncertainties. The safe harbor provisions of Section 21E of the Securities Exchange Act of 1934, as amended, and Section 27A of the Securities Act of 1933, as amended, apply to forward-looking statements made by us. We caution you that no statements contained in this Form 10-KSB should be construed as a guarantee or assurance of future performance or results. These forward-looking statements involve risks and uncertainties, which include risks and uncertainties associated with, among other things, the outcome of an informal inquiry by the SEC that appears to be in connection with certain analysts reports about us and our press releases, the outcome of pending class action litigation alleging violations of federal securities laws, whether the government will implement WVAS at all or with the inclusion of a SOCRATES® wake vortex sensor, the impact of competitive products and pricing, limited visibility into future product demand, slower economic growth generally, difficulties inherent in the development of complex technology, new products sufficiency, availability of capital to fund operations, research and development, fluctuations in operating results, and these and other risks are discussed in the "Known Trends, Risks and Uncertainties" in the Management's Discussion and Analysis of Financial Condition and Results of Operations section of this Form 10-KSB. The actual results that we achieve may differ materially from any forward-looking statements due to such risks and uncertainties. These forward-looking statements are based on current expectations, and, except as required by law, we assume no obligation to update this information whether as a result of new information, future events or otherwise. Readers are urged to carefully review and consider the various disclosures made by us in this Form 10-KSB and in our other reports filed with the Securities and Exchange Commission that attempt to advise interested parties of the risks and factors that may affect our business.

SOCRATES®, UNICORN™ and TIICM™ are trademarks of ours. This Form 10-KSB also refers to trademarks and trade names of other companies and organizations.

All information in this Form 10-KSB has been retroactively adjusted to reflect a 1-for-3 reverse stock split that was effective December 31, 2003.

Unless the context indicates otherwise, all references in this Form 10-KSB to "we," "our, " "us," "the company," "FST" and "Flight Safety" refer on a consolidated basis to Flight Safety Technologies, Inc, a Nevada Corporation, or to our former subsidiary, Flight Safety Technologies Operating, Inc., a Delaware corporation (sometimes referred to as "FSTO") that was merged into FST on June 27, 2003.

PART I

Item 1. Description of Business.

Overview

We are developing three new technologies designed to enhance aviation safety and efficiency. These technologies include SOCRATES®, UNICORN™, and TIICM™.

SOCRATES® is a technology we are working to develop into a ground based laser acoustic sensor to detect and track wake vortices at airports.

UNICORN™ is a technology we are working to develop into an airborne radar for collision avoidance.

TIICM™ is a technology we are working to develop into a system to protect airliners against terrorist threat.

We are developing SOCRATES® to be a component for possible inclusion in a wake vortex advisory system, known as WVAS, that the National Aeronautics and Space Administration (NASA) is developing. We believe that our SOCRATES® wake vortex sensor, upon completion and deployment in concert with other components of WVAS, can potentially;

Improve the safety of aircraft arrivals and departures;
Streamline the air traffic control process;
Reduce passenger delays; and
Generate substantial cost savings for the airline industry and other airport users.

An initial "proof of principle" test of our SOCRATES® wake vortex sensor was conducted at JFK International Airport in May 1998. We subsequently completed testing of an expanded and improved SOCRATES® technology, using a NASA Boeing 757 as the source aircraft, at Langley Air Force Base in December 2000. On September 13, 2003, we completed a three-week test of an improved SOCRATES® wake vortex sensor at Denver International Airport. Based upon our analysis of initial data, this test demonstrated a major increase in the capability and reliability of the sensor. Building upon these three tests, we have further developed our SOCRATES® wake vortex sensor and expect to test a 16 beam configuration during September, 2005.

We have conducted research, development, and testing of our SOCRATES® wake vortex sensor in conjunction with Lockheed Martin Corporation pursuant to a ten year teaming agreement dated May 1, 1997, under which we are the prime contractor. Under the teaming agreement, we generally have subcontracted to Lockheed Martin Corporation significant participation in the development and assembly of the hardware components of our SOCRATES® wake

vortex sensor, including the low power laser generators, reflectors, and receivers. Lockheed Martin Corporation personnel also have supported the operation of this equipment during tests of our SOCRATES® wake vortex sensor through various stages of development to date, have been developing software used in analyzing test data and worked with us in analyzing test data itself. Our payments to Lockheed Martin Corporation under the teaming agreement have averaged approximately $840,000 per each of our fiscal years and 46% of our average annual contract revenue. We anticipate that upon full approval and deployment of our SOCRATES® wake vortex sensor, we would continue to subcontract much of these functions to Lockheed Martin Corporation. There can be assurance our relationship with Lockheed Martin Corporation will continue after expiration of the teaming agreement in May 2007.

We also are developing a collision avoidance and ground proximity warning system for aircraft based on our technology referred to as UNICORN™.

On September 13, 2002, we received a frequency assignment from the Federal Communications Commission for experimental purposes and development of UNICORN™. In August 2003, we signed a contract with Georgia Tech Applied Research Corporation, (GTARC), under which GTARC commenced work on the construction of our UNICORN™ antenna elements. We also contracted with Microwave Solutions, Limited, in England to produce the radar electronic modules. An initial proof-of-principle tower based test of the UNICORN™ system was conducted in August of 2005.

Although we initially conceived UNICORN™ for application to the small airplane (general aviation) market, higher than anticipated development costs, production cost estimates that significantly exceed our initial projections, and increasing competition for this type of product, have caused us to refocus our priorities on government requirements for UAV applications. We now believe that the most effective approach is to initially seek governmental funding opportunities for the development of a UNICORN™ UAV application and then evaluate commercial products as a potential follow-on opportunity, if and when we can obtain government funding.

During the past year we began pursuing a third new technology initiative, called TIICM™ (Tactical Integrated Illuminating Countermeasure) for protection of airliners against certain shoulder launched terrorist missile threats. We believe that TIICM™ may be a more cost-effective solution to this problem than competing military systems which are currently being funded by the government. We are working on TIICM™ with Sanders Design International a small innovative defense contractor based in New Hampshire, and Analogic Corporation, a successful developer and manufacturer of medical imaging and baggage screening products, based in Massachusetts. We have committed funding of about $300,000 to TIICM™ thus far and, depending on results of research, development and testing, may invest further in TIICM™.

We contracted with Georgia Tech Applied Research Corporation (GTARC) to utilize their government approved simulation model to subject TIICM™ to 30,000 simulated missile attacks on a Boeing 737 aircraft. Preliminary results of this analysis were encouraging. There can be no assurance as to if or when we will be able to successfully develop TIICM™, that our TIICM™ efforts will result in any contracts, or that our relationships with other companies to develop TIICM™ will be successfully formalized or revenues or profits to us.

Since our inception, our primary source of funding has been three successive contracts with the federal government aggregating approximately $16.2 million for research, development and testing of our SOCRATES® wake vortex sensor. We have not had any revenues from commercial sales of SOCRATES®, UNICORN™ or TIICM™, and we do not expect such sales for several years. We have incurred cumulative losses of $4,295,881 as of May 31, 2005, which we have funded with the proceeds of three equity offerings. We may need to raise additional capital to complete our future research and development. We may consider and execute from time to time strategic investments, acquisitions or other transactions that we believe will benefit us and complement our current operations, technologies, and

resources.

History

We are a Nevada corporation that was incorporated in May 2001 under the name of Reel Staff, Inc. to provide staffing services to film, video and television production companies. Prior to a share exchange in September 2002 with the shareholders of Flight Safety Technologies, Inc., (FSTO), a Delaware corporation, our operations were minimal and our revenues were not material. Our organization and limited operations primarily were funded by (i) a contribution of services from shareholders, who in return were issued common stock and (ii) $12,075 of proceeds from a private placement of our common stock to investors. In October 2001, we registered these shares with the SEC under the Securities Act of 1933 pursuant to an SB-2 Registration Statement, as amended, that we filed with the SEC in order to make our shares of common stock eligible for public trading. Since that time, we have filed periodic reports with the SEC pursuant to the Securities Exchange Act of 1934.

In September 2002, we consummated a share exchange with the stockholders of FSTO. FSTO originally commenced operations in 1997 as a Wyoming corporation. FSTO was co-founded by two of our directors, Samuel A. Kovnat and Frank L. Rees. In consideration of his shares, Mr. Rees assigned his SOCRATES® and UNICORN™ patents to FSTO. In consideration of Mr. Kovnat's shares, he contributed intellectual capital and services to FSTO. Advanced Acoustic Concepts, Inc. and Leonard Levie were also founders of FSTO. Advanced Acoustic Concepts, Inc. received shares of common stock in FSTO in consideration of its release of any claims on the UNICORN™ patent contributed by Mr. Rees and Mr. Levie received his shares in consideration of contributing his business experience, and developing an initial business plan for FSTO. As a result, FSTO owned patents on our SOCRATES® and UNICORN™ technologies.

FSTO received our original contract with the federal government for the research and development of our SOCRATES® technology in connection with its potential application to wake vortices on May 29, 1997. Since then, FSTO has received two additional contracts for the continuation of research and development of our SOCRATES® technology. On November 3, 2000, FSTO completed a private placement of preferred stock arranged by Spencer Trask Securities Incorporated which resulted in net proceeds to us of approximately $1,500,000. In consideration of this placement, Spencer Trask Intellectual Capital Company, LLC received shares of our common stock and warrants to acquire our preferred stock, as well as placement agency fees and reimbursement of certain costs. All of the preferred shares and warrants for preferred shares were converted, respectively, to common stock and warrants for common stock pursuant to their terms as a result of the share exchange.

The share exchange was facilitated by Dunhill Venture Partners Corp., a Vancouver based firm. Dunhill Venture Partners Corp. also facilitated a private placement of a total of 283,334 shares of our common stock and 283,334 warrants, each for one share of our common stock, to Wakefield Holdings Corp. and Nicholson Group Limited, pursuant to Regulation S promulgated by the SEC, which resulted in aggregate proceeds to us of $1.7 million. In January 2003, we registered these shares and the warrant shares with the SEC pursuant to an SB-2 Registration Statement. During July and August 2003, the warrants were exercised, and we issued the 283,334 warrant shares, generating $1.7 million in aggregate proceeds to us. As a result of the share exchange, we discontinued our previous

operations and changed our name to Flight Safety Technologies, Inc., FSTO changed its name to Flight Safety Technologies Operating, Inc., FSTO became our subsidiary and stockholders of FSTO acquired approximately 53% of our outstanding common stock. In June 2003, FSTO merged into us, and we now own the patents on and are continuing the development of our SOCRATES® and UNICORN™ technologies. The financial information contained in this Form 10-KSB reflects the consolidated results of our operations and those of FSTO.

During February 2004, we sold 1,514,300 units at $6.00 per unit in a registered underwritten secondary public offering. Each unit consisted of two shares of our common stock and a warrant to purchase one share of our common stock at $3.30 a share. Separate trading of the common shares and warrants began on March 1, 2004. We received net proceeds from this offering of approximately $7.6 million.

Principal Products Under Development and Market Opportunities

SOCRATES® Technology

General

Based on testing to date, we believe our SOCRATES® technology has the potential to provide sensor information for a ground-based wake vortex advisory system, or WVAS, to detect dangerous air turbulence. The SOCRATES® sensor is intended:

- To operate under a wide variety of weather conditions;
- To provide warning to air traffic controllers of wake turbulence hazards that pilots may encounter;
- To not require the presence of large atmospheric particles such as rain or ice crystals to detect disturbances; and
- To be cost-effective and easy to operate.

SOCRATES® is our proprietary opto-acoustic technology designed to detect, locate and track various forms of air turbulence, including clear air turbulence. While our present focus is on air turbulence created by aircraft wakes, we believe that with future research and development our SOCRATES® technology may also enable the detection of various hazardous atmospheric phenomena, such as windshear and microbursts.

Air turbulence creates patterns of low-frequency sound waves something like the ring patterns that form in a body of water after a pebble has been tossed into it or a boat has cut through it. These low-frequency sound waves typically travel for long distances through the atmosphere without impediment. As currently developed, our SOCRATES® wake vortex sensor uses low power laser light beams projected 50 to 100 meters across the ground in the vicinity of airport approach and departure corridors. Reflector devices direct the beams back to a receiver. SOCRATES® measures changes in the speed of the light waves of the laser beams. These changes indicate that the laser has interacted with sound waves emanating from air disturbances. Based on these changes, we believe SOCRATES® technology, upon completion of research, development and testing, will enable a WVAS to detect the presence of wake vortex turbulence.

Unlike radar technologies, we believe SOCRATES® will be effective without need for the presence of rain, ice crystals, or other aerosols because SOCRATES® uses lasers to detect interaction with sound waves, not with atmospheric particles.

We believe a SOCRATES®-based WVAS will be relatively cost-effective and easy to implement because such a system would not require airports to lengthen existing or add new runways, to build large towers, acquire additional land on their peripheries, or engage in potentially lengthy and costly environmental negotiations with residential communities, as is required to install Terminal Doppler Weather Radar, (TDWR) systems. In addition, SOCRATES® may offer capability in a wide variety of weather conditions.

Alternate technologies for detecting wake turbulence phenomena may be limited by certain weather conditions such as fog, more expensive, difficult to implement, or incapable of providing sufficiently early warnings for pilots to take appropriate action. We believe the products we are developing and intend to develop based on SOCRATES® may mitigate many of the shortcomings associated with these types of technologies.

SOCRATES® Wake Vortex Sensor

Whenever an airplane is in flight, and especially when flying slowly, as during takeoff, approach, and landing, the wing flaps and wings create wake vortices, which are similar to horizontal tornadoes trailing back from the wing tips. If another plane enters this vortex, even several minutes after the first plane has passed, the pilot's control of the aircraft may be compromised. To address these hazards, the Federal Aviation Administration (FAA) has established increased spacing requirements between airplanes as they land and take-off. In 1996, the FAA expanded these requirements for airplane separations by introducing a new category for additional separation behind B-757 aircraft. The increased space between planes has translated into even more time in the air, which causes flight delays and increases in fuel and flight crew costs. A new very large aircraft, the A-380 being introduced by Airbus Industries, is anticipated to further exacerbate wake-induced flight delays.

Our initial focus for SOCRATES® is development of a wake vortex sensor to detect, locate and track wake vortex turbulence. The sensor will include a low power laser transmitter and receiver, a reflector and special computer electronics designed to translate changes in laser transmissions into data on the presence and location of wake vortex turbulence. We are designing our sensor so that upon successful completion of further development, testing and FAA approval, it could become a component in a WVAS to be used by air traffic controllers in establishing safe separation between successive arriving and departing aircraft. In furthering this development, among other things, we plan to expand the present 16-beam sensor, integrate the sensor with other components of WVAS, as well as develop operating protocols for WVAS and the sensor that define how they would be used by air traffic controllers and pilots. NASA and the FAA are planning for the integration of other components of WVAS including advanced weather sensors, prediction software for both the vortex movement and the persistence of existing wind conditions, adaptive spacing procedures and communication links between the sensors and the air traffic control facilities. WVAS still faces technical hurdles and, furthermore, must be accepted by a variety of constituencies involved in the National Airspace System, including, but not limited to, air traffic controllers and pilots. We can make no assurance whether or when the FAA will implement WVAS, either with or without our SOCRATES® wake vortex sensor.

We plan for our SOCRATES® wake vortex sensor to generate information that will assist Air Traffic Controllers (ATC) in determining more precisely when it is safe for a plane to land or take off behind a heavier category of aircraft. This may enable the FAA to decrease the existing aircraft wake vortex spacing, thereby increasing airport capacity, reducing delays and saving money for the airline industry. Our SOCRATES® wake vortex sensor also would increase safety by issuing an alert to controllers in instances where a standard separation may not have given sufficient time for a wake vortex to dissipate or move out of the way. A "proof of principle" test of our SOCRATES® wake vortex sensor that operated with 2 laser beams was conducted at JFK International Airport in May 1998. We completed controlled testing of an expanded and improved SOCRATES® wake vortex sensor that operated with 4 laser beams, using a NASA Boeing 757 as the source aircraft at Langley Air Force Base in December 2000.

In September 2003, we completed a three-week test of an improved SOCRATES® wake vortex sensor that operated with 4 laser beams at Denver International Airport. This test was part of a NASA-sponsored wake acoustics test and is part of NASA's continuing efforts to improve aviation safety and capacity. A principal purpose of this NASA-sponsored test was to acquire adequate field data using carefully calibrated microphone arrays to develop a firm scientific basis for the use of sound in detecting, tracking, and characterizing wake vortices created by arriving aircraft. The operation of our SOCRATES® wake vortex sensor recorded acoustic emissions generated by wake vortices from a variety of aircraft, including Boeing 737 and 757 aircraft, Airbus A319 and A320 aircraft, and even smaller regional jets. The sensor recorded these emissions directly above our sensor at an elevation of approximately 500 feet above ground level. We performed a preliminary analysis of the results and provided a "quick-look" report to NASA and Volpe in October 2003. Our Final Report, in summary, showed an 81% detection rate for our SOCRATES® sensor system. The results were from three weeks of collected data and approximately 750 data points.

Following the 2003 Denver test, we received government funding to upgrade and expand our SOCRATES® wake vortex sensor from a 4-beam to a 16-beam system and test this expanded sensor in September of 2005. Our goal in the test of our expanded sensor will be to detect and track wake vortices at ranges up to 1,100 meters and altitudes up to 250 meters above the sensor site. We have performed analysis based on phased array radar and sonar systems which we believe indicate that this goal should be achievable. However, we can make no assurance as to whether the expanded SOCRATES® system will perform effectively and meet our expectations until we complete design, engineering, testing, and analysis of test results. If the test of this expanded system is successful, we plan to produce an emulation of an operational SOCRATES® wake vortex sensor in 2006 or 2007. If and when the FAA approves our sensor and proceeds with the implementation of WVAS, we will propose that the FAA include our sensor in the installation of WVAS at major U.S. airports. Each of these airports will require a system customized for its particular runway layout and topography. At this time, we do not know if we can successfully develop our SOCRATES® wake vortex sensor, if the federal government will provide the funding required to complete our plan, if we will successfully implement the plan and testing, or if the government will implement WVAS at all or with the inclusion of our SOCRATES® wake vortex sensor.

SOCRATES® Wake Vortex Sensor Market Opportunity

The FAA is the federal agency in charge of airport safety and air traffic control in the U.S. In this role, it acquires, owns and is responsible for operating the equipment that monitors and controls the National Airspace System, including the equipment deployed at airports and in all air traffic control facilities. As such, the FAA would be the primary potential customer for our SOCRATES® wake vortex sensor in the U.S.

In June 2003, the FAA approved a long-term mission needs statement and related investment plan that contemplates expenditures by FAA and NASA of $206 million during the period running from U.S. fiscal year 2003 through 2010 on wake vortex detection research and development. The FAA investment plan includes deployment of a prototype WVAS and culminates in development of wake turbulence capability at selected airports and integration with controller tools. The mission needs statement may not be approved at all necessary levels of the federal government, and the federal government may not provide the funding required to complete the mission needs statement. This funding must be annually requested by the FAA, authorized and approved by Congress, and approved by the President. There is no assurance as to what amount of contract funding, if any, we will receive in connection with the mission needs statement to complete the research, development, and testing of our SOCRATES® wake vortex sensor for inclusion in a WVAS. To date, the FAA has not requested Congress to appropriate funds for this purpose. The FAA has assigned an overall moderate to high risk rating to the implementation of this program due to technical unknowns and risks associated with getting controllers and pilots to accept a ground or flight deck based system.

We believe the FAA's substantial investment in addressing the problems associated with wake vortex turbulence and its issuance of the long-term mission needs statement for wake turbulence indicate its awareness that there is a growing need in the aviation industry for technologies to combat the wake vortex problem. There are many other participants and constituencies that could have an interest in the deployment and financing of our sensor as part of a WVAS. For example, the International Federation of Airline Pilots Associations, (IFALPA), which represents over 100,000 pilots worldwide and is recognized as the global voice of pilots on both labor and aviation safety issues, officially states a requirement for vortex monitoring in any system designed to safely reduce the current wake vortex-related spacing requirements. The busier airports, which are typically owned and operated by state and local authorities, also have a natural interest in increasing airport safety and efficiency. Airlines also could benefit from installation of a WVAS, which we believe could include our SOCRATES® wake vortex sensor, through increased safety and efficiencies and a reduction in fuel costs attributable to delays.

Factors contributing to industry support include:

Airline traffic delays from all causes at busy airports. The Air Transport Association estimated that delays attributable to the air traffic control system cost the industry and its passengers and shippers a record $6.5 billion in 2000. These costly delays could be reduced if landings and take-offs were optimally spaced based on actual vortex behavior.

Resistance to building additional runways to alleviate airport congestion. Airports do not want to bear the expense, which can run in the billions of dollars, and surrounding communities do not want to suffer the adverse environmental and aesthetic effects, of adding runways.

Public pressure on governmental agencies to promote aviation safety. Recent aviation catastrophes and near-disasters, especially those with unexplained or turbulence-related causes, have focused public attention on air safety.

The target market for our SOCRATES® wake vortex sensor include as many as 100 of the busiest airports worldwide. We initially will focus on U.S. airports with closely spaced parallel runways, such as the San Francisco, Anchorage, Newark, Boston Logan, Philadelphia, St. Louis, and Los Angeles International Airports. We believe that our SOCRATES® wake vortex sensor may be instrumental in helping the FAA and airports to achieve approval and implementation of WVAS.

Based upon installations at up to 100 airports worldwide, we estimate the total market size for our SOCRATES® wake vortex sensor as part of a WVAS at up to $1 billion. Our preliminary estimate is based on, among other things: our assumption of successful product development and FAA certification; estimates we performed of the number of airports that would benefit from the implementation of WVAS; the number and configuration of runways; a long-term projection of the cost of manufacturing, installing, and testing our SOCRATES® wake vortex sensor; and the cost of our current 16-beam SOCRATES® wake vortex sensor scaled up to an operational 32-beam sensor at each end of each runway. We estimate the price of our SOCRATES® wake vortex sensor will be roughly $9 to $20 million per airport installation, depending on, among other things, the number and configuration of runways. These projections do not include any revenue from field service which we plan to provide if appropriate arrangements can be made with specific airports and the FAA. These estimates have not been reviewed or validated by any third party. We have not updated and have no immediate plans to update these projections.

These estimates also assume the availability of funding from the FAA, airports and other sources for purchase and installation of our SOCRATES®™ wake vortex sensors as part of WVAS. While we hope the FAA and U.S. government will support such purchase and installation of our SOCRATES® wake vortex sensors, when and if a WVAS becomes operational, we do not have any commitment or assurance from the FAA or other branches of the U.S. government to support us in this regard.

UNICORN™ Technology

General

Our original plan for UNICORN™ technology was to provide a low-cost, combined, collision alerting and ground proximity warning capability for general aviation aircraft, including private, business and smaller regional and commercial aircraft. Since fiscal year ended May 31, 2004, we also have been investigating the potential application of our UNICORN™-based "see and be seen" collision avoidance technology for unmanned air vehicles, (UAVs), including military, other government, and commercial operations.

Accelerating government requirements for UAV applications in the US domestic airspace, together with higher than anticipated development costs, production cost estimates based on information we obtained from ongoing product development that significantly exceed our initial projections, and increasing competition in the general aviation market for UNICORN™-like products have caused us to refocus our priorities. We now believe that the most effective approach is to seek governmental funding opportunities for UAV applications of UNICORN™ and then evaluate commercial products as a follow-on opportunity.

Our UNICORN™ technology is based on a unique implementation of radar technology in an airborne system to detect and track aircraft and detect the ground below and ahead of the airplane. We believe that fixed element antennas on the top and bottom of the aircraft could provide full spherical coverage for threat detection up to four nautical miles of collision avoidance coverage. UNICORN™ would alert pilots to a potential collision threat by both audible and visual means, and the locations of the threat aircraft would be shown on either an existing or dedicated cockpit display.

Following a recommendation of support from the FAA in September 2002, the Federal Communication Commission (FCC) issued us an Experimental Radio Station License facilitating UNICORN™ antenna development on either of two frequencies: 5145 MHz in the FAA aviation band and 3650-3700 MHz in the non-aviation band. These frequencies may be used at any of three designated locations in the eastern U.S. until September 1, 2006. If we demonstrate progress and continued ability to develop UNICORN™, we may be able to obtain an extension of the approval by application.

We acquired the UNICORN™ technology from Advanced Acoustic Concepts, Inc., (AAC), in January 2000 in exchange for shares of our common stock. We have agreed to pay AAC a lump sum payment of $150,000 after we receive revenues from sales of UNICORN™ products of $1,000,000. In addition, we will pay to AAC a continuing royalty of 3% of all net sales of UNICORN™ products thereafter.

UNICORN™ UAV Collision Avoidance System

We have initiated very preliminary discussions with the federal government about the possible use of UNICORN™ technology on Unmanned Air Vehicles, or UAV's, to perform the "see and avoid" function. There is increasing interest on the part of civil and military authorities in operating UAVs in parts of the National Airspace System other than military restricted areas. These operations could not take place unless the collision safety issue is addressed. We believe that our UNICORN™ technology may have the potential to meet this emerging need.

A UNICORN™-based UAV collision avoidance system would contain an antenna and computerized electronics that are similar in concept to those used in the UNICORN™ general aviation products we have been developing. However, the audio alert and visual display would be replaced by a computerized interface with the onboard flight control system of the UAV. This interface would override the flight control system to cause the UAV to take evasive maneuvers required to avoid collision with other aircraft and/or ground-based objects such as terrain and obstructions.

TIICM™ Tactical Integrated Illumination Countermeasure Technology

TIICM™ is intended to provide low-cost, highly effective shield to protect airliners against the threat of some terrorist missiles. TIICM™ represents a new concept that integrates and augments certain lighting elements (such as

anti-collision lights) mounted on wing tips, tail sections and/or at the top and bottom of aircraft fuselage sections, together with particular sequencing of these illumination sources to both attract certain missile seeker elements and to "spoof" certain threat missile guidance systems.

We are developing TIICM™ in conjunction with Sanders Design International (SDI), a New Hampshire company. In April, 2004, we executed a 10 year Teaming Agreement with SDI under which we would be the prime contractor with respect to development of counter-technologies for certain anti-aircraft shoulder fired missiles. Under additional arrangements with SDI, we would share joint ownership of the TIICM™ patent if a new patent application is filed and if this results in an award of a new patent. A prior patent was awarded to SDI in February, 2004 that is the subject of a licensing agreement between SDI and Analogic Corporation, a company located in Peabody, Massachusetts. This licensing agreement may limit our ability to earn revenue from TIICM™. Although we are, and have been working as a team with both SDI and Analogic, we have not yet finalized a business relationship agreement with Analogic regarding TIICM™ and there can be no assurance that we will be successful in doing so.

Although we are cautiously optimistic based on our preliminary concept formulation research and analysis, there can be no assurance that TIICM™ will ultimately be successful in achieving a cost-benefit advantage against more well established and mature competing technologies, or that we will receive any significant revenues or profits from TIICM™.

Sales and Marketing

SOCRATES® Wake Vortex Sensor

We believe that, upon successful completion of research, development, and testing of our SOCRATES® wake vortex sensor and the WVAS, the FAA may approve the use of our SOCRATES® wake vortex sensor in a WVAS implementation due to the growing demand for cost-effective ways to improve airport safety and capacity and the advantages of our technology over existing alternatives. Our strategies for selling SOCRATES®-based products for use in airports will include:

Closely coordinating with the FAA, which would acquire and deploy WVAS including SOCRATES® technology at United States airports;

Assisting airports to apply for the allocation of airport improvement grants to acquire WVAS;

Targeting the busiest U.S. airports followed by international airports with a campaign including informational seminars and direct marketing; and

Publicizing the advantages of our SOCRATES® wake vortex sensor in promoting advanced air safety and airport productivity to members of Congress, aircraft manufacturers, commercial airlines, and air travel trade industry groups.

UNICORN™ Airborne Radar Technology

During the past year we have become increasingly aware of an emerging requirement to integrate collision avoidance capability into the flight control systems of unmanned aerial vehicles (referred to by the government as "see-and-avoid" for UAV's). We now intend to focus on obtaining government funded UNICORN-For-UAV development. If we can obtain government funding and successfully develop a UNICORN™ UAV application, we believe that research, development, testing and FAA certification of a UNICORN™ UAV product will assist us, and in certain respects, be applicable to continuing our research and development of an improved and more sophisticated but nevertheless relatively inexpensive UNICORN™ technology. We believe such a technology may in the future be able to penetrate the aviation industry when integrated with cooperative surveillance techniques.

The potential uses of UAV's over the next 20-30 years include:

Traditional military surveillance
Customs/Border patrol surveillance
Harbor/port surveillance
Regional and local law enforcement
Fire fighting
Crop dusting

Government officials have estimated as many as 20,000 UAV's may be employed in the US domestic airspace over the next 20 years. If, as, and when we can complete the development and flight testing of a UAV UNICORN product, we intend to market UNICORN to:

Government - Military and Department of Homeland Security users
UAV Manufacturers
Commercial UAV users

There can be no assurance that we will successfully complete the development of UNICORN, integrate UNICORN into UAV systems, or gain any market acceptance for UNICORN as a UAV or general aviation product.

TIICM™ Sales and Marketing

If, as, and when we can successfully complete sufficient research, development and testing and gain government approval of TIICM™ technology, we would anticipate initiating a market strategy to include:

Working closely with US Government Officials to gain their support for marketing TIICM™ to the US airline fleet which consists currently of about 6,800 aircraft.

Targeting an initial market of the smaller commercial aircraft currently employed, and the US airline companies that operate them.

Working with the aircraft manufacturers such as Boeing and Airbus Industries.

Working with the Air Transport Association (ATA).

Working with congress to provide appropriation funding for TIICM™.

Extending the potential market to include international airliners.

Extending the potential applicability of TIICM™ for use in military aircraft uses.

There can be no assurance that TIICM™ will achieve any market acceptance in any of these uses.

Competition

SOCRATES® Wake Vortex Sensor

The aviation and airport safety business is very competitive. We expect competition in hazardous weather applications and wake vortex detection and warning sensors and systems to intensify as air travel and airport congestion continue to increase worldwide, and as public scrutiny of aviation safety heightens. Although we are not aware of any other company or organization developing technologies such as ours, it is possible that others could develop or improve their systems to achieve similar results. We may face competition from established companies in the aviation systems marketplace, which are currently providing or developing technologies and products such as Low Level Windshear Alert Systems, airborne and ground-based Doppler Radar, Lidar, Laser Doppler Velocimetry, Terminal Doppler Weather Radar, and the Minix Winglet. These companies include Allied Signal/Honeywell, Coherent Technologies, Northrop Equipment Corp., Raytheon Corp., Christian Hugues and others. The chart below describes these alternative ground-based technologies.

Technology	Description	Limitations	Mfr.	Status
Low Level Windshear Alert Systems ("LLWAS")	Detects windshears & microbursts 50 - 150 feet above ground Alerts triggered when wind speeds are not consistent at multiple wind sensors around airport and runways	Limited range Can be unreliable Early warning insufficient since only detects windshear in immediate vicinity	Raytheon	Commercially Available
Doppler Radar	Airborne and ground-based systems Detect speed and location of disturbances by reflecting electromagnetic waves off atmospheric particles	Often misses small phenomena Limited detection range Need airborne rain or ice crystals to reflect radar Insufficient early warning	Raytheon	Limited Installations
Lidar ("Light detection and rangefinding")	Airborne and ground-based systems Detect disturbances by measuring the reflection and scattering of a powerful infrared pulse Greater accuracy than radar	Does not work in clouds Insufficient early warning	Coherent Technologies, Inc.	Commercially Available
Laser Doppler Velocimetry	Airborne and ground-based systems Measures the speed and location of disturbances by analyzing the frequencies of two laser beams reflected off atmospheric particles Greater range and accuracy than radar	Does not work in clouds Insufficient early warning	None	Research and Development
Terminal Doppler Weather Radar ("TDWR")	Ground-based system Detects hazardous atmospheric conditions in the airport terminal area Detects changing winds to give early warning of hazardous conditions Highly reliable and accurate	Requires tall towers to be installed 8-12 miles away from airport, which are expensive and often encounter resistance from residential communities Does not capture small phenomena like wake vortices	Raytheon	Limited Installations
Minix Winglet			None	

	Solid, light wing tip attachment made of Kevlar and carbon Eliminates vortex pressure around wings Increases speed Reduces fuel consumption Allows aircraft to carry more weight	May not address the dominant wake vortices created by the outer tip of the main flap May adversely affect the lift-to-drag ratio of the aircraft May not work as advertised		Research and Development

We believe our SOCRATES® wake vortex sensor may offer many advantages over the products and technologies provided by these competitors, although further research, development, and testing are needed to complete our sensor and make it operational. We believe that if, as and when our SOCRATES® wake vortex sensor is fully developed and operational, these advantages may position us to penetrate the market, particularly for a ground-based wake vortex sensor. We believe the advantages of a wake vortex sensor based on our SOCRATES® technology will include:

Greater reliability in foggy or cloudy weather conditions that often impede lidar-based systems;
Superior accuracy, even for small disturbances other systems often miss;
Earlier warning of potential hazards;
No need for large atmospheric particles to detect disturbances; and
Greater cost-effectiveness and easier implementation.

UNICORN™ Technology

Competition for the "see and avoid" function in the UAV community consists of optical and radar systems. An optical system under development by Defense Research Associates (DRA) provides fairly accurate azimuth and elevation to the target during visual weather conditions but little or no range information. The field of view is also limited to plus or minus 110 degrees in azimuth and plus or minus 20 degrees in elevation. A 35 GHz radar system tested on a UAV by the Navy is quite limited in range and also has the limited field of view.

We believe that, if and when successfully developed and tested, our UNICORN™-based products may offer potential advantages over currently available alternatives in the UAV and, later, the general aviation market for small aircraft. Current competition in the general aviation market includes the following:

Technology	Description	Limitations	Mfr.	Status
Transponder	9900BX Traffic Advisory System	Only detects transponders; Relatively expensive	Ryan	In production
Transponder	Monroy ATD-200		Monroy	In production

		Only detects transponders; Does not provide time to collision		
Transponder	L3-Goodrich Skywatch Traffic Advisory System	Only detects transponders	Goodrich	In production
TCAS	Traffic Alert & Collision Avoidance System	Only detects transponders; Relatively expensive	Rockwell and Honeywell	In production

General

Our ability to compete successfully in the market for air safety products will depend on our success in:

Completing on a timely basis the research and development, prototyping, testing, and production of our SOCRATES®, UNICORN™-based, and TIICM™ products;

Obtaining FAA approval of our SOCRATES® wake vortex sensor and UNICORN™ and TIICM™ products;

Marketing and selling our products to airports, the FAA, airlines and manufacturers and owners of general aviation aircraft;

Promoting awareness and acceptance of our products among members of Congress and other government officials, aircraft manufacturers, commercial airlines, and air travel industry trade groups; and

Developing and/or acquiring additional technologies and products to meet the changing needs of the aviation industry.

Many of our potential competitors have longer operating histories, greater name and brand recognition and substantially greater financial, technical, marketing, management, service, support, and other resources than we do. Therefore, they may be better able to respond than we can to new or changing requirements, technologies, or standards. We may not be able to compete successfully against current or future competitors, and the competitive

pressures may materially and adversely affect our business, operating results and financial condition.

Government Funding

A substantial amount of our time and expenditures have been spent on the research, development and testing of our SOCRATES® wake vortex sensor. A substantial portion of our funding for research and development contracts of our SOCRATES® wake vortex sensor has and is expected to continue to come from appropriations of the federal government. These appropriations, from which we have been allocated an aggregate of approximately $16.2 million in contract funding to date, have been earmarked by Congress for the procuring federal agencies, FAA and NASA, for funding, monitoring and administering the development of SOCRATES® technology to enhance airport and airline safety.

For U.S. fiscal year 2004, an additional $5 million NASA appropriation specifically for continued work on project SOCRATES® was enacted into law. In November, 2004 our sponsoring agencies released $3,237,310 of these funds and approved an extension of our contract, statements of work, and appropriate work orders which includes a major airport test of the expanded 16 beam SOCRATES® wake vortex sensor at Denver International Airport (DIA), which is scheduled in September 2005.

For U.S. fiscal year 2005, the government appropriated $5 million to NASA specifically for additional research and development work on SOCRATES® and data analysis of the test at DIA of the 16 beam SOCRATES® system. We have not yet received any of these funds, and prior to any extension of our contract, the government must release these funds and request cost and technical proposals which we must submit for review and approval of the government. As of the date of this report, we have not received such request and the timing for release of funds and such request is not clear. Any delay in obtaining a contract extension might require us to draw upon our cash after October 1, 2005 to fund our operations.

On December 12, 2003, Public Law 108-176 was passed authorizing FAA funding for U.S. fiscal years 2004 through 2007. The new law, designated "Vision 100 - Century of Aviation Reauthorization Act," authorizes the FAA to spend from its $2 billion Air Navigation Facilities & Equipment annual budget such funds as may be necessary in each of the next four U.S. fiscal years for the development and analysis of a wake vortex advisory system (WVAS). We are aiming to complete development of our SOCRATES® wake vortex sensor for inclusion in any such system which NASA is currently developing. The government must successfully test and accept WVAS and our SOCRATES® wake vortex sensor for integration into any such system. Funds can only be made available for each year by appropriation legislation and pursuant to contract and work orders between us and the procuring federal agency. To date, the FAA has not requested Congress to appropriate funds for this purpose. There is no assurance as to whether or when these funds will be appropriated, how these funds will be allocated among us, participating agencies, and other parties presently or in the future involved in development of the wake vortex advisory system, or what portion of these funds, if any, we ultimately may receive.

Upon successful completion of research and development of our SOCRATES® wake vortex sensor, we would also depend upon the FAA for procurement and installation of WVAS including our sensor in U.S. airports. In June 2003, the FAA approved a long-term mission needs statement that contemplates expenditures by FAA and NASA of $206 million during the period running from U.S. fiscal year 2003 through 2010 on wake vortex detection research and development, including deployment of a prototype WVAS and culminating in development of wake turbulence capability at selected airports and integration with controller tools. The mission needs statement may not be approved at all necessary levels of the federal government and the federal government may not provide the funding required to complete the mission needs statement, which must be annually requested by the FAA, authorized and approved by Congress, and approved by the President. There is no assurance as to what amount of contract funding, if any, we will

receive in connection with the mission needs statement. To date, the FAA has not requested Congress to authorize or appropriate these funds. The FAA has assigned an overall moderate to high risk rating to this program due to technical unknowns and risks associated with getting controllers and pilots to accept a ground or flight deck, or both, based system.

The U.S. government may terminate our government contract at any time if it determines such termination is in the best interests of the government or may terminate, reduce or modify it because of budgetary constraints or any change in the government's requirements. Furthermore, the federal government may hold, reduce or eliminate future funding for research and development of our SOCRATES® wake vortex sensor or WVAS as a result of a reduction in support or opposition from supervising agencies, changes in budgetary priorities or decisions to fund competing systems or components of systems. If this occurs, it will reduce our resources available for research and development of our proprietary technologies, new products or enhancements to our SOCRATES® or UNICORN™ technologies and to market our products. Reduction of funding from the federal government could delay achievement of or increases in profitability, create a substantial strain on our liquidity, resources, and product development, and have a material adverse effect on the progress of our research and development and our financial condition.

Our Intellectual Property and Technology

SOCRATES® Technology

We intend to rely on a combination of patent protection, trademark protection, trade secret protection, copyright protection, and confidentiality agreements to protect our intellectual property rights. We have received a United States patent relating to our SOCRATES® technology (US Patent No. 6,034,760 issued on March 7, 2000). We have pending patent applications abroad relating to our SOCRATES® technology. However, there can be no assurance any patent will issue from these pending applications. We also may apply to federally register various copyrights in our software and documentation with the United States Copyright Office and abroad.

Our SOCRATES® technology patent, includes two fundamental claims: a method claim and an apparatus claim. The method claim covers a laser device that produces an optical beam, directs that beam into the atmosphere and measures the effect of sound waves on the beam as an indicator of hazardous weather conditions that have produced those sound waves in the atmosphere. The apparatus claim covers the apparatus for performing the method claim. Both of these claims cover systems that are mounted either directly on the front of an aircraft or on the ground adjacent to a runway. We have received patents on the SOCRATES® technology in Australia, Canada, China, Israel, and New Zealand. We have filed corresponding patent applications, based upon the United States application, for a patent on our SOCRATES® technology in Japan, Democratic Peoples Republic of Korea, Norway, Saudi Arabia, Turkey, and the European Patent Organization.

We have taken certain steps to preserve our rights in our SOCRATES®-related technologies under our contracts with the federal government. However, as under any government funded research and development contract, the Federal Acquisition Regulations provide that the federal government may have paid-up rights to use our SOCRATES®-related technologies under certain circumstances.

On April 26, 2004, in conjunction with the renewal of a nondisclosure agreement, we were advised by Lockheed Martin Corporation that it owns a certain patent which predates our SOCRATES® patent and, according to Lockheed Martin Corporation, contains some intellectual property related to our SOCRATES® patent. We are conducting further discussions with Lockheed Martin Corporation on potential ways to expand and extend the relationship and believe the outcome of such discussions will resolve any intellectual property concerns. We cannot predict or provide any assurance on the outcome of these discussions and whether any outcome will be satisfactory to us.

Also, our SOCRATES® trademark is now registered on the Principal Register, having Registration No. 2,967,386.

UNICORN™ Technology

We also have received a United States patent relating to our UNICORN™ technology (US Patent No. 6,211,808 issued on April 3, 2001). We have received patents on the UNICORN™ technology in Australia, Canada, and New Zealand. We have filed corresponding patent applications, based upon the United States application, for a patent on our UNICORN™ technology in Canada, Japan, Australia, New Zealand and countries throughout the United Kingdom and Europe. However, there can be no assurance any patent will result from these pending applications. We also may apply to federally register various copyrights in our software and documentation with the United States Copyright Office and abroad.

Our UNICORN™ technology patent includes claims which cover a collision avoidance airborne radar system. The invention incorporates a unique antenna design which provides three-dimensional surveillance to provide collision warning as well as ground proximity and terrain avoidance alerting to the pilot.

It selectively uses each microwave sector as a way to determine the direction of any received radar echo from another close-by aircraft or the ground below or terrain ahead that poses a potential threat within that coverage. Controlling the integration of these functions permits detection of several almost simultaneous potential threat encounters. The claims cover any UNICORN™-based system whose antenna may be fabricated in an equivalent way and subdivided for low drag-profile mounting above and below the fuselage of an aircraft. The UNICORN™ system is fully independent, in that, unlike most other collision avoidance systems in current use, it does not require that other aircraft in the vicinity have a cooperative warning system such as a transponder beacon.

Also, our UNICORN™ trademark application has received its Notice of Allowance.

TIICM™ Technology

We filed a Provisional Patent Application with the United States Patent and Trademark Office in February 2005 for TIICM™ (Tactical Integrated Illuminating Countermeasure) technology in conjunction with Sanders Design International (SDI), (a New Hampshire company). TIICM™ is intended to provide a low-cost, highly effective shield to protect airliners against the threat of some terrorist missiles. We are in the process of preparing a final patent application for TIICM™. Under our arrangement with SDI, we will share ownership of the TIICM™ patent, if the application is filed and results in a new patent award. There can be no assurance that any patent will result from our TIICM™ filing.

Government Approval and Regulations

The airport and airline industry is subject to extensive government oversight and regulation. To introduce a product for commercial sale, we must successfully complete research, development, and testing of the product and obtain necessary governmental approvals for installation of our SOCRATES® wake vortex sensors in airports or installation of UNICORN™ technology in small aircraft. For our SOCRATES® wake vortex sensors, the FAA must commission WVAS for use in the National Airspace System. As UNICORN™ and TIICM™ technologies are airborne systems, they must be FAA certified for use on aircraft. Any factor that delays or adversely affects this process, including delays in development or difficulty in obtaining federal government approval of the product, could adversely affect our business, financial condition, or results of operations.

Additionally, as a result of receiving funding from the federal government, our business and operations are subject to numerous government laws and regulations. In the near term, and for so long as we receive funding from the federal government, we will be subject to many procurement and accounting rules and regulations of the federal government. We are also subject to periodic audits by the Defense Contract Audit Agency. To date, we have incurred six audits and reports have been issued to our government customer which have stated that we are performing in full accordance with Federal Acquisitions Regulations.

Employees

As of May 31, 2005, we had eight full-time and two part-time employees. Our employees are not members of a union, and we are not aware of any efforts on their part to form or join a union. We believe that our relationship with our employees is good.

We recently added an additional executive to our management staff. Mr. Robert Knight has been named Vice President for Business Administration and General Counsel.

Item 2. Description of Property.

Our primary offices, located in Mystic, Connecticut, are leased on an annual basis at a monthly rate of $2,625. We also utilize satellite office space that we lease or use on a month to month basis pursuant to the following arrangements with the following parties: (i) Baltimore, Maryland leased from our executive vice president and director, Frank L. Rees, at $500 per month; (ii) Chicago, Illinois is space provided without charge by our president and director, William B. Cotton; and (iii) North Kingston, Rhode Island leased from The Meadows Professional Office Park on an annual basis at a monthly rate of $1,150; and (iv) Lancaster, Pennsylvania space provided without charge by our Senior Engineer Robert L. Cooperman. We believe that our facilities are adequate to satisfy our projected requirements and that additional space will be available if needed.

Item 3. Legal Proceedings.

Several lawsuits have been filed in the United States District Court for the District of Connecticut, by purchasers of our common stock naming us, certain of our executive officers and directors, and certain underwriters, who sold shares of our common stock to the public, as defendants. The suits assert claims under Section 10b of the Securities Exchange Act of 1934 and Rule 10b-5 promulgated thereunder and under Section 11 of the Securities Act of 1933. The complaints allege, among other things, that we failed to disclose material details from a report circulated by Volpe in October 2001, which generally concerned the timetable and our prospects for achieving operational viability of the SOCRATES® wake vortex sensor. The plaintiffs seek unspecified damages on behalf of a purported class of purchasers of our securities.

We firmly believe that the claims contained in the complaints are without merit and intend to conduct a vigorous defense in these matters. These lawsuits could be time-consuming and costly and could divert the attention of our management. These lawsuits or any future lawsuits filed against us could harm our business.

As previously reported, in December 2003, we learned that the SEC staff is conducting an informal investigation that appears to be looking into certain analyst reports about us, and our press releases. The SEC staff has not asserted that we have acted improperly or illegally. We have voluntarily cooperated fully with the staff's informal investigation. We believe that we have acted properly and legally with respect to these analyst reports and our press releases. We can predict neither the length, scope, or results of the informal investigation nor its impact, if any, on us or our operations.

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

None.

PART II

Item 5. Market for Common Equity and Related Stockholder Matters.

Market Information

On January 14, 2002, our common stock became eligible to trade on the NASD Over-the-Counter Bulletin Board, or OTCBB, under the symbol RELS. No reported trades of the stock on the OTCBB occurred prior to July 21, 2002. Effective September 6, 2002, the symbol changed to FLST. Effective December 31, 2003, the symbol changed to FSFY as a result of our 1-for-3 reverse stock split that was effective December 31, 2003.

On January 30, 2004, our common stock became eligible to trade on the American Stock Exchange, or AMEX, under the symbol FLT. As of August 25, 2005, we had 8,215,110 shares of common stock outstanding, of which 6,187,306 shares trade on the AMEX. The following chart shows the high and low sales price of our common stock for each of our fiscal quarters since public trading started as quoted on the OTCBB and subsequently the AMEX (giving retroactive effect to the reverse stock split):

Fiscal Quarter	High	Low
8/31/02	$10.50	$5.25
11/30/02	$6.90	$4.23
2/28/03	$6.72	$2.70
5/31/03	$3.00	$1.74
8/31/03	$18.72	$2.22
11/30/03	$9.90	$6.36
2/29/04	$7.95	$2.56
5/31/04	$2.98	$1.41
8/31/04	$1.82	$1.00
11/30/04	$1.88	$1.31
2/28/05	$1.74	$1.12
5/31/05	$2.09	$1.30

The quotations reflect inter-dealer prices, without retail mark-up, mark-down or commission, and may not represent actual transactions.

As of May 31, 2005, we had 93 record holders of our common stock, as reflected on the books of our transfer agent. A significant number of shares were held in street name and, as such, we believe that the actual number of beneficial owners is significantly higher.

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Equity Compensation Plans

The table below provides information relating to our equity compensation plans as of August 24, 2005.

Plan category	Number of securities to be issued upon exercise of outstanding options, warrants and rights	Weighted-average price of outstanding options, warrants and rights	Number of securities remaining available for future issuance under compensation plans (excluding securities reflected in first column)
Equity compensation plans approved by shareholders	--	--	--
Equity compensation plans not approved by security holders	969,621	$4.92	(a)

(a) The equity compensation plan not approved by shareholders is comprised of individual common stock option agreements issued to directors, consultants and employees of ours, as summarized below. The common stock options vest between one and three years of the date of issue and expire within three years of the vesting date for options issued before 5-31-04 and ten years from the grant date for options issued after 5-31-04. The exercise prices of the current outstanding options are $6.00 per share for options issued before 5-31-04 and $3.50 for options issued after 5-31-04. Since these options are issued in individual compensation arrangements, there are no options available under any plan for future issuance.

Options issued to:	Number of options	Exercise price	Vesting dates	Expiration dates
Employees		$6.00	2002	
Consultants		$6.00	2002	2005
Present	145,834	$6.00	2002-2005	2005
Directors	195,452	$6.00	2002-2005	2005-2008
Former	166,668	$3.50	2004-2007	2005-2008
Directors	41,667			2014
	420,000			
Employees	969,621			
Total issued				

Dividends

We have never declared or paid any cash dividends on our common stock. For the foreseeable future, we intend to retain any earnings to finance the development and expansion of our business, and we do not anticipate paying any cash dividends on our common stock. Any future determination to pay dividends will be at the discretion of our Board of Directors and will be dependent upon then existing conditions, including our financial condition and results of operations, capital requirements, contractual restrictions, business prospects, and other factors that our Board of Directors considers relevant.

Recent Sales of Unregistered Securities

There have been no sales of unregistered securities within the last three years which would be required to be disclosed pursuant to Item 701 of Regulation S-B, except for the following:

In June 2001, prior to the share exchange with FSTO, as Reel Staff, Inc., we issued 613,750 shares of our common stock to three accredited investors and seventeen non-accredited investors at $0.02 per share. The shares were issued in a transaction which we believe satisfies the requirements of that exemption from the registration and prospectus delivery requirements of the Securities Act of 1933, which exemption is specified by the provisions of Section 4(2) of that act and Rule 506 of Regulation D promulgated pursuant to that act by the SEC. Specifically, the offer was made to "accredited investors", as that term is defined under applicable federal and state securities laws, and no more than 35 non-accredited investors. Based on the information provided in the subscription documents, which were completed by all investors, we believe that each of the non-accredited investors was sophisticated because each non-accredited investor has such knowledge and experience in financial and business matters that he or she is capable of evaluating the merits and risks of the prospective investment. Each investor was given adequate access to sufficient information about us to make an informed investment decision. We did not use any public solicitation or general advertising in connection with this offering. There were no commissions paid on the sale of these shares. The net proceeds to us were $12,075. 10,000 of those shares were issued to Renee Close in exchange for graphic design services, which were valued at $200.

On September 1, 2002, as part of a share exchange with FSTO, as Reel Staff, Inc., we issued 8,211,728 shares of common stock to stockholders of FSTO in return for a 96.54% ownership interest in FSTO. On June 27, 2003, we issued 294,129 shares of our common stock to remaining shareholders of FSTO as a result of FSTO being merged into us pursuant to Delaware and Nevada law. The securities issued in the share exchange and the merger were exempt from registration pursuant to Section 4(2) of the Securities Act of 1933, as amended, because this issuance was not a public offering.

On September 1, 2002, prior to the share exchange with FSTO, as Reel Staff, Inc., we issued 850,000 common shares and 850,000 warrants, each warrant to purchase one of our common shares. The shares and warrants were issued in a private placement in reliance upon Regulation S under the Securities Act of 1933. The common shares were issued at a price of $2.00 per share, resulting in aggregate proceeds of $1,700,000 and net proceeds after costs of issuance of approximately $1,500,000. We subsequently registered these shares and the shares underlying the warrants pursuant to an SB-2 Registration Statement that became effective February 19, 2003. As of August 31, 2003, all such warrants had been exercised, resulting in additional aggregate proceeds of $1,700,000.

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Item 6. Management's Discussion and Analysis of Financial Condition and Results of Operations.

Cautionary Statement Pursuant to Safe Harbor Provisions of the Private Securities Litigation Reform Act of 1995:

Except for the historical information presented in this document, the matters discussed in this annual report on Form 10-KSB for the twelve month period ending May 31, 2005 or otherwise incorporated by reference into this document, contain "forward-looking statements" (as such term is defined in the Private Securities Litigation Reform Act of 1995). These statements are identified by the use of forward-looking terminology such as "believes", "plans", "intend", "scheduled", "potential", "continue", "estimates", "hopes", "goal", "objective", expects", "may", "will", "should" or "anticipates" or the negative thereof or other variations thereon or comparable terminology, or by discussions of strategy that involve risks and uncertainties. The safe harbor provisions of Section 21E of the Securities Exchange Act of 1934, as amended, and Section 27A of the Securities Act of 1933, as amended, apply to forward-looking statements made by us. We caution you that no statements contained in this Form 10-KSB should be construed as a guarantee or assurance of future performance or results. These forward-looking statements involve risks and uncertainties, which include risks and uncertainties associated with, among other things, the outcome of an informal inquiry by the SEC that appears to be in connection with certain analysts reports about us and our press releases, the outcome of pending class action litigation alleging violations of federal securities laws, whether the government will implement WVAS at all or with the inclusion of a SOCRATES™ wake vortex sensor, the impact of competitive products and pricing, limited visibility into future product demand, slower economic growth generally, difficulties inherent in the development of complex technology, new products sufficiency, availability of capital to fund operations, research and development, fluctuations in operating results, and these and other risks are discussed in the "Known Trends, Risks and Uncertainties" section of this Form 10-KSB. The actual results that we achieve may differ materially from any forward-looking statements due to such risks and uncertainties. These forward-looking statements are based on current expectations, and, except as required by law, we assume no obligation to update this information whether as a result of new information, future events or otherwise. Readers are urged to carefully review and consider the various disclosures made by us in this Form 10-KSB and in our other reports filed with the Securities and Exchange Commission that attempt to advise interested parties of the risks and factors that may affect our business.

Overview

Our current operations have been funded substantially by U.S. Congressional appropriations resulting in three successive sole source contracts with agencies of the federal government for research, development, and testing of our SOCRATES™ wake vortex sensor and related work pertaining to a wake vortex advisory system, sometimes known as WVAS, that NASA is developing. We estimate the appropriations to the FAA totaled approximately $9.6 million in U.S. fiscal years ending September 30, 1997 through September 30, 2000 for research and development of our SOCRATES™ wake vortex sensor; and appropriations to NASA for research and development of our SOCRATES™ wake vortex sensor totaled approximately $18.5 million in U.S. fiscal years ending September 30, 2001 through September 30, 2004. From these amounts, we have received three contracts aggregating approximately $16.2 million. As of May 31, 2005, we have recognized an aggregate of approximately $14.5 million of contract revenue with $0.4 million in contract receivable as of May 31, 2005. Our current SOCRATES™ government contract backlog is approximately $1.7 million.

We have entered into these contracts with the Volpe National Transportation Systems Center of the U.S. Department of Transportation ("Volpe"). Volpe funds our contracts when, as, and if it and other sponsoring federal agencies approve a statement of work and specific task orders under the statement of work. When funded, we invoice the federal government monthly based on our direct costs, including overhead and general and administrative plus a fixed fee for that month and typically receive payment by electronic wire transfer within two weeks of invoicing. Certain costs, such as lobbying, product development, and business development expenses that are not allowable under these contracts, research and development costs we incur over certain cost caps set by the U.S. government, costs incurred while our contracts are not funded, or costs deemed unreasonable by the government are not reimbursable under our government contracts and have been funded primarily by proceeds of our equity offerings. All of our government contracts and funding are subject to the requirements of the Federal Acquisition Regulations.

Without notice to, or opportunity for prior review by us, Volpe circulated a report in October 2001 which recommended curtailing further government expenditure on our SOCRATES™ wake vortex sensor due to a high risk assessment of achieving operational feasibility. Together with our major subcontractor, Lockheed Martin Corp., we vigorously disputed and extensively discussed its assertions with Volpe and NASA. Subsequent to these discussions, NASA requested and we submitted a proposal for $2.221 million of additional SOCRATES™ wake vortex sensor research, development and testing with an immediate objective of better characterizing the wake acoustics and background noise. In November 2002, Volpe approved and funded a new work order in the amount of $1.230 million for the first phase of this proposal and in March 2003, a second work order was approved and funded in the amount of $991,000. Included in the funding was a 7% fixed fee over and above our research and development costs plus overhead, general and administrative costs. The statement of work continued our previous contract to develop and test our SOCRATES™ wake vortex sensor. This funding ended an 11-month period, from December 15, 2001 to November 19, 2002, without government funding to develop our SOCRATES™ wake vortex sensor.

On September 30, 2003, we received our third successive sole source contract from Volpe, titled Phase III SOCRATES™, for an aggregate of $3.975 million to continue work on developing our SOCRATES™ wake vortex sensor. We used these funds to expand our current SOCRATES™ wake vortex sensor from a four beam configuration (which

was tested at the Denver International Airport in September 2003) to eight beams and began engineering for further expansion to sixteen beams. This contract was funded from a U.S. fiscal year 2003 Omnibus Appropriation of $4.5 million to the NASA budget for research, development, and testing of our SOCRATES® wake vortex sensor.

For U.S. fiscal year ended September 30, 2004, an additional $5 million NASA appropriation specifically for continued work on project SOCRATES™ had been enacted into law. On November 30, 2004, after a three month period without contract funding, our sponsoring agencies approved a $3.237 million modification and extension of our contract. As and when set forth in the contract modification, statement of work and appropriate work orders, Volpe has advanced funds to us to complete the expansion of our SOCRATES™ wake vortex sensor from a eight beam configuration to a sixteen beam configuration and to conduct a test of the expanded sixteen beam SOCRATES™ wake vortex sensor, which we expect to occur at Denver International Airport in September 2005. Although we are cautiously optimistic, there can be no assurance that this test will be successful. Failure to achieve the desired results could limit or delay our prospects for deployment of a SOCRATES™ wake vortex sensor.

For U.S. fiscal year ended September 30, 2005, Congress enacted, and the President signed into law on December 8, 2004, the Omnibus Appropriations Bill, Public Law 108-447, which contained a further $5 million to NASA specifically designated for project SOCRATES™. We expect to obtain a new contract for approximately $3.5 million of these funds, and we have drafted a statement of work and cost proposal that we expect Volpe will review and must approve together with our government sponsors before any funds are available to us. Availability of the funds also may depend on the success of our SOCRATES™ test at Denver International Airport. We can make no assurance as to the timing for release or amount of funds, if any, which we ultimately may receive from the U.S. fiscal year 2005 appropriation.

We believe the federal government has indicated a long-term interest in the development of a wake vortex advisory system and our SOCRATES™ wake vortex sensor for potential inclusion in such a system. However, the federal government has in the past delayed or reduced and may in the future delay, reduce, or eliminate funding for research and development of our SOCRATES™ wake vortex sensor or the wake vortex advisory system as a result of, among other things, a reduction in support or opposition from supervising agencies or the U.S. Congress, lack of progress or setbacks in our SOCRATES™ research and development, changes in budgetary priorities, fiscal constraints caused by federal budget deficits, or decisions to fund competing systems or components of systems. If any such delays or reductions occur, it will reduce our resources available for research and development of our proprietary technologies,

new products or enhancements to SOCRATES™ or UNICORN™ technologies and to market our products. Reduction of or delays in contract funding from the federal government could delay achievement of or increase in profitability, if any, create a substantial strain on our liquidity, resources and product development, and have a material adverse effect on the progress of our research and development and our financial condition.

We also are pursuing development of a collision and ground proximity warning system we refer to as UNICORN™. We believe that UNICORN™ may have application to unmanned air vehicles operated for a variety of private and governmental purposes. We have entered into three significant internally funded research and development contract commitments with subcontractors and consultants and have paid approximately $240,000 for different aspects of this project. As of May 31, 2005 the cumulative research and development expense for UNICORN™ is approximately $850,000.

During the past fiscal year, we also began the exploratory development of a third major technology initiative called TIICM™ (Tactical Integrated Illuminating Countermeasure) in conjunction with Sanders Design International (SDI), a New Hampshire company. TIICM™ is intended to provide a low cost yet highly effective shield of protection for airliners against the threat of certain terrorist-launched missiles. In April 2004, we executed a ten year Teaming Agreement with SDI under which we would be the prime contractor on development of counter technologies to anti-aircraft shoulder fired missiles. As of May 31, 2005 we have committed approximately $300,000 of our independent research and development funds to TIICM™. We have entered into additional arrangements with SDI pursuant to which we intend to apply for patent protection on TIICM™ with SDI and would share joint ownership of any resulting patent. We have also been working on TIICM™ with Analogic Corporation located in Peabody, Massachusetts which has certain rights to TIICM™ pursuant to a license agreement it executed with SDI, which may limit our ability to earn revenue from TIICM™. There can be no assurance that any new patents on TIICM™ will be issued, or that we will derive any revenue or profit from TIICM™, nor any expectation that we will receive any government or commercial funding for TIICM™, or that our relationship with Analogic will result in a mutually acceptable formal business relationship agreement.

We have experienced significant losses since our inception. Losses for our three fiscal years ending May 31, 2005, 2004 and 2003 were $1,411,644, $424,214, and $943,974, respectively. The net loss for our fiscal year ended May 31, 2003 was caused primarily by three factors: (1) unallowable expenses under our government contract, (2) rate ceilings; and (3) expenses during unfunded periods for SOCRATES™ research and development. With the reinstatement of the government contract funding in November 2002, the loss for our fiscal year ended May 31, 2004

was caused by the remaining two factors: (1) rate ceilings during the first six months, and (2) unallowable expenses under our government contract. The loss for the fiscal year ending May 31, 2005 was caused by: (1) unallowable expenses, (2) expenses during a partially unfunded period, and (3) unreasonable expenses. The unreasonable expense category represents general and administrative expenses, primarily legal expenses and independent research and development expense which we believe are necessary but are significantly higher compared to prior years and may be considered unreasonable by the Defense Contract Audit Agency.

Our third consecutive and current government contract that we initially received on September 30, 2003 does not include rate ceilings. If the government deems our allowable expenses to be reasonable, of which there can be no assurance, the absence of rate ceilings should eliminate or reduce a significant source of losses in previous years. We will continue to incur certain unallowable expenses or allowable expenses the government deems unreasonable. We also remain subject to the risk of further delay, reduction or elimination in federal contract funding. However, it is our view that the elimination of rate ceilings is a significant improvement to our historical contract terms.

Critical Accounting Policies and Estimates

The discussion and analysis of our financial condition and results of operations are based on our financial statements that have been prepared according to accounting principles generally accepted in the United States of America. In preparing these financial statements, we are required to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses and related disclosures of contingent assets and liabilities. We evaluate these estimates on an on-going basis. We base these estimates on historical experiences and on various other assumptions that we believe are reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities. Actual results may differ from these estimates under different assumptions or conditions. Our management has discussed these estimates and assumptions with our finance and audit committee. At this point in our operations, subjective judgments do not have a material impact on our financial statements except as discussed in the next paragraph.

Federal Acquisitions Regulations require that, among other things, our reimbursable costs are reasonable. We have analyzed our actual overhead rate of 69% and general administrative rate of 62% for the fiscal year ended May 31, 2005. We believe all component costs have been ordinary and necessary but that government auditors may consider our legal expenses, independent research and development expense for UNICORN™ technology, and certain other general and administrative expenses as of the fiscal year ended May 31, 2005 unreasonable for a company our size. For rate setting purposes, we have excluded $500,000 for potential unreasonable expenses, which reduced the general and administrative rate to 41% for the fiscal year ended May 31, 2005. Since there is a degree of subjectivity in the judgment of what levels of cost are reasonable, we can make no assurance that the government will not require further adjustments.

Our financial statements and notes thereto include an item for "Other Receivables" that is described therein. Other Receivables includes recoverable rate differences resulting from the difference between the current adjusted general and administrative rate of 41% compared to our provisional rate of 29%, which has created a difference of $158,000 for the fiscal year ended May 31, 2005. In addition, $133,000 was the difference between the provisional rate and actual rate for fiscal year ending May 31, 2004 which brings the total recoverable rate difference to $291,000 as of May 31, 2005. We believe this amount will be recoverable along with other contract cost differences, some higher and others lower, when our sponsoring government agency has reviewed our request for contract cost growth which in total is approximately $218,000. Under our government contract, we are entitled to receive this amount as long as it is allowable and reasonable and the contracting officer approves the cost growth due to rate adjustments. The portion of other receivables represented by recoverable rate difference also reflects our judgment that we expect the government will have a funding source available to pay us the recoverable rate difference. This source may result from a reallocation of items within our existing contract to reflect actual expenditures, from use of funds available for a subsequent contract, or from reserve sources otherwise available to the government.

We have assessed our prospects for payment and based on the experience of our management under these procedures, we believe that we will receive these amounts upon final government review and audit of our contract. We therefore have recognized them as revenue, although ultimate collection will depend upon availability of one or more of the foregoing sources for payment, of which we can make no assurance.

Results of Operations

FLIGHT SAFETY TECHNOLOGIES, INC.

Statements of Operations and Comprehensive Income (Loss)
For the Years Ended May 31, 2005 and May 31, 2004

	May 31, 2005	May 31, 2004
Contract Revenues	$ 3,310,871	$ 3,593,784
Cost of Revenues	2,233,773	2,392,166
Gross Profit	1,077,098	1,201,618
Operating Expenses		
Research and development	557,137	170,832
Selling, general and administrative	2,001,871	1,390,801
Depreciation and amortization	125,660	88,053
Total Operating Expenses	2,684,668	1,649,686
Loss from operations	(1,607,570)	(448,068)
Other Income (Expense)		
Interest income	223,586	39,749
Loss before provision for income taxes	(1,383,984)	(408,319)
Provision for income taxes	27,660	15,895
Net Income (Loss)	(1,411,644)	(424,214)
Other Comprehensive Income (Loss)		
Unrealized (loss) on investments	(44,522)	(119,501)
Comprehensive Income (loss)	$(1,456,166)	$(543,715)
Net Loss Per Share		
Basic and diluted	$ (.17)	$ (.07)
Weighted Average Number of Shares Outstanding		
Basic and diluted	8,217,971	6,194,059

Revenues

. To date, our revenues have consisted almost entirely of revenues earned from our three successive SOCRATES™ wake vortex sensor research and development contracts with the federal government.

Contract revenue for the fiscal year ended May 31, 2005 was $3,310,871, compared to $3,593,784 for the fiscal year ended May 31, 2004.

The $282,913 decrease for the fiscal year ended May 31, 2005 compared to the same period of the prior year was due to a period of partial funding during September, October and November 2004, our second quarter of fiscal year 2005. As of May 31, 2005, our contract receivable against our government contract was $415,617 as compared to $532,043 as of May 31, 2004.

Costs of Revenues

. Subcontractor, consultant and direct labor expenses comprise our costs of revenues. Direct contract costs for the fiscal years ended May 31, 2005 was $2,233,773 or 67.5% of revenue compared to 2,392,166 or 66.6% for the same fiscal year ended May 31, 2004.

When our government contract is funded, charges to direct costs do not generally impact our operating income because each contract covers its own direct costs. However, during periods when our government contract is not funded or if the actual direct cost of a specific task order exceeds its budgeted funding and the government is not willing to reallocate direct costs between task orders, any such costs we may incur are not reimbursable and must be funded from our own resources.

Research and Development

. Our research and development expense for fiscal year ended May 31, 2005 was $557,137, compared to $170,832 for the same period ended May 31, 2004. The increase in research and development expenses of $386,305 in fiscal year ended May 31, 2005 compared to May 31, 2004 was primarily due to the increase of approximately $135,000 for salaries and wages and approximately $250,000 for consultants, travel and other miscellaneous expense primarily for our UNICORN ™ project. The increase for our UNICORN ™ project expenses were for the development of UNICORN™ antenna and radar components and a proof-of-principle test in August, 2005. In addition, in the fiscal year ended May 31, 2005, we began a research and development project for TIICM™ (Tactical Integrated Illumination Countermeasure).

Operating Expenses. Government contractors are required to categorize operating expenses as overhead expenses or general and administrative expenses. These two indirect "cost pools" are then divided by their appropriate "direct cost base" combinations of direct contract cost, which determines the contractors overhead and general and administrative rates. These rates, for our first two government contracts, were subject to ceilings, which were set at 70% for overhead and 20% for general and administrative. Our third contract is not limited by rate ceilings. Instead, we submitted provisional billing rates of 83% for overhead and 29% for general and administrative for our fiscal year ending May 31, 2005. These provisional rates were based on forecasted direct and indirect costs and were audited by the Defense Contract Audit Agency (DCAA) and approved by the DOT/Volpe Center on September 13, 2004. Our actual rates, for our fiscal year ended May 31, 2004, based on actual allowable costs incurred, were submitted to the government for

audit on September 16, 2004. When our actual rates have been audited, we will adjust our government contract billings higher or lower to reflect the audited actual rates versus the previous estimated provisional billing rates. As long as actual costs are reasonable, of which there can be no assurance, we can include them in our actual rate and receive reimbursement for them. However, if the government will not approve an increase in contract funding to cover a billing adjustment that is higher than our provisional rates, we may not be able to obtain reimbursement for the increase. Our historical rates are shown below.

	For Year Ended 5-31-03	For Year Ended 5-31-04	For Year Ended 05-31-05
Overhead Rates			
General and Admin. Rates	89%	80%	69%
	67%	35%	41%

The above rates for each of the previous periods include only allowable operating expenses and have been lower over the last two years due to increased contract funding and the increase in our direct cost base. We believe the overhead rate will average over time approximately 75%. We expect that our general and administrative rate which was 41% as of May 31, 2005, will be approximately 39% for our fiscal year ending May 31, 2006. We believe government auditors will consider a 41% rate reasonable, although we can make no assurance in this regard.

Our un-reimbursable non-contract costs include: 1) expenses considered unallowable per Federal Acquisition Regulations (FAR), such as lobbying, stock based compensation and company car expense, 2) over ceiling expenses, 3) expenses incurred during periods without government contract funding and/or 4) expenses the government considers unreasonable. These non-contract costs are not reimbursable under our U.S. government contracts and must be paid from other sources, primarily proceeds from the public and private sales of our equity securities. Non-contract costs have been the primary use of this source of liquidity and have had a significant impact on our operating loss to date. Our non-contract costs are detailed below:

	For the Fiscal Year Ended	
	5-31-05	5-31-04
Unallowable expenses (1) & (2)	$799,053	$375,221
Over-ceiling expenses	--	257,066
Expenses during unfunded period	401,903	--
Potential unreasonable expense	500,000	--
Total	$1,700,956	$632,287

Notes:

(1) Includes $109,964 of stock based compensation expense for the fiscal year ended 5-31-05.
(2) Includes $62,959 of stock based compensation expense for the fiscal year ended 5-31-04.

Our total selling, general and administrative expenses consist of allowable and unallowable expenses and for the fiscal year ended May 31, 2005 was $2,001,871, compared to $1,390,801 for the same period ended May 31, 2004.

The increase in selling, general and administrative expense of $611,070 in the fiscal year ended May 31, 2005 compared to May 31, 2004 was primarily due to an increase in unallowable expenses. The unallowable expenses increase of approximately $425,000 was primarily due to increased legal fees for issues concerning intellectual property and class action suits, directors and officers insurance, company cars, investor relations and stock based compensation. The remaining increase of approximately $186,000 for allowable selling, general and administrative expenses was primarily due to increased salary and wages, employee benefits, directors fees and office rent.

Over-ceiling expenses for the fiscal year ended May 31, 2005 were $0 compared to $257,066 for the fiscal year ended May 31, 2004 because our third government contract received on September 30, 2003 eliminated rate ceilings.

Expenses during unfunded periods were $401,903 during the fiscal year ended May 31, 2005 compared to $0 for the same period ended May 31, 2004 because most of our contract work was not funded during September, October, and November 2004. We received a contract modification for an additional $3.237 million in government funding on November 30, 2004. As a result, we expect to be funded through September 30, 2005 which should eliminate the unfunded operating expenses during the period of June 1, 2005 through September 30, 2005, the first quarter of our fiscal year 2006, although we can make no assurance in this regard.

After a review of our general and administrative expenses, we have determined that some of our legal, research and development and certain other expenses for the fiscal year ending May 31, 2005 could be considered unreasonable. Accordingly, we have excluded $500,000 for potential unreasonable expenses, from the calculation of our actual rates, for the fiscal year ended May 31, 2005.

Liquidity and Capital Resources

Our liquidity is primarily provided by revenue from our government contracts and proceeds from the sale of our equity securities.

Our third contract, titled Phase III SOCRATES®, is the third successive contract that we have received to continue work on our SOCRATES® wake vortex sensor and was initially funded at $3.975 million. Between August 31, 2004 and November 30, 2004, we were negotiating a modification and extension of our Phase III Contract and during this period there was only partial government funding for SOCRATES® research and development. On November 30, 2004, Volpe approved a contract modification for additional funding of $3.237 million which we will use to expand our current SOCRATES® wake vortex sensor from its present four beam configuration to sixteen beams plus other improvements. Our funded contract backlog for the second part of our Phase III contract as of May 31, 2005 was $1.718 million.

As of May 31, 2005 and May 31, 2004, our cash and investments were $7,888,831 and $9,552,289, respectively. The decrease in cash on hand and investments of $1,663,458 was primarily attributable to the net losses for the fiscal year ended May 31, 2005, capital additions, and the purchase of treasury stock and inventory during the fiscal year ending May 31, 2005. The purchase of inventory for $108,044 represents purchasing of long lead SOCRATES® system components to further expand to a 32 beam system.

As of May 31, 2005, we had other receivables of $330,010 compared to $194,479 as of May 31, 2004. The increase is primarily due to $158,000 of unbilled government contract receivables which represents the difference between provisional rates for overhead and general administrative provisional rates of 83% and 29%, and the actual rates for the twelve months ended May 31, 2005 of 69% and 41%, respectively, applied to our direct costs incurred in our Phase III SOCRATES® contract through May 31, 2005. We expect to recover the indirect costs represented by the unbilled contract receivable after we receive a contract modification for cost growth requested March 29, 2005 from the DOT/Volpe Center, although we can make no assurance in these regards.

We had total current liabilities, including accounts payable, of $769,653 as of May 31, 2005 compared to $757,170 as of May 31, 2004. Accounts payable as of May 31, 2005 were $589,313, which included $319,391 to our subcontractor, Lockheed Martin Corporation, and $269,922 in other expenses compared to accounts payable as of May 31, 2004 of $615,911, which included $412,329 to Lockheed Martin, and $203,582 in other expenses.

We anticipate that our funded contract balance for the second part of our Phase III contract of $1,718,258 as of May 31, 2005 will fund our direct contract costs and allowable operating expenses until approximately September 30, 2005. During this period, we have budgeted and expect to incur approximately $150,000 in non-contract unallowable costs and approximately $250,000 in research and development. During this period, we have budgeted and expect to receive approximately $100,000 in fees from our contract billing and approximately $75,000 of interest income. Assuming we operate within budget, as to which we can make no guaranty or assurance, we estimate our available cash and investments should be approximately $7,650,000 as of September 30, 2005. In addition, we have budgeted and expect to have a balance of approximately $7,000,000 as of May 31, 2006. Any acceleration or delays in the performance of these contracts by us or our subcontractors could, respectively, exhaust or extend our contract funding prior to or after September 30, 2005. In either event, we might be required to draw upon our cash before we anticipate which would reduce the foregoing estimate.

Our use of cash projections does not consider any additional contract funding we may receive from the Omnibus Appropriations Bill for U.S. fiscal year 2005 which contains a further $5 million appropriation to NASA specifically designated for continued research and development on project SOCRATES®. We expect to receive a contract for approximately $3.5 million of this appropriation if and when our sponsoring agencies approve a statement of work and issue a new contract for appropriate work orders to us, of which we can make no assurance. Prior to any new

contract the government will request and we must submit a cost and technical proposal for review and approval of the government. As of the date of this report, we have not received such request and the timing for release of such request is estimated to be approximately August 31, 2005. Any delay in obtaining a contract extension also might require us to draw upon our cash to fund our operations.

From time to time, we may consider and execute strategic investments, acquisitions, or other transactions that we believe could benefit us and could require use of some or all of our liquidity. To facilitate such transactions and enhance our liquidity position for these and other purposes, such as working capital for research and development, we also may conduct from time to time various types of equity offerings, including, but not limited to, public or private offerings of common or preferred stock based on a negotiated fixed share value, or floating market price of our publicly traded shares. If we encounter delays in, or are unable to procure, contract funding from the U.S. government for further research development and testing of our SOCRATES® wake vortex sensor, incur costs over budget, or make a strategic investment, our cash resources will be reduced more rapidly than we presently anticipate. In such event, we may need to obtain additional capital to maintain operations. There can be no guarantee or assurance of our future ability to obtain capital for any of the foregoing purposes and, if obtained, the terms and conditions of such capital may dilute our present shareholders' ownership.

Known Trends, Risks and Uncertainties

Our business and future success are subject to many risks. The following describes some of the general and specific trends, risks, and uncertainties to which our business is subject and should be read with care.

Risks Related to Our Business

Our limited operating history and lack of commercial operations make it difficult to evaluate our prospects.

Since we began operations in 1997, we have generated limited revenues solely from three SOCRATES® technology research and development contracts with agencies of the federal government that fund, administer, and oversee these contracts. The federal government has funded these contracts from earmarked U.S. Congressional appropriations to agencies that have awarded these contracts to us on a sole source basis without competitive bidding. Under these contracts, we are reimbursed for certain allowable research and development costs and are paid a fee calculated as a percentage of costs.

We have not as yet received any revenue from the sale of any products. We do not anticipate receiving any such revenue unless and until our SOCRATES®, UNICORN™ or TIICM™ based products become operational, which could take several years. Our estimates of the market size for the products we are developing are based on many assumptions and uncertainties. These estimates are currently being evaluated by an outside consulting firm. The actual markets and price we can charge for our products, if and when we successfully complete their development, could be substantially less and our costs could be greater than our estimates. It therefore is difficult to assess our prospects for commercial sales, revenues and profitability.

We have incurred and, for the next several years, can be expected to incur operating losses.

To date, we have incurred significant net losses, including net losses of $1,411,644 for our fiscal year ended May 31, 2005 and $424,214 for the fiscal year ended May 31, 2004. We had an accumulated deficit of $4,295,881 as of May 31, 2005. We anticipate we may continue to incur operating losses for at least the next several years. We may never generate material revenues or achieve or maintain profitability. Substantially all our revenues have been devoted to payment of costs incurred in the research, development, and testing of our SOCRATES® or UNICORN™ technology. Our ability to achieve, maintain, and/or increase profitability will depend in large part upon the successful further development and testing of our SOCRATES®, UNICORN™-based, and TIICM™ products, Congressional appropriations and our ability to obtain additional federal research and development contracts for SOCRATES®, UNICORN™ and TIICM™ based products, approval of our SOCRATES®, UNICORN™-based, and TIICM™ products and systems by various agencies of the federal government, procurement of our products and systems by the FAA, airports and the aviation industry, and the availability of funding to finance such procurements.

Lack of future funding from the federal government to complete research and development of our SOCRATES™ wake vortex sensor could adversely affect our business.

Without notice to, or opportunity for prior review by us, the John A. Volpe National Transportation Systems Center of the U. S. Department of Transportation's Research and Special Programs Administration, or Volpe, circulated a report in October 2001 which recommended curtailing further government expenditure on our SOCRATES® wake vortex sensor due to a high risk assessment of achieving operational feasibility. Because of this report and the events of September 11, 2001, the government did not fund our SOCRATES™ research and development contract from December 15, 2001 to November 19, 2002. Together with our major subcontractor, Lockheed Martin Corporation, we vigorously disputed and extensively discussed its assertions with Volpe and NASA. Subsequently, Volpe and NASA requested and we submitted a proposal for approximately $2.2 million of additional SOCRATES® technology

research, development and testing with an immediate objective of better characterizing the wake acoustics and background noise. We received contract funding for this proposal and subsequent

proposals and we believe the federal government will continue to have a long-term interest in the development of a wake vortex advisory system and our SOCRATES® wake vortex sensor for inclusion in such a system. However, the U.S. government may terminate our government contract at any time if it determines such termination is in the best interests of the government or may terminate, reduce or modify it because of budgetary constraints or any change in the government's requirements. Furthermore, the federal government has in the past delayed or reduced and may in the future delay, reduce, or eliminate funding for research and development of our SOCRATES® wake vortex sensor or the wake vortex advisory system as a result of, among other things, a reduction in support or opposition from supervising agencies or the U.S. Congress, changes in budgetary priorities, fiscal constraints caused by federal budget deficits, or decisions to fund competing systems or components of systems. If this occurs, it will reduce our resources available for research and development of our proprietary technologies, new products or enhancements to SOCRATES®, UNICORN™ or TIICM™ technologies and to market our products. Reduction of contract funding from the federal government could delay achievement of or increases in profitability, if any, create a substantial strain on our liquidity, resources and product development, and have a material adverse effect on the progress of our research and development and our financial condition.

The government will not pay us for SOCRATES® research and development if we do not perform on our contract.

We perform our government contracts pursuant to specific work orders from the government. Such work orders include, but are not limited to, analysis of data, research, development of our SOCRATES® technology, planning and conduct of testing, and preparation of various reports. If we do not perform the contracts in accordance with their terms, the government may withhold payment on our invoices that we submit monthly. Furthermore, if at any point the government considers a test to be a failure, it may cease to approve further work orders or fund further contracts. Loss of funding on our SOCRATES® contract would have a material adverse effect on our business, financial condition, and results of operations.

Our success depends on our successful product development and testing.

Our future success will depend upon our ability to successfully complete the development, testing, and commercialization of our technologies and our ability to develop and introduce new products and services to meet industry, government, and client requirements. We are planning to eventually develop a number of products, based on our SOCRATES®, UNICORN™ and TIICM™ technologies. The process of developing such products contains significant technological and engineering hurdles and is extremely complex and expensive. In 2001, Volpe and associated federally funded research centers prepared reports which concluded it was unlikely SOCRATES® would result in a sensor that could be used for any operational procedure and even for research because of technical unknowns relating to an understanding of wake vortices and the need to obtain acceptance of WVAS by controllers and pilots. We believe this

conclusion was premature and based on an incomplete understanding of SOCRATES® and its operational potential. In our opinion, the testing and analysis we have conducted has increasingly supported this potential and resulted in the continuation of funding for our government contracts for research, development and testing of our SOCRATES® technology. However, there still are technical, engineering and program integration hurdles we must meet to develop

SOCRATES® into an operational sensor, including, but not limited to, expanding the sensor to at least sixteen and as many as thirty-two laser beams, integrating the sensor into and with the other components of WVAS, and developing operating protocols for WVAS that define how it would be used by air traffic controllers and pilots. In the case of UNICORN™, we must successfully overcome development, engineering and testing hurdles to produce an operational product and obtain FAA approval of this product. Furthermore, we will need to extend the term of the experimental license the FCC has granted us and, ultimately, obtain a permanent license from the FCC for the operation of UNICORN™. We might not successfully complete the development of our SOCRATES®, UNICORN™ or TIICM™ technologies into operational products and our products may not be commercially viable. Our failure to complete development of any such products and achieve market acceptance would have a material adverse effect on our business, financial condition, and results of operations.

In addition, certain of our products will require customized installation to address unique characteristics of their environments. Customization could place an additional burden on our resources or delay the delivery or installation of products which, in turn, could have a material adverse effect on our relationship with clients, our business, financial condition, and results of operations.

Our success depends on federal government approval of our products and related systems.

The airport and aviation industry is subject to extensive government oversight and regulation. To introduce our SOCRATES®, UNICORN™ or TIICM™ based products for commercial sale, we must successfully complete research, development, and testing and obtain necessary governmental approvals for their installation. Upon approval by the Federal Aviation Administration, or FAA, our SOCRATES® wake vortex sensor would be part of a multi-component wake vortex advisory system that also will require government approvals before it can be deployed. Any factor that delays or adversely affects this approval process, including delays in development or inability to obtain necessary government approvals, could have a material adverse effect on our business, financial condition, and results of operations, and we can make no assurance when or if all such approvals will be obtained.

Our business relies on a strategic alliance with Lockheed Martin Corporation.

In May 1997, we signed a Teaming Agreement with Lockheed Martin Corporation to jointly develop and market SOCRATES® based products. This agreement will expire in May 2007, unless certain earlier termination provisions occur or the agreement is extended by mutual agreement. The agreement stipulates that we serve as prime contractor and Lockheed Martin Corporation as subcontractor in the development and any deployment of our SOCRATES®

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wake vortex sensor. Although to date we have generally worked in close cooperation with Lockheed Martin Corporation, there is no assurance that this relationship will be sustained. Future disagreements as to work scope, revenue share, profit margins, ownership of intellectual property, or technical, marketing, or management philosophy, could adversely impact the relationship. Since we view our strategic relationship with Lockheed Martin Corporation as a vital element of our business plan, any erosion of this relationship could have a negative impact on our business and future value.

On April 26, 2004, in conjunction with the renewal of a nondisclosure agreement, we were advised by Lockheed Martin Corporation that it owns a certain patent which predates our SOCRATES® patent and, according to Lockheed Martin Corporation, contains some intellectual property related to our SOCRATES® patent. Lockheed Martin Corporation has told us that it was prevented from previously disclosing the patent to us because of a government secrecy order. After consultation with counsel, including our patent counsel, we strongly believe that the Lockheed Martin Corporation patent will not impair the value of our SOCRATES® patent because our SOCRATES® patent is aimed at improving air traffic safety, a use not contemplated by the Lockheed Martin Corporation patent.

Furthermore, it is our position that Lockheed Martin Corporation acknowledged and accepted our invention of the SOCRATES® technology in the Teaming Agreement between us in May 1997. We have met several times with Lockheed Martin Corporation to discuss the matter and potential opportunities relating to our SOCRATES® patent. To date, Lockheed Martin Corporation continues to disagree with our position. Nevertheless, we believe that management of both companies acknowledged the value and strength of the relationship and the desire to preserve it. We are conducting further discussions with Lockheed Martin Corporation on potential ways to expand and extend the relationship and resolve any intellectual property concerns. We cannot predict or provide any assurance on the outcome of these discussions and whether any outcome will be satisfactory to us.

We may need to raise additional capital.

While we completed a public offering in February of 2004 resulting in net proceeds of approximately $7.6 million, we cannot be certain that such financing will be adequate or sufficient for our future needs. We face many uncertainties with respect to research and development and the timing of commercialization of our SOCRATES®, UNICORN™ and TIICM™ based products, the availability and level of government funding, the FAA approvals required for our products, and the long sales cycle from initial customer contact to actual, if any, revenue generation. Depending on the outcome of these uncertainties, we might not be able to generate sufficient, if any, revenue or investment capital to fund our operations over the period of years we believe are required to commercialize our products. In each of our last three fiscal years, we have incurred substantial operating losses which we have funded, in part, with equity capital that we raised from new investors.

We will continue to incur significant expenses for research and development and testing of our SOCRATES®, UNICORN™ and TIICM™ technology and may continue to experience such losses prior to commercialization and thereafter. If we cannot achieve commercialization of our SOCRATES®, UNICORN™ and TIICM™ technologies with the proceeds of our recent public offering or if we are unable to generate sufficient working capital from revenue from government funding or private contracts for these purposes, we might need to seek additional capital. In addition, other unforeseen costs and research and development costs of later generation SOCRATES®, UNICORN™ and TIICM™ based products also could require us to seek additional capital. We do not have any credit facilities in place and, should the need for additional capital arise, we may not be able to obtain sufficient, if any, additional capital or raise such capital on acceptable terms. If we need to obtain additional debt or equity capital, it may include our entry into joint ventures or issuance of additional securities, which may cause dilution to our current capital structure and stockholders' ownership. Additional securities also could have a greater priority as to dividends, distributions and other rights than our common stock.

For the life of our public warrants, the underwriter's warrants issued pursuant to our recent public offering, and our existing unregistered warrants, the holders thereof are given the opportunity to profit from a rise in the market for our common stock, with a resulting dilution in the interest of all other stockholders. So long as these warrants are outstanding, the terms on which we could obtain additional capital may be adversely affected. The holders of these

warrants might be expected to exercise them at a time when we would, in all likelihood, be able to obtain any needed capital by a new offering of securities on terms more favorable than those provided by these warrants.

Loss of key personnel could adversely affect our business.

Our future success depends to a significant degree on the skills, experience and efforts of our executive officers, Samuel A. Kovnat, Chairman of the Board and Chief Executive Officer, William B. Cotton, President and Director, Frank L. Rees, Executive Vice President and Director, David D. Cryer, Chief Financial Officer, Treasurer and Secretary, and Dr. Neal Fine, Senior Vice President for Technology. The sustained unavailability of any one or more of those individuals for any reason could have a material adverse impact on our operations and prospects.

At a recent meeting of our Board of Directors, Mr. Kovnat and Mr. Rees announced their intention to retire on November 30, 2007. The Board intends to develop an orderly plan of succession to appropriately carry the company forward.

We anticipate hiring additional executive officers in the future. We may not be able to complete the hiring of these additional officers in a timely manner or at all. We also depend on the ability of our executive officers and other members of senior management to continue to work effectively as a team.

Government regulation could adversely affect our business.

As a result of receiving contract funding from the federal government and our involvement in the field of aviation, our business and operations are subject to numerous government laws and regulations. In the near term, and for so long as we receive funding from the federal government, we will be subject to many procurement and accounting rules and regulations of the federal government. We are also subject to periodic audits by the Defense Contract Audit Agency, or DCAA. To date, we have incurred six audits by the DCAA, and reports have been issued to our government customer which has stated that we are performing in accordance with Federal Acquisitions Regulations. There is no assurance that any of the results or contents of any future audits will portray us favorably. These rules and regulations are complex in nature and sometimes difficult to interpret or apply. Adherence to these rules is reviewed by participating agencies of the federal government. If such agencies suspect or believe that violations of procurement or accounting rules and regulations have occurred, they may refer such matters to other enforcement divisions of the federal government, such as the U.S. Attorney's Office or the Inspector General's office. If we violate these rules and regulations, even if unintentionally, we may have to pay fines and penalties or could be terminated from receiving further funding from the federal government. If we market, sell and install our products in foreign countries, the laws, rules and regulations of those countries, as well as certain laws of the United States, will apply to us. Existing as well as new laws and regulations of the United States and foreign countries which regulate aviation and airports could also adversely affect our business.

Our success depends on our ability to protect our proprietary technology.

Any failure by us to protect our intellectual property could harm our business and competitive position. For example, although we have sought patent protection for our technologies, the steps we have taken or intend to take with regard

to protecting our technologies may not be adequate to defend and prevent misappropriation of our technology, including the possibility of reverse engineering and the possibility that potential competitors will independently develop technologies that are substantially equivalent or superior to our technology. Furthermore, any patent we have obtained or may obtain may subsequently be invalidated for any of a variety of reasons. In addition, even if we are issued a patent, we may not be able to gain any commercial advantage from such patent. Existing United States laws afford only limited intellectual property protection.

We intend to use a combination of patent, trade secret, copyright and trademark law, nondisclosure agreements, and technical measures to protect our proprietary technology. We intend to enter into confidentiality agreements with and obtain assignments of intellectual property from all of our employees, as well as with our clients and potential clients, and intend to limit access to and distribution of our technology, documentation and other proprietary information. However, the steps we take in this regard may not be adequate to deter misappropriation or independent third-party development of our technology. In addition, the laws of some foreign countries do not protect proprietary technology rights to the same extent as

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do the laws of the United States. If we resort to legal proceedings to enforce our intellectual property rights, the proceedings could be burdensome and expensive and could involve a high degree of risk to our proprietary rights if we are unsuccessful in such proceedings. Moreover, our financial resources may not be adequate to enforce or defend our rights in our technology. Additionally, any patents that we apply for or obtain may not be broad enough to protect all of the technology important to our business, and our ownership of patents does not in itself prevent others from securing patents that may block us from engaging in actions necessary to our business, products, or services.

Other companies may claim that we infringe their intellectual property or proprietary rights.

If our proprietary technology violates or is alleged to violate third party proprietary rights, we may be required to reengineer our technology or seek to obtain licenses from third parties to continue offering our technology without substantial reengineering. Any such efforts may not be successful or if successful could require payments that could have a material adverse effect on our profitability and financial condition. Any litigation involving infringement claims against us would be expensive and time-consuming, and an adverse outcome may result in payment of damages or injunctive relief that could materially and adversely affect our business.

Under certain circumstances, the federal government may be able to use our SOCRATES®-related technologies or other technologies developed with government funding without payment to us.

We have taken certain steps to preserve our rights in our SOCRATES®-related technologies under our contracts with the federal government. However, as is the case with all research and development contracts funded by the federal government, the Federal Acquisition Regulations provide that, under certain circumstances, the federal government may have paid-up rights to use, or have used on its behalf, our SOCRATES®-related technologies or other technologies developed with government funding. We do not expect that the federal government will attempt to use our SOCRATES®-related technologies without compensating us. Nevertheless, if the federal government attempts to exercise these rights, it is difficult to predict what effect, if any, it may have on us. If the federal government succeeds in exercising these rights, it may have a material adverse effect on our business operations and financial performance, which could negatively affect the value of our stock.

Our future customers, including the FAA, may not accept the price of or be able to finance our products.

At present, we cannot precisely fix a price for the sale and installation of an initial SOCRATES® wake vortex sensor at airports or UNICORN™-based collision avoidance systems in small aircraft or TIICM™ in commercial airliners. We estimate that the cost of our SOCRATES™ wake vortex sensor will be roughly $9 million to $20 million per airport installation, depending on, among other things, the number and configuration of runways. Due to developments in the market for general aviation collision warning and avoidance products and information we have

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obtained from our ongoing research, development and engineering of UNICORN™, we now expect the UNICORN™-based system could be more complex than we originally envisioned. As a result, we anticipate the wholesale price of this product could be substantially greater than the $10,000 price we have previously estimated. As we develop further information on the configuration and components of a UNICORN™-based system for general aviation, related production costs, and rapidly evolving competitive technologies, we will reassess the potential market for a commercial UNICORN™-based collision avoidance system for general aviation. Our current goal is to use and build on the UNICORN™ research and development we have conducted to date for application to unmanned air vehicles, if we can obtain government funding for this purpose. While we have had discussions with the federal government in this regard, it is still too early to assess our prospects for obtaining such funding. Because we have not completed the research, development, and testing of either product or received final approvals for either of them from the federal government, we have not commenced production or marketing efforts. We currently do not anticipate having these products ready for commercial sale for at least several years. We therefore are not yet in a position to gauge the reaction of potential customers to the pricing of these products or future products and whether such potential customers will be able to afford and finance our products.

We believe that the increase in efficiency and safety to airports, airlines, and private aircraft resulting from our products will justify the substantial anticipated cost of sales and installation of these products. However, our customers' ability to afford such costs will depend, in part, on the health of the overall economy, the financial condition and budget priorities of the federal government, particularly the FAA and NASA, profitability of airports, airlines, and aircraft manufacturers, and the availability of private and government sources of funding to finance the sales and acquisition of our products. While a variety of potential funding sources exist, inability of the FAA, airlines or airports to access or obtain funding for purchase and installation of our products could have a material adverse impact on sales of our SOCRATES®, UNICORN™ or TIICM™ based products.

We may experience long sales cycles.

We expect to experience long time periods between initial sales contacts and the execution of formal contracts for our products and completion of product installations. The cycle from first contact to revenue generation in our business involves, among other things, selling the concept of our technology and products; developing and implementing a pilot program to demonstrate the capabilities and accuracy of our products; negotiating prices and other contract terms; and, finally, installing and implementing our products on a full-scale basis. We anticipate this cycle will entail a substantial period of time, on average between seven to twelve months, and the lack of revenue experienced during this cycle and the expenses involved in bringing new sales to the point of revenue generation would put a substantial strain on our resources.

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Our success will depend on our ability to create effective sales, marketing, production and installation forces.

At present and for the near future, we will depend upon a relatively small number of employees and subcontractors to complete the research and development of our SOCRATES® wake vortex sensor and pursue research and development of other SOCRATES®, UNICORN™ and TIICM™ based products. The marketing and sales of these products will require us to find additional capable employees or subcontractors who can understand, explain, market, and sell our technology and products to airports, airlines, and airplane manufacturers. We also will need to assemble new personnel and/or contractors for production and installation of our products. Upon successful completion of research and development, these demands will require us to rapidly increase the number of our employees, vendors, and subcontractors. There is intense competition for capable personnel in all of these areas, and we may not be successful in attracting, integrating, motivating, or retaining new personnel, vendors, or subcontractors for these required functions.

Our business could be adversely affected if our products fail to perform properly.

Products and systems as complex as ours may contain undetected errors or "bugs," which result in system failures, or failure to perform in accordance with industry expectations. Despite our plans for quality control and testing measures, our products including any enhancements may contain such bugs or exhibit performance degradation, particularly during the early stages of installation, and deployment. Product or system performance problems could result in loss of or delay in revenue, loss of market share, failure to achieve market acceptance, adverse publicity, injury to our reputation, diversion of development resources and claims against us by governments, airlines, airline customers, and others.

We could be subject to liability claims relating to malfunction of our technology.

Sale of our products will depend on their ability to improve airport, airline, and airplane safety and efficiency. We will take great care to test our products and systems after installation and before actual operation to insure accuracy and reliability. The FAA acquires air traffic control equipment for U.S. airports, and typically assumes the principal product liability risk for such equipment. However, unforeseen problems, misuse, or changing conditions could cause our products and systems to malfunction or exhibit other operational problems. Such problems could cause, or be perceived to cause, airplane accidents, including passenger fatalities. We may receive significant liability claims if governments, airlines, airports, passengers and other parties believe that our systems have failed to perform their intended functions. Liability claims could require us to spend significant time and money in litigation, pay substantial damages, and increased insurance premiums, regardless of our responsibility for such failure. Although we plan to maintain liability insurance, such coverage may not continue to be available on reasonable terms or be available in amounts sufficient to cover one or more large claims, and the insurer may disclaim coverage as to any claim.

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We face significant competition from other companies.

The air safety systems and air traffic control industries are already highly competitive. Other industry participants could develop or improve their own systems to achieve the cost efficiencies and value that we believe our products will provide upon successful completion of research and development. Additional companies may enter the market with competing systems as the size and visibility of the market opportunity increases. In addition, the government could cause us to compete against other companies for research and development or production and deployment of our SOCRATES® wake vortex sensor, when and if we successfully complete its development. Many of our potential competitors have longer operating histories, greater name recognition, substantially greater financial, technical, marketing, management, service, support, and other resources than we do. Therefore, they may be able to respond more quickly than we can to new or changing opportunities, technologies, standards, or customer requirements. Competition could reduce our revenues and margins and have a material adverse effect on our operations.

New products or technologies will likely increase the competitive pressures that we face. Increased competition could result in pricing pressures, reduced margins, or the failure of our products to achieve or maintain market acceptance. The development of competing products or technologies by market participants or the emergence of new industry or government standards may adversely affect our competitive position. As a result of these and other factors, we may be unable to compete effectively with current or future competitors. Such inability would likely have a material adverse effect on our business, financial condition, or results of operations.

Rapid technological change could render our systems obsolete.

Our business in general is characterized by rapid technological change, frequent new product and service introductions and enhancements, uncertain product life cycles, changes in customer requirements, and evolving industry standards which make us susceptible to technological obsolescence. The introduction of new products embodying new technologies, the emergence of new industry standards, or improvements to existing technologies could render our products and systems obsolete or relatively less competitive. Our future success will depend upon our ability to continue to develop and introduce a variety of new products and to address the increasingly sophisticated needs of our customers. We may experience delays in releasing new products and systems or enhancements in the future. Material delays in introducing new products and systems or enhancements may cause customers to forego purchases of our products and systems and purchase products and systems of competitors instead.

Failure to properly manage growth could adversely affect our business.

To implement our strategy, we believe that we will have to grow rapidly. Rapid growth may strain our management, financial, and other resources. To manage any future growth effectively, we must expand our sales, marketing, production, installation, and customer support organizations, invest in research and development of new products or enhancements to existing systems that meet changing customer needs, enhance our financial and accounting systems and controls, integrate new personnel or contractors, and successfully manage expanded operations. We may not be able to effectively manage and coordinate our growth so as to achieve or maximize future profitability.

We must hire and retain skilled personnel.

Our success depends in large part upon our ability to attract, train, motivate, and retain highly skilled employees, particularly sales and marketing personnel, scientists, engineers, and other technical support personnel. Our failure to attract and retain the highly trained technical personnel that are integral to our direct sales, product development, installation, support, and professional services may limit the rate at which we can generate sales or develop new products or system enhancements, which could have a material adverse effect on our business, financial condition, or results of operations.

Any acquisition we make could disrupt our business and harm our financial condition.

We may attempt to acquire businesses or technologies that we believe are a strategic fit with our business. We currently have no commitments for any acquisition. Any future acquisition may result in unforeseen operating difficulties and expenditures, and may absorb significant management attention that would otherwise be available for ongoing development of our business. Since we may not be able to accurately predict these difficulties and expenditures, these costs may outweigh the value we realize from a future acquisition. Future acquisitions could result in issuances of equity securities that would reduce our stockholders' ownership interest, the incurrence of debt, contingent liabilities, amortization of expenses related to other intangible assets and the incurrence of large, immediate write-offs.

You should carefully read and evaluate this entire Form 10-KSB and our current SEC filings including the risks it describes and not consider or rely upon any statement, information or opinion about us that is not contained in this Form 10-KSB and our current SEC filings.

Certain statements, information and opinions about us have appeared and may continue to appear in published news reports, analysts reports, other media sources and our web site. Some of the information contained in these reports or sources may not be material to understanding our business or may be out of date, erroneous or inconsistent with that disclosed in this Form 10-KSB and our current SEC filings. In making a decision to invest in our securities, you should not rely upon any of these statements, information or opinions and should only rely upon, consider and carefully evaluate the information and risks contained in this Form 10-KSB and our current SEC filings.

We currently are involved in an informal SEC investigation.

The staff of the SEC is conducting an informal investigation that appears to be looking into certain analyst reports about us and our press releases. To date, the SEC staff has not asserted that we have acted improperly or illegally. We have voluntarily agreed to cooperate fully with the staff's informal investigation. We believe that we have acted properly and legally with respect to these analyst reports and our press releases. However, we can neither predict the length, scope, or results of the informal investigation nor its impact, if any, on us or our operations. An adverse outcome, which we cannot predict, could negatively impact the market value of our securities and could divert the

efforts and attention of our management team from our ordinary business operations.

We may suffer losses from various investments that we make and related market risks.

From time to time, we may make various types of investments which include, but may not be limited to, acquisitions of other companies, strategic transactions and joint ventures, repurchase of our shares, and general investment of our available cash in various types of debt and equity securities. Some of these investments, such as acquisitions or joint ventures, may involve a high degree of risk and we could lose the entire amount of our investment. Other investments are intended to be conservative, e.g., investment of cash reserves in high quality bonds or equity funds, but are subject to judgments about many factors beyond our control which can adversely affect these types of investments. For example, a rise in such interest rates will adversely affect the value of fixed income securities we hold and we may incur a loss of principal if we have to sell under such conditions. A decline in interest rates may reduce our investment income. We attempt to be prudent in making any of the foregoing investments, which are reviewed and approved by management and our board of directors. These types of transactions are necessary and important for the success of our overall business and our efforts to create value for our shareholders. However, we have suffered losses on certain of these investments and can make no assurance that we will not suffer losses in the future. Any such losses could have a material adverse impact on our results of operations and cash available to support our operations and investment in research and development.

Risks Related to Investment in Our Securities

The price of our securities could be volatile and subject to wide fluctuations.

The market price of the securities of a pre-commercial, research and development stage aviation technology company, such as ours, can be especially volatile. Thus, the market price of our securities could be subject to wide fluctuations. In fact, the trading volume and price of our shares have fluctuated greatly. Subject to the information set forth in this Form 10-KSB, we are unaware of any specific reasons for this volatility and cannot predict whether or for how long it will continue.

If our revenues do not grow or grow more slowly than we anticipate, we are unable to procure federal contracts for our SOCRATES® wake vortex sensor UNICORN™ or TIICM™ research and development, we encounter technical or engineering obstacles to the successful commercial development of SOCRATES®, UNICORN™ or TIICM™, our operating or capital expenditures exceed our expectations and cannot be adjusted accordingly, or if some other event adversely affects us, the market price of our securities could decline. In addition, if the market for aviation technology stocks or the stock market in general experiences a loss in investor confidence or otherwise fails, the market price of our securities could fall for reasons unrelated to our business, results of operations, and financial condition. The market price of our securities also might decline in reaction to events that affect other companies in our industry even if these events do not directly affect us. Furthermore, the sale in the open market of recently sold securities or newly issued securities, which we may sell from time to time to raise funds for various purposes, and securities issuable upon the exercise of purchase rights under existing options and warrants may place downward pressure on the market price of our securities.

Speculative traders may anticipate a decline in the market price of our securities and engage in short sales of our securities. Such short sales could further negatively affect the market price of our securities.

Litigation could adversely affect our operating results and financial condition.

Companies that have experienced volatility in the market price of their stock have been the subject of securities class action litigation. We and certain of our officers and current directors are defendants in pending litigation (as described in "Part II - Other Information, Item 1. Legal Proceedings" of this Form 10-KSB) that alleges violations of federal securities laws. We firmly believe that the claims contained in the complaint are without merit and intend to conduct a vigorous defense in this matter. However, defending against existing and potential securities and class action litigation will likely require significant attention and resources and, regardless of the outcome, result in significant legal expenses, which will adversely affect our results unless covered by insurance or recovered from third parties. If our defenses are ultimately unsuccessful, or if we are unable to achieve a favorable resolution, we could be liable for damage awards that could materially adversely affect our results of operations and financial condition.

An active trading market for our securities may not be developed or sustained which could limit the liquidity of an investment in our securities.

There is a limited trading market for our securities. From January 2002 through January 29, 2004, our common stock traded on the OTC Bulletin Board, an inter-dealer automated quotation system for equity securities. The securities sold in our recent public offering, together with the shares that formerly traded on the OTC Bulletin Board, have been approved for listing and are currently trading on the American Stock Exchange. There is no assurance that we will be able to continue to meet the listing requirements and that our securities will remain listed on the American Stock Exchange. If we are delisted from the American Stock Exchange, an investor

could find it more difficult to dispose of, or to obtain accurate quotations as to the market value of, our securities. Additionally, regardless of which exchange our securities may trade on, an active and liquid trading market may not develop or, if developed, may not be sustained, which could limit security holders' ability to sell our securities at a desired price.

If any of our securities are delisted from the American Stock Exchange, we may be subject to the risks relating to penny stocks.

If any of our securities were to be delisted from trading on the American Stock Exchange and the trading price of such security remains below $5.00 per share on the date such security was delisted, trading in such security would also be subject to the requirements of certain rules promulgated under the Securities Exchange Act of 1934. These rules require additional disclosure by broker-dealers in connection with any trades involving a security defined as a penny stock and impose various sales practice requirements on broker-dealers who sell penny stocks to persons other than established customers and accredited investors, generally institutions. The additional burdens imposed upon broker-dealers by such requirements may discourage broker-dealers from effecting transactions in our securities, which could severely limit the market price and liquidity of such securities and the ability of purchasers to sell our securities in the secondary market. A penny stock is defined generally as any non-exchange listed equity security that has a market price of less than $5.00 per share, subject to certain exceptions.

A large number of shares may be sold in the market following our recent public offering which may cause the price of our securities to decline.

Sales of a substantial number of shares of our common stock or other securities in the public markets, or the perception that these sales may occur, could cause the market price of our common stock or other securities to decline and could materially impair our ability to raise capital through the sale of additional securities. We have 8,215,110 shares of our common stock outstanding. Of our outstanding shares, 6,566,475 are eligible for public trading. Of our restricted shares, 98,044 will be eligible for public trading after June 27, 2005.

Certain events could result in a dilution of your ownership of our common stock.

We currently have 8,215,110 shares of common stock outstanding and an aggregate of 2,989,993 warrants and options. The exercise price of all of our common stock equivalents ranges from $3.30 to $6.00 per share of common stock. Some of these warrants and options may provide antidilution protection to their holders which would result in our issuance of shares in addition to those under the warrant or option, upon the occurrence of sales of our common stock below certain prices, stock splits, redemptions, mergers, and other similar transactions. Furthermore, from time to time we may issue additional shares of common stock in private or public transactions to raise funds for working capital, research and development, acquisitions, or other purposes. If one or more of these events occurs, the number of outstanding shares of our common stock would increase and dilute your percentage ownership of our common stock.

If we do not maintain an effective registration statement or comply with applicable state securities laws, you may not be able to exercise our public warrants.

For any holder to be able to exercise our public warrants, the shares of our common stock underlying the public warrants must be covered by an effective and current registration statement and qualify or be exempt under the securities laws of the state or other jurisdiction in which you live. We cannot assure you that we will continue to maintain a current registration statement relating to the shares of our common stock underlying our public warrants or that an exemption from registration or qualification will be available throughout their term. This may have an adverse effect on demand for our public warrants and the prices that can be obtained from reselling them.

Our public warrants may be redeemed on short notice. This may have an adverse impact on their price.

We may redeem our public warrants for $0.25 per warrant, subject to adjustment in the event of a stock split, dividend or the like, upon 30 days' notice so long as the last reported sale price per share of our common stock as reported by the principal exchange or trading market on which our common stock trades equals or exceeds $10.00 (subject to adjustment) for twenty consecutive trading days ending on the tenth day prior to the date we give notice of redemption. If we give notice of redemption, holders of our public warrants will be forced to sell or exercise the public warrants they hold or accept the redemption price. The notice of redemption could come at a time when, under specific circumstances or generally, it is not advisable or possible to sell or exercise our public warrants.

Our officers, directors and 5% stockholders will exercise significant control over us.

Our current officers, directors and 5% stockholders, in the aggregate, control approximately 33.65% of our outstanding common stock (including common stock issuable to such person or group within 60 days after May 31, 2005). As a result, these stockholders acting together will be able to exert significant control over matters requiring stockholder approval, including the election of directors, approval of mergers, and other significant corporate transactions. This concentration of ownership could delay, prevent, or deter a change in control, and could deprive our stockholders of an opportunity to receive a premium for their stock as part of a sale of us and could affect the market

price of our stock.

We do not intend to pay cash dividends.

We have never paid cash dividends on our stock and do not anticipate paying any cash dividends in the foreseeable future.

We may spend our funds in ways with which our stockholders may not agree.

The use of proceeds description from our recent public offering reflected our then-current planning and was only an estimate that is subject to change in our discretion. Furthermore, a substantial portion of the net proceeds from our recent public offering was not allocated for specific uses. Consequently, our management can spend our funds in ways with which our stockholders may not agree. We cannot predict that our funds will be invested or otherwise utilized to yield a favorable return.

Item 7. Financial Statements.

The audited financial statements are annexed to this report, commencing on page F-1.

Item 8. Changes In and Disagreements With Accountants on Accounting and Financial Disclosure.

Effective October 3, 2002, we terminated our then current accountant, Quintanilla, a Professional Accounting Corporation, and engaged Kostin, Ruffkess & Company, LLC, which has offices in Farmington and New London, Connecticut, as our principal independent public accountant. The decision to engage Kostin, Ruffkess & Company, LLC was made by our Finance and Audit Committee in accordance with Section 301 of the Sarbanes-Oxley Act of 2002. The decision was based on a relocation of our principal place of business from California to Connecticut.

We had not previously consulted with Kostin, Ruffkess & Company, LLC regarding the application of accounting principles to a specific completed or contemplated transaction, or the type of audit opinion which might be rendered on our financial statements, and no written or oral advice was provided to us concluding there was an important factor to be considered by us in reaching a decision as to an accounting, auditing, or financial reporting issue. Neither did we discuss with Kostin, Ruffkess & Company, LLC any accounting, auditing, or financial reporting issue that was a subject of disagreement between us and Quintanilla, our previous independent accountants, as there were no such disagreements.

Effective February 10, 2005 we replaced Kostin, Ruffkess & Company with Wolf & Company, P.C. The decision to use Wolf & Company as our independent public accountant has been approved by the Audit and Finance Committee of our board of directors.

Kostin's reports on our financial statements did not contain any adverse opinion or disclaimer of opinion, nor were they qualified or modified as to uncertainty, audit scope or accounting principles.

In connection with their audit for our fiscal year ending May 31, 2004 and up to the date of termination, which was the result of Kostin & Ruffkess ceasing operations with respect to public companies, there were no disagreements with Kostin on any matters of accounting principles or practices, financial statement disclosure of auditing scope or procedure, which disagreement(s), if not resolved to the satisfaction of Kostin would have caused Kostin to make reference to the subject matter of the disagreement(s) in connection with its report on our financial statements. Since Kostin's engagement as our accountant on October 3, 2002, there have been no reportable events as defined in Item 304(a)(1)(iv) of Regulation S-B. We have authorized Kostin to respond fully to any inquiries of our new auditors relating to their engagement as our independent accountant. We previously provided Kostin with a copy of this report on Form 8-K and have furnished the letter from Kostin attached hereto as Exhibit 99.2, in which Kostin states it agrees with the preceding statements, to the Securities and Exchange Commission.

We have not previously consulted with Wolf & Company regarding the application of accounting principles to a specific completed or contemplated transaction, or the type of audit opinion which might be rendered on our financial statements, and no written or oral advice was provided to us concluding there was an important factor to be considered by us in reaching a decision as to an accounting, auditing, or financial reporting issue. Neither did we discuss with Wolf & Company any accounting, auditing, or financial reporting issue that was a subject of disagreement between us and Kostin, as there were no such disagreements.

Item 8A. Controls and Procedures.

(a) Evaluation of disclosure controls and procedures

. Our chief executive officer and chief financial officer have reviewed and evaluated the effectiveness of our disclosure controls and procedures (as defined in Rules 13a-15 and 15d-15 under the Securities Exchange Act of 1934 (the "Exchange Act")) as of the end of the period covered by this annual report. Based on that evaluation, the chief executive officer and chief financial officer have concluded that our current disclosure controls and procedures are effective to ensure that information required to be disclosed by us in reports that we file or submit under the Exchange Act are recorded, processed, summarized, and reported within the time periods specified in the Securities and Exchange Commission rules and forms.

(b) Changes in internal controls

. There have not been any significant changes in our internal controls or in other factors that could significantly affect these controls subsequent to the date of their evaluation. There were no significant deficiencies or material weakness in the internal controls, and therefore no corrective actions were taken.

Item 8B. Other Information.

None

PART III

Item 9. Directors, Executive Officers, Promoters and Control Persons; Compliance With Section 16(a) of the Exchange Act.

Information about our Directors is incorporated by reference from the information under the caption "Proposal No. 2 - Election of Directors" and "Section 16 Beneficial Ownership Reporting Compliance" in our Proxy Statement for our 2005 Annual Meeting of Stockholders to be filed on or before September 28, 2005.

Item 10. Executive Compensation.

Incorporated by reference from the information under the caption "Executive and Director Compensation" in our Proxy Statement for the 2005 Annual Meeting of Stockholders to be filed on or before September 28, 2005.

Item 11. Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters.

Incorporated by reference from the information under the caption "Stock Ownership of Certain Beneficial Owners, the Board of Directors, and Executive Officers" in our Proxy Statement for the 2005 Annual Meeting of Stockholders to be filed on or before September 28, 2005.

Item 12. Certain Relationships and Related Transactions.

Incorporated by reference from the information under the captions "Certain Relationships and Related Transactions" in our Proxy Statement for the 2005 Annual Meeting of Stockholders to be filed on or before September 28, 2005.

Item 13. Exhibits.

Exhibit No.	Description
3.1	Amended and Restated Articles of Incorporation (1)
3.2	By-Laws (2)
10.1	Employment Agreement effective as of November 4, 2003, between Flight Safety Technologies, Inc.
10.2	and Samuel A. Kovnat (3)
	Employment Agreement effective as of November 4, 2003, between Flight Safety Technologies,
10.3	Inc.
	and William B. Cotton (4)
10.4	Employment Agreement effective as of November 4, 2003, between Flight Safety Technologies, Inc.
10.5	and David D. Cryer (5)
10.6	Employment Agreement effective as of November 4, 2003, between Flight Safety Technologies, Inc.
10.7	and Frank L. Rees (6)

Teaming Agreement dated May 1, 1997, by and between FSTO and Lockheed Martin Corporation
10.8 (7)
Share Exchange Agreement between Reel Staff, Inc. and Flight Safety Technologies, Inc.,
10.9 dated June 24, 2002, as amended July 15, 2002 (8)
Cost Reimbursement Research Project Agreement between Flight Safety Technologies, Inc.
23.1 and Georgia Tech Applied Research Corporation (9)
23.2 Phase III Contract issued by U.S. Department of Transportation/RSPA/Volpe Center,
31.1 dated September 30, 2003 (10)
Agreement between Flight Safety Technologies, Inc. and Advanced Acoustics Concepts, Inc.,
31.2 dated January 14, 2000 (11)
*Consent of Kostin, Ruffkess & Company, LLC
32.1 *Consent of Wolf & Company, P.C.
*Chief Executive Officer Certification as Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act
of 2002 (18 U.S.C. Section 1350).
*Chief Financial Officer Certification as Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act
of 2002 (18 U.S.C. Section 1350).
*Certification of Chief Executive Officer and Chief Financial Officer as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 (18 U.S.C. Section 1350).

*Submitted herewith

(1) Incorporated by reference to Exhibit 3.1 on our Form 10-QSB, which was filed on April 6,
(2) 2004.
(3) Incorporated by reference to Exhibit 3.2 on our Form SB-2, which was filed on August 9, 2001.
(4) Incorporated by reference to Exhibit 10.1 on our Form SB-2/A, which was filed on January 29,
(5) 2004.
(6) Incorporated by reference to Exhibit 10.2 on our Form SB-2/A, which was filed on January 29,
(7) 2004.
(8) Incorporated by reference to Exhibit 10.3 on our Form SB-2/A, which was filed on January 29,
(9) 2004.
(10) Incorporated by reference to Exhibit 10.4 on our Form 10-QSB, which was filed on April 6,
(11) 2004.
Incorporated by reference to Exhibit 10.7 on our 8-KA, which was filed on November 6, 2002.
Incorporated by reference to Exhibit 10.1 on our Form 8-K, which was filed on July 18, 2002.
Incorporated by reference to Exhibit 10.7 on our Form SB-2/A, which was filed on November 26, 2003.
Incorporated by reference to Exhibit 10.8 on our Form SB-2/A, which was filed on November 26, 2003.
Incorporated by reference to Exhibit 10.9 on our Form SB-2/A, which was filed on November 26, 2003.

Item 14. Principal Accountant Fees and Services.

Incorporated by reference from the information under the captions "Audit and Related Fees" in our Proxy Statement for the 2005 Annual Meeting of Stockholders to be filed on or before September 28, 2005.

In accordance with Section 13 or 15(d) of the Exchange Act, the registrant caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

Flight Safety Technologies, Inc.
a Nevada corporation

August 26, 2005 By:

Samuel A. Kovnat
Chairman and Chief Executive Officer

POWER OF ATTORNEY

KNOW ALL PERSONS BY THESE PRESENTS, that each person whose signature appears below constitutes and appoints Samuel A. Kovnat, his attorneys-in-fact, each with the power of substitution, for him in any and all capacities, to sign any amendments to this Report on Form 10-KSB, and to file the same, with Exhibits thereto and other documents in connection therewith with the Securities and Exchange Commission, hereby ratifying and confirming all that each of said attorneys-in-fact, or substitute or substitutes may do or cause to be done by virtue hereof.

In accordance with the Exchange Act, this report has been signed below by the following persons on behalf of the registrant and in the capacities and on the dates indicated.

SIGNATURES

Signature	Date
/s/ William B. Cotton	August 26, 2005

William B. Cotton, Director, President

/s/ Frank L. Rees	August 26, 2005
Frank L. Rees, Director, Executive Vice President	
/s/ David D. Cryer	August 26, 2005
David D. Cryer, Chief Financial Officer, Secretary, Treasurer	
/s/ Kenneth S. Wood	August 26, 2005
Kenneth S. Wood, Director	
/s/ Jackson Kemper	August 26, 2005
Jackson Kemper, Director	
/s/ Larry L. Pressler	August 26, 2005
Larry L. Pressler, Director	
/s/ Joseph J. Luca	August 26, 2005
Joseph J. Luca, Director	

FLIGHT SAFETY TECHNOLOGIES, INC.

Financial Statements

May 31, 2005

To The Board of Directors
Flight Safety Technologies, Inc.

INDEPENDENT AUDITORS' REPORT

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Stockholders
Flight Safety Technologies, Inc.
Mystic, Connecticut

We have audited the accompanying balance sheet of Flight Safety Technologies, Inc. as of May 31, 2005 and the related statements of operations and comprehensive income (loss), changes in stockholders' equity and cash flows for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit. The financial statements of Flight Safety Technologies, Inc. as of May 31, 2004 and for the year then ended were audited by other auditors who have ceased operations with respect to public companies. Those auditors expressed an unqualified opinion on those financial statements in their report dated July 7, 2004, except for Note 12 of those financial statements as to which the date was August 12, 2004.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the 2005 financial statements referred to above present fairly, in all material respects, the financial position of Flight Safety Technologies, Inc. as of May 31, 2005, and the results of its operations and its cash flows for the year then ended, in conformity with accounting principles generally accepted in the United States of America.

/s/ Wolf & Company, P.C.

Boston, Massachusetts
August 18, 2005

FLIGHT SAFETY TECHNOLOGIES, INC.

Balance Sheets
as of
May 31, 2005 and May 31, 2004

		2005		2004
Assets				
Current assets:				
Cash and cash equivalents	$	2,519,837	$	2,180,863
Contract receivables		415,617		532,043
Other receivables		---		194,479
Investments held to maturity		4,033,759		4,991,669
Investments available for sale, at fair value		835,233		1,879,755
Inventory		108,044		---
Other current assets		51,721		28,840
Total current assets		7,964,211		9,807,649
Property and equipment, net of accumulated depreciation of $328,608 and $216,356		208,562		259,252
Other Assets:				
Intangible assets, net of accumulated amortization of $47,377 and $33,969		180,562		149,990
Investments held to maturity		500,002		500,002
Other receivables		330,010		---
Total other assets		1,010,574		649,992
Total Assets	$	9,183,347	$	10,716,893

Liabilities and Stockholders' Equity

Current liabilities:

Accounts payable	$	589,313	$	615,911	
Accrued expenses		180,340		141,259	
Total current liabilities		769,653		757,170	

Stockholders' equity:

Preferred Stock, $0.001 par value, 5,000,000 shares authorized, none issued and outstanding				---	
Common stock, $0.001 par value, 50,000,000 shares authorized, 8,331,410 shares issued		8,331		8,331	
Additional paid-in-capital		13,069,863		13,105,863	
Treasury Stock, 116,300 shares at cost		(199,827)	$		34.62

Granted	.8		50.12
Vested	(1)		35.05
Forfeited	(1)		50.21
RSUs at September 30, 2006	.8	$	49.80

(1) Amounts rounded to zero.

For the three and nine months ended September 30, 2006, we recorded pretax stock-based compensation expense of $12 million and $62 million, respectively, and $8 million and $84 million, respectively, for the corresponding periods in 2005, in general and administrative expenses. We also recorded related tax benefits of $4 million and $22 million

for the three and nine months ended September 30, 2006, respectively, and $3 million and $29 million, respectively, for the corresponding periods in 2005. As of September 30, 2006, $89 million of total unrecognized compensation costs related to stock options, SARs and RSUs are expected to be recognized over a weighted-average period of 2.1 years.

All of our employees are eligible to participate in our Employee Stock Purchase Plan (the ESPP). Employees may contribute a percentage of their base salary through payroll deductions. Contributions are accumulated for a six-month offering period and used to purchase stock at the end of the six-month offering period (the Purchase Date). On the Purchase Date, stock is purchased for all participating employees based on the contributions accumulated (subject to a $25,000 annual limit per employee). A six-month accumulation period commenced on December 19, 2005 and ended on June 16, 2006. The purchase price for this offering was at a 5% discount from the closing price of our common stock on the Purchase Date. For the six months ended June 30, 2006, approximately .1 million shares of common stock

were purchased under the ESPP at the purchase price of $37.27 per share. On June 19, 2006, another six-month accumulation period commenced. This accumulation period ends on December 15, 2006, and the purchase price for this offering is at a 5% discount from the closing price of our common stock on the Purchase Date.

10. Debt

The carrying value of long-term debt at September 30, 2006 and December 31, 2005 was as follows:

(Millions)	September 30, 2006	December 31, 2005
Senior notes, 7.375%, due 2006 [1]	$	$ 450.0
Senior notes, 5.75%, due 2011	449.5	
Senior notes, 7.875%, due 2011	448.4	448.1
Senior notes, 6.0%, due 2016	745.7	
Senior notes, 6.625%, due 2036	798.4	
Senior notes, 8.50%, due 2041 [2]		707.6
Total long-term debt	2,442.0	1,605.7
Less current portion of long-term debt [1]		(450.0)
Long-term debt, less current portion	$ 2,442.0	$ 1,155.7

(1) The 7.375% senior notes were repaid in February 2006.

(2) The 8.5% senior notes were redeemed and repaid in June 2006.

In June 2006, we issued $2.0 billion of senior notes, comprised of $450 million of 5.75% senior notes due 2011, $750 million of 6.0% senior notes due 2016 and $800 million of 6.625% senior notes due 2036. The proceeds from these senior notes were used to redeem the entire $700 million aggregate principal amount of our 8.5% senior notes due 2041 and to repay approximately $400 million of commercial paper borrowings, outstanding since the March 1, 2006 maturity of the entire $450 million aggregate principal amount of our 7.375% senior notes. The remainder of the net proceeds were used for general corporate purposes, including share repurchases. In connection with the redemption of the $700 million, 8.5% senior notes, we wrote-off deferred debt issuance costs associated with these senior notes and recognized the deferred gain from the interest rate swaps that hedged these senior notes (in May 2005, we sold these interest rate swaps; the resulting gain from which was to be amortized over the remaining life of these senior notes). As a result of the foregoing, we recorded an $8 million after tax ($12 million pretax) non-cash charge in operating expenses for the nine months ended September 30, 2006.

Additionally, in connection with our June 2006 debt issuance, we terminated the five forward starting swaps (with an aggregate notional value of $1.0 billion) that we entered into between August 2005 and June 2006 in order to hedge the change in cash flows associated with interest payments generated by the forecasted issuance of the senior notes. As a result of the termination of the five forward starting swaps, we received approximately $15 million which was recorded as accumulated other comprehensive income and will be amortized as a reduction of interest expense over the life of the applicable senior notes issued in June 2006.

On January 20, 2006, we entered into an amended and restated unsecured $1 billion, five-year revolving credit agreement (the Facility) superceding our previously existing credit facility. The Facility also provides for up to $150 million of letters of credit to be issued at our request, which count as usage of the available commitments under the Facility. The Facility permits the aggregate commitments under the Facility to be expanded to a maximum of $1.35 billion upon our agreement with one or more financial institutions. Various interest rate options are available under the Facility. Any revolving borrowings mature on the termination date of the Facility. We pay facility fees on the Facility ranging from .05% to .175% per annum, depending upon our long-term senior unsecured debt rating. The Facility contains a financial covenant that requires us to maintain a ratio of total debt to consolidated capitalization as of the end of each fiscal quarter ending on or after December 31, 2005 at or below .4 to 1.0. For this purpose, consolidated capitalization equals the sum of shareholders equity, excluding any minimum pension liability adjustment and any net unrealized capital gains and losses, and total debt (as defined in the Facility). We met this requirement at September 30, 2006.

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In January 2006, certain of our subsidiaries entered in a one-year $45 million variable funding credit program with a bank to provide short-term liquidity to those subsidiaries. Borrowings under this program are secured by certain assets of those subsidiaries. At September 30, 2006, there was $1.5 million outstanding under this program at an interest rate of 6.11%.

11. Capital Stock

On September 29, 2005, January 27, 2006, April 28, 2006 and September 29, 2006 the Board authorized four share repurchase programs for the repurchase of up to $750 million, $750 million, $820 million and $750 million, respectively, of common stock ($3.1 billion in aggregate). During the nine month period ended September 30, 2006, we repurchased approximately 52 million shares of common stock at a cost of approximately $2.0 billion (approximately $59 million of these repurchase transactions were settled in early October 2006), completing the September 29, 2005 and January 27, 2006 authorizations and utilizing a portion of the April 28, 2006 authorization. As of September 30, 2006, we had authorization to repurchase up to approximately $937 million of common stock remaining under the April 28, 2006 and September 29, 2006 authorizations.

In connection with the stock split described in Note 1, the Board approved an amendment to our Articles of Incorporation. The amendment increased the number of common shares we may issue to 2.9 billion shares effective February 17, 2006 (which has subsequently been reduced due to our share repurchase activity). This increase is in the same proportion that the shares distributed in the stock dividend increased the number of issued common shares.

On September 29, 2006, the Board declared an annual cash dividend of $.04 per share to shareholders of record at the close of business on November 15, 2006. The dividend will be paid on November 30, 2006.

12. Dividend Restrictions and Statutory Surplus

Under regulatory requirements as of September 30, 2006, the amount of dividends that may be paid through the end of 2006 by our insurance and HMO subsidiaries to Aetna without prior approval by regulatory authorities is approximately $336 million in the aggregate. There are no such restrictions on distributions from Aetna to its shareholders.

At September 30, 2006, the combined statutory capital and surplus of our insurance and HMO subsidiaries was $4.4 billion. At December 31, 2005, such capital and surplus was $4.5 billion.

13. Commitments and Contingencies

Managed Care Class Action Litigation

From 1999 through early 2003, we were involved in purported class action lawsuits as part of a wave of similar actions targeting the health care payor industry and, in particular, the conduct of business by managed care companies. These cases, brought on behalf of health care providers (the Provider Cases), alleged generally that we and other defendant managed care organizations engaged in coercive behavior or a variety of improper business practices in dealing with health care providers and conspired with one another regarding this purported wrongful conduct.

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Effective May 21, 2003, we and representatives of over 900,000 physicians, state and other medical societies entered into an agreement (the Physician Settlement Agreement) settling the lead physician Provider Case, which was pending in the United States District Court for the Southern District of Florida (the Florida Federal Court). We believe that the Physician Settlement Agreement, which has received final court approval, resolved all then pending Provider Cases filed on behalf of physicians that did not opt out of the settlement. During the second quarter of 2003, we recorded a charge of $75 million ($115 million pretax) (included in other operating expenses) in connection with the Physician Settlement Agreement, net of an estimated insurance recoverable of $72 million pretax. We believe our insurance policies with third party insurers apply to this matter and have been vigorously pursuing recovery from those insurers in Pennsylvania state court (the Coverage Litigation). During the second quarter of 2006, the Philadelphia, Pennsylvania state trial court issued a summary judgment ruling dismissing all of our claims in the Coverage Litigation. We have appealed that ruling and intend to continue to vigorously pursue recovery from our third party insurers. However, as a result of that ruling, we concluded that the estimated insurance recoverable of $72 million pretax that was recorded in connection with the Physician Settlement Agreement is no longer probable of collection for accounting purposes, and therefore, during the second quarter of 2006, we wrote-off that recoverable. We continue to work with plaintiffs representatives in implementing the Physician Settlement Agreement and the issues that may arise under that agreement.

Several Provider Cases filed in 2003 on behalf of purported classes of chiropractors and/or all non-physician health care providers also make factual and legal allegations similar to those contained in the other Provider Cases, including allegations of violations of the Racketeer Influenced and Corrupt Organizations Act. These Provider Cases seek various forms of relief, including unspecified damages, treble damages, punitive damages and injunctive relief. These Provider Cases have been transferred to the Florida Federal Court for consolidated pretrial proceedings. We intend to defend each of these cases vigorously.

Insurance Industry Brokerage Practices Matters

We have received subpoenas and other requests for information from the New York Attorney General, the Connecticut Attorney General, other attorneys general and various insurance and other regulators with respect to an industry wide investigation into certain insurance brokerage practices, including broker compensation arrangements, bid quoting practices and potential antitrust violations. We may receive additional subpoenas and requests for information from these attorneys general and regulators. We are cooperating with these inquiries.

In connection with this industry wide review, we have received, and may receive, additional subpoenas and requests for information from other attorneys general and other regulators, and we have been named in related litigation.

Other Litigation and Regulatory Proceedings

We are involved in numerous other lawsuits arising, for the most part, in the ordinary course of our business operations, including employment litigation and claims of bad faith, medical malpractice, non-compliance with state regulatory regimes, marketing misconduct, failure to timely pay medical claims, investment activities, patent infringement and other intellectual property litigation and other litigation in our Health Care and Group Insurance businesses. Some of these other lawsuits are or are purported to be class actions. We intend to defend these matters vigorously.

In addition, our current and past business practices are subject to review by, and from time to time we receive subpoenas and other requests for information from, various state insurance and health care regulatory authorities and other state and federal authorities. There also continues to be heightened review by regulatory authorities of the managed health care industry s business practices, including utilization management, delegated arrangements and claim payment practices. As a leading national managed care organization, we regularly are the subject of such reviews. These reviews may result, and have resulted, in changes to or clarifications of our business practices, as well as fines, penalties or other sanctions.

We are unable to predict at this time the ultimate outcome of the remaining Provider Cases, the insurance industry brokerage practices matters or other litigation and regulatory proceedings, and it is reasonably possible that their outcome could be material to us.

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14. Segment Information

Summarized financial information of our segments for the three and nine months ended September 30, 2006 and 2005 were as follows:

(Millions)	Health Care	Group Insurance	Large Case Pensions	Corporate Interest	Total Company
Three months ended September 30, 2006					
Revenue from external customers	$ 5,503.4	$ 449.5	$ 52.8	$	$ 6,005.7
Operating earnings (loss) [1]	447.0	34.6	10.6	(25.9)	466.3
Three months ended September 30, 2005					
Revenue from external customers	$ 4,907.3	$ 445.9	$ 59.1	$	$ 5,412.3
Operating earnings (loss) [1]	346.5	32.3	9.6	(21.1)	367.3
Nine months ended September 30, 2006					
Revenue from external customers	$ 16,361.0	$ 1,391.1	$ 160.1	$	$ 17,912.2
Operating earnings (loss) [1]	1,160.5	102.8	30.0	(69.6)	1,223.7
Nine months ended September 30, 2005					
Revenue from external customers	$ 14,251.0	$ 1,361.0	$ 166.2	$	$ 15,778.2
Operating earnings (loss) [1]	1,046.2	92.7	21.2	(58.6)	1,101.5

[1] Operating earnings (loss) excludes net realized capital gains or losses and the other items described in the reconciliation below.

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The following table reconciles operating earnings to income from continuing operations in the Consolidated Statements of Income for the three and nine months ended September 30, 2006 and 2005:

	Three Months Ended September 30,		Nine Months Ended September 30,	
(Millions)	**2006**	**2005**	**2006**	**2005**
Operating earnings	$ 466.3	$ 367.3	$ 1,223.7	$ 1,101.5
Net realized capital gains, net of tax	10.1	5.5	14.2	12.1
Reduction of reserve for anticipated future losses on discontinued products [(1)]			75.0	43.4
Physician class action settlement insurance-related charge [(2)]			(47.1)	
Debt refinancing charge [(3)]			(8.1)	
Acquisition-related software charge [(4)]			(6.2)	
Income from continuing operations	$ 476.4	$ 372.8	$ 1,251.5	$ 1,157.0

(1) We reduced the reserve for anticipated future losses on discontinued products by $75.0 million ($115.4 million pretax) and $43.4 million ($66.7 million pretax) in the nine months ended September 30, 2006 and 2005, respectively. We believe excluding any changes to the reserve for anticipated future losses on discontinued products provides more useful information as to our continuing products and is

consistent with the treatment of the results of operations of these discontinued products, which are credited/charged to the reserve and do not affect our results of operations. Refer to Note 15 for additional information on the reduction of the reserve for anticipated future losses on discontinued products.

(2) As a result of a trial court s ruling in the nine months ended September 30, 2006, we concluded that a $72.4 million pretax receivable from third party insurers related to certain litigation we settled in 2003 was no longer probable of collection for accounting purposes. As a result, we wrote-off this receivable in the nine months ended September 30, 2006. We believe this charge neither relates to the

ordinary course of our business nor reflects our underlying business performance and therefore, we have excluded it from operating earnings for the nine months ended September 30, 2006 (refer to Note 13).

(3) In connection with the issuance of $2.0 billion of our senior notes in the nine months ended September 30, 2006, we redeemed all $700 million of our 8.5% senior notes due 2041. In connection with this redemption, we wrote-off debt issuance costs associated with the 8.5% senior notes due 2041 and recognized the deferred gain from the interest rate swaps that had hedged the 8.5% senior notes due 2041 (in May 2005, we sold these interest rate swaps; the resulting gain from which was to be amortized over the

remaining life of the 8.5% senior notes due 2041). As a result of the foregoing, we recorded an $8.1 million ($12.4 million pretax) net charge in the nine months ended September 30, 2006. We believe this charge neither relates to the ordinary course of our business nor reflects our underlying business performance and therefore, we have excluded it from operating earnings for the nine months ended September 30, 2006 (refer to Note 10).

(4) As a result of the acquisition of Broadspire Disability in the nine months ended September 30, 2006, we acquired certain software which eliminated the need for similar software that we had been developing internally. As a result, we ceased our own software

development and impaired amounts previously capitalized, resulting in a $6.2 million ($8.3 million pretax) charge to net income, reflected in general and administrative expenses for the nine months ended September 30, 2006. This charge does not reflect the underlying business performance of Group Insurance.

15. Discontinued Products

We discontinued the sale of our fully guaranteed large case pension products (single-premium annuities (SPAs) and guaranteed investment contracts (GICs)) in 1993. Under our accounting for these discontinued products, a reserve for anticipated future losses from these products was established, and we review it quarterly. As long as the reserve continues to represent our then best estimate of expected future losses, results of operations of the discontinued products, including net realized capital gains and losses, are credited/charged to the reserve and do not affect our results of operations. Our results of operations would be adversely affected to the extent that future losses on the products are greater than anticipated and favorably affected to the extent that future losses are less than anticipated. The current reserve reflects our best estimate of anticipated future losses.

The factors contributing to changes in the reserve for anticipated future losses are: operating income or loss, realized capital gains or losses and mortality gains or losses. Operating income or loss is equal to revenue less expenses. Realized capital gains or losses reflect the excess (deficit) of sales price over (below) the carrying value of assets sold and any other-than-temporary impairments. Mortality gains or losses reflect the mortality and retirement experience related to SPAs. A mortality gain (loss) occurs when an annuitant or a beneficiary dies sooner (later) than expected. A retirement gain (loss) occurs when an annuitant retires later (earlier) than expected.

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At the time of discontinuance, a receivable from Large Case Pensions continuing products equivalent to the net present value of the anticipated cash flow shortfalls was established for the discontinued products. Interest on the receivable is accrued at the discount rate that was used to calculate the reserve. The offsetting payable, on which interest is similarly accrued, is reflected in continuing products. Interest on the payable generally offsets the investment income on the assets available to fund the shortfall. At September 30, 2006, the receivable from continuing products, net of related deferred taxes payable of $135 million on accrued interest income, was $311 million. At December 31, 2005, the receivable from continuing products, net of related deferred taxes payable of $127 million on accrued interest income, was $372 million. These amounts were eliminated in consolidation.
Results of discontinued products for the three and nine months ended September 30, 2006 and 2005 were as follows (pretax):

(Millions)	**Results**	**Charged (Credited) to Reserve for Future Losses**	**Net[1]**
Three months ended September 30, 2006			
Net investment income	$ 76.8	$	$ 76.8
Net realized capital gains	7.9	(7.9)	
Interest earned on receivable from continuing products	6.7		6.7
Other revenue	2.8		2.8
Total revenue	94.2	(7.9)	86.3
Current and future benefits	82.3	.8	83.1
Operating expenses	3.2		3.2
Total benefits and expenses	85.5	.8	86.3
Results of discontinued products	$ 8.7	$ (8.7)	$
Three months ended September 30, 2005			
Net investment income	$ 72.3	$	$ 72.3
Net realized capital gains	12.3	(12.3)	
Interest earned on receivable from continuing products	7.4		7.4
Other revenue	3.8		3.8
Total revenue	95.8	(12.3)	83.5
Current and future benefits	85.2	(5.1)	80.1
Operating expenses	3.4		3.4
Total benefits and expenses	88.6	(5.1)	83.5
Results of discontinued products	$ 7.2	$ (7.2)	$

Nine months ended September 30, 2006			
Net investment income	$ 236.2	$	$ 236.2
Net realized capital gains	28.4	(28.4)	
Interest earned on receivable from continuing products	22.1		22.1
Other revenue	13.9		13.9
Total revenue	300.6	(28.4)	272.2
Current and future benefits	249.0	14.4	263.4
Operating expenses	8.8		8.8
Total benefits and expenses	257.8	14.4	272.2
Results of discontinued products	$ 42.8	$ (42.8)	$
Nine months ended September 30, 2005			
Net investment income	$ 248.0	$	$ 248.0
Net realized capital gains	12.2	(12.2)	
Interest earned on receivable from continuing products	23.1		23.1
Other revenue	16.3		16.3
Total revenue	299.6	(12.2)	287.4
Current and future benefits	258.2	21.1	279.3
Operating expenses	8.1		8.1
Total benefits and expenses	266.3	21.1	287.4
Results of discontinued products	$ 33.3	$ (33.3)	$

(1) Amounts are reflected in the September 30, 2006 and 2005 Consolidated Statements of Income, except for interest earned on the receivable from continuing products, which was eliminated in consolidation.

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Assets and liabilities supporting discontinued products at September 30, 2006 and December 31, 2005 were as follows: [1]

(Millions)		September 30, 2006		December 31, 2005
Assets:				
Debt securities available for sale	$	2,897.0	$	3,032.3
Equity securities available for sale		56.4		43.1
Mortgage loans		641.8		644.9
Investment real estate		81.0		103.6
Loaned securities		230.0		289.3
Other investments [2]		662.8		603.3
Total investments		4,569.0		4,716.5
Collateral received under securities loan agreements		237.3		295.4
Current and deferred income taxes		107.8		88.9
Receivable from continuing products [3]		445.9		498.8
Total assets	$	5,360.0	$	5,599.6
Liabilities:				
Future policy benefits	$	3,804.7	$	3,908.4
Policyholders funds		24.6		23.5
Reserve for anticipated future losses on discontinued products		1,021.2		1,052.2
Collateral payable under securities loan agreements		237.3		295.4
Other liabilities		272.2		320.1
Total liabilities	$	5,360.0	$	5,599.6

(1) Assets supporting the discontinued products are distinguished from assets supporting continuing products.

(2) Includes debt securities on deposit as required by regulatory authorities of $21.8 million and $21.3 million at September 30, 2006 and December 31, 2005, respectively. These securities are considered restricted assets and were included in long-term investments on the Consolidated Balance Sheets.

(3) The receivable from continuing products is eliminated in consolidation.

At September 30, 2006 and December 31, 2005, net unrealized capital gains on debt securities available for sale are included above in other liabilities and are not reflected in consolidated shareholders equity. The reserve for anticipated future losses is included in future policy benefits on the Consolidated Balance Sheets.

The reserve for anticipated future losses on discontinued products represents the present value (at a risk-free rate of return at the time of discontinuance, consistent with the duration of the liabilities) of the difference between the expected cash flows from the assets supporting discontinued products and the cash flows expected to be required to meet the obligations of the outstanding contracts. Calculation of the reserve for anticipated future losses requires projection of both the amount and the timing of cash flows over approximately the next 30 years, including consideration of, among other things, future investment results, participant withdrawal and mortality rates as well as the cost of asset management and customer service. Since 1993, there have been no significant changes to the assumptions underlying the calculation of the reserve related to the projection of the amount and timing of cash flows,

except as noted below.

The projection of future investment results considers assumptions for interest rates, bond discount rates and performance of mortgage loans and real estate. Mortgage loan cash flow assumptions represent management s best estimate of current and future levels of rent growth, vacancy and expenses based upon market conditions at each reporting date. The performance of real estate assets has been consistently estimated using the most recent forecasts available. Since 1997, a bond default assumption has been included to reflect historical default experience, since the bond portfolio increased as a percentage of the overall investment portfolio and reflected more bond credit risk, concurrent with the declines in the commercial mortgage loan and real estate portfolios.

The previous years actual participant withdrawal experience is used for the current year assumption. Prior to 1995, the Company used the 1983 Group Annuitant Mortality table published by the Society of Actuaries (the Society). In 1995, the Society published the 1994 Uninsured Pensioner s Mortality table, which we have used since then.

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Our assumptions about the cost of asset management and customer service reflect actual investment and general expenses allocated over invested assets.
The activity in the reserve for anticipated future losses on discontinued products for the nine months ended September 30, 2006 was as follows (pretax):

(Millions)	
Reserve for anticipated future losses on discontinued products at December 31, 2005	$1,052.2
Operating income	9.2
Net realized capital gains	28.4
Mortality and other	5.2
Tax benefits [1]	41.6
Reserve reduction	(115.4)
Reserve for anticipated future losses on discontinued products at September 30, 2006	$1,021.2

[1] Amount represents tax credits primarily from tax advantaged investments which were reclassified within the liabilities supporting discontinued products from deferred tax liabilities.

Management reviews the adequacy of the discontinued products reserve quarterly and, as a result, $115 million ($75 million after tax) and $67 million ($43 million after tax) of the reserve was released in the nine months ended September 30, 2006, and 2005, respectively, primarily due to favorable investment performance and favorable mortality and retirement experience compared to assumptions underlying the reserve calculation.

16. Discontinued Operations

On July 8, 2004, we were notified that the Congressional Joint Committee on Taxation approved a tax refund of approximately $740 million, including interest, relating to businesses that were sold in the 1990s by our former parent company. Also in 2004, we filed for, and were approved for, an additional $35 million tax refund related to other businesses that were sold by our former parent company. The tax refunds were recorded as income from discontinued operations in 2004. We received approximately $666 million of the tax refunds during 2004 and $69 million in 2005. We received the final approximately $50 million payment of these refunds in February 2006, which resulted in an additional $16 million of income from discontinued operations for the nine months ended September 30, 2006.

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Report of Independent Registered Public Accounting Firm

The Board of Directors and Shareholders
Aetna Inc.:

We have reviewed the consolidated balance sheet of Aetna Inc. and subsidiaries as of September 30, 2006, the related consolidated statements of income for the three-month and nine-month periods ended September 30, 2006 and 2005 and the related consolidated statements of shareholders equity and cash flows for the nine-month periods ended September 30, 2006 and 2005. These condensed consolidated financial statements are the responsibility of the Company s management.

We conducted our reviews in accordance with the standards of the Public Company Accounting Oversight Board (United States). A review of interim financial information consists principally of applying analytical procedures and making inquiries of persons responsible for financial and accounting matters. It is substantially less in scope than an audit conducted in accordance with the standards of the Public Company Accounting Oversight Board (United States), the objective of which is the expression of an opinion regarding the financial statements taken as a whole. Accordingly, we do not express such an opinion.

Based on our reviews, we are not aware of any material modifications that should be made to the condensed consolidated financial statements referred to above for them to be in conformity with U.S. generally accepted accounting principles.

We have previously audited, in accordance with standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheet of Aetna Inc. and subsidiaries as of December 31, 2005, and the related consolidated statements of income, shareholders equity, and cash flows for the year then ended (not presented herein); and in our report dated March 1, 2006, we expressed an unqualified opinion on those consolidated financial statements. In our opinion, the information set forth in the accompanying consolidated balance sheet as of December 31, 2005, is fairly stated, in all material respects, in relation to the consolidated balance sheet from which it has been derived.

/s/ KPMG LLP
Hartford, Connecticut
October 26, 2006

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Item 2. Management s Discussion and Analysis of Financial Condition and Results of Operations (MD&A)

Unless the context otherwise requires, references to the terms we, our or us used throughout this MD&A refer to Aetna Inc. (Aetna) and its subsidiaries (collectively, the Company).

OVERVIEW

We are one of the nation s leading diversified health care benefits companies, serving approximately 29.8 million people with information and resources to help them make better informed decisions about their health care. We offer a broad range of traditional and consumer-directed health insurance products and related services, including medical, pharmacy, dental, behavioral health, group life, long-term care and disability plans, and medical management capabilities. Our customers include employer groups, individuals, college students, part-time and hourly workers, health plans and government-sponsored plans. Our operations are conducted in three business segments: Health Care, Group Insurance and Large Case Pensions.

The following MD&A provides a review of our financial condition as of September 30, 2006 and December 31, 2005 and results of operations for the three and nine months ended September 30, 2006 and 2005. This Overview should be read in conjunction with the entire MD&A, which contains detailed information that is important to understanding our results of operations and financial condition, the consolidated financial statements and other data presented herein as well as the MD&A contained in our 2005 Annual Report on Form 10-K (the 2005 Annual Report). This Overview is qualified in its entirety by the full MD&A.

Our operating profit for the three and nine months ended September 30, 2006, compared to the corresponding periods in 2005, reflects growth in our Heath Care business. The increase in our operating profit primarily reflects growth in revenue from increases in membership levels and rate increases for renewing membership in 2006 as well as continued general and administrative expense efficiencies. We experienced membership growth in both our Risk (where we assume all or a majority of risk for medical and dental care costs) and administrative services contract (ASC) products. As of September 30, 2006, we served approximately 15.4 million medical members (consisting of approximately 34% Risk members and 66% ASC members), 13.4 million dental members, 10.2 million pharmacy members and 15.3 million group insurance members. Our operating profit for the nine months ended September 30, 2006 increased even though we experienced a higher Commercial Risk medical cost ratio in our Health Care segment during 2006.

We continued to generate strong cash flows from operations in 2006. Cash flows provided by operating activities in 2006 reflect the receipt of approximately $50 million, representing the final refund payment from the completion of certain Internal Revenue Service audits associated with businesses previously sold by our former parent company (refer to Note 16 of Condensed Notes to Consolidated Financial Statements for additional information). Operating cash flows were used to fund ordinary course operating activities and to make $245 million in voluntary contributions to our pension plan.

Other sources and uses of cash include the proceeds from our 2006 debt offering and repurchases of our common stock, respectively. In June 2006, we issued $2.0 billion of senior notes, the proceeds of which were used to redeem our 8.5% senior notes, to repay approximately $400 million of commercial paper borrowings and for general corporate purposes, including share repurchases. Refer to Liquidity and Capital Resources Financings, Financing Capacity and Capitalization and Note 10 of Condensed Notes to Consolidated Financial Statements for additional information. We also continued our share repurchase programs during the nine months ended September 30, 2006, repurchasing 52 million shares of our common stock at a cost of approximately $2.0 billion (approximately $59 million of these repurchase transactions were settled in early October 2006).

Effective January 1, 2006, we adopted Statement of Financial Accounting Standards (FAS) No. 123 Revised, *Share-Based Payment* (FAS 123R). FAS 123R requires us to expense the fair value of all stock-based compensation awards issued to employees and non-employees. Stock-based compensation expense is measured at the grant date, based on the fair value of the award. The expense is recognized over the requisite service period, which primarily is the vesting period, except for retirement eligible individuals for whom a majority of the expense is recognized in the year of grant. We applied the modified-retrospective approach of adopting FAS 123R and accordingly, all prior period financial information was adjusted to reflect our stock compensation activity since 1995. We recorded stock-based compensation expense, included in general and administrative expenses, of $8 million ($12 million pretax) and $5 million ($8 million pretax), representing $.01 per common share each, in the third quarter of 2006 and 2005, respectively, and $40 million ($62 million pretax) and $55 million ($84 million pretax), representing $.07 and $.09 per common share, for the nine months ended September 30, 2006 and 2005, respectively. Stock-based compensation expense is recorded in each of our segments (primarily Health Care and Group Insurance). Refer to our segment results below and Notes 2 and 9 of Condensed Notes to Consolidated Financial Statements for additional information.

Summary of Consolidated Results for the Three and Nine Months Ended September 30, 2006 and 2005:

	Three Months Ended September 30,		**Nine Months Ended September 30,**	
(Millions, except per share amounts)	**2006**	**2005**	**2006**	**2005**
Total revenues	$6,299.5	$5,700.7	$18,786.2	$16,624.5
Income from continuing operations [1]	476.4	372.8	1,251.5	1,157.0
Net income [2]	476.4	372.8	1,267.6	1,157.0
Income from continuing operations per common share	.85	.62	2.16	1.91
Net income per common share	.85	.62	2.19	1.91

[1] Income from continuing operations for the three months ended September 30, 2006 and 2005 reflects favorable development of prior period health care cost estimates of approximately $29 million ($45 million pretax) and $15 million ($24 million pretax), respectively. Income from continuing operations for the nine months ended September 30, 2005 reflects the release of approximately $65 million ($103 million pretax) of reserves related to the New York Market Stabilization Pool. This development was recorded in the Health Care segment and is discussed in further detail below in the discussion of Health Care results. Other items reflected in income from continuing operations include:

- Ø For the nine months ended September 30, 2006 and 2005 we reduced the reserve for anticipated future losses on discontinued products in the Large Case Pensions segment by $75.0 million ($115.4 million pretax) and $43.4 million ($66.7 million pretax), respectively.

- Ø For the nine months ended September 30, 2006 we recorded a charge of $47.1 million ($72.4 million pretax) in connection with the write off of an insurance recoverable as a result of a trial court summary judgment ruling (refer to Note 13 of Condensed Notes to Consolidated Financial Statements), and a net charge of $8.1 million ($12.4 million pretax) related to the write off of debt issuance costs and the recognition of deferred gains on terminated interest rate swaps in connection with the redemption of our 8.5% senior notes due 2041 (refer to Note 10 of Condensed Notes to Consolidated Financial Statements). Both of these charges are reflected in the Health Care segment.

- Ø As a result of the acquisition of Broadspire Disability in the first quarter of 2006, we acquired certain software which eliminated the need for similar software we had been developing internally. As a result, we ceased our own software development and impaired amounts previously capitalized, resulting in a $6.2 million ($8.3 million pretax) charge to net income, reflected in general and

administrative expenses for the nine months ended September 30, 2006 in the Group Insurance segment.

(2) Net income for the nine months ended September 30, 2006 includes income from discontinued operations of $16.1 million related to the completion of certain Internal Revenue Service audits associated with businesses previously sold by our former parent company.

Management Update

Effective October 1, 2006, Chief Executive Officer and President Ronald A. Williams was appointed Chairman of the Board succeeding John W. Rowe, M.D. who retired from Aetna and Aetna s Board of Directors (the Board) on that date. In connection with his retirement, Dr. Rowe and Aetna entered into a consulting agreement on terms previously disclosed.

On April 27, 2006, we announced that Alan M. Bennett, Senior Vice President and Chief Financial Officer, plans to retire in the first quarter of 2007. Mr. Bennett has been our Chief Financial Officer since 2001. We are conducting a comprehensive search for a replacement, and Mr. Bennett is assisting us in the process to assure an orderly transition.

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Acquisition of Broadspire Disability Business

On March 31, 2006, we acquired the disability and leave management businesses of Broadspire Services, Inc. and Broadspire Management Services, Inc. (collectively, Broadspire Disability) for approximately $161 million. Broadspire Disability operates as a third party administrator, offering absence management services, including short-term and long-term disability administration and leave management, to employers.

Severance Charge

In the fourth quarter of 2006, we will record an after tax severance charge of approximately $16 million ($24 million pretax) related to ongoing initiatives intended to streamline our organization, align our resources and reduce general and administrative expenses. This charge will consist of costs related to actions under a plan of involuntary termination of employees and will include the elimination of approximately 650 positions.

Use of Non-GAAP Measures in this Document

The discussion of our results of operations that follows is presented based on our reportable segments in accordance with FAS No. 131, *Disclosures about Segments of an Enterprise and Related Information*, and is consistent with our segment disclosure included in Note 14 of Condensed Notes to Consolidated Financial Statements. Each segment s discussion of results is based on operating earnings, which is the measure reported to our Chief Executive Officer for purposes of assessing the segment s financial performance and making operating decisions, such as allocating resources to the segment. Our operations are conducted in three business segments: Health Care, Group Insurance and Large Case Pensions.

Our discussion of the results of operations of each business segment is based on operating earnings, which exclude realized capital gains and losses as well as other items from net income reported in accordance with U.S. generally accepted accounting principles (GAAP). We believe excluding realized capital gains and losses from net income to arrive at operating earnings provides more useful information about our underlying business performance. Realized capital gains and losses arise from various types of transactions, primarily in the course of managing a portfolio of assets that support the payment of liabilities; however these transactions do not directly relate to the underwriting or servicing of products for our customers and are not directly related to the core performance of our business operations. We also may exclude other items from net income to arrive at operating earnings should those other items similarly not relate to the ordinary course of our business. In each segment discussion below, we present a table that reconciles operating earnings to net income reported in accordance with GAAP. Each table details the realized capital gains and losses and any other items excluded from net income, and the footnotes to each table describe the nature of each other item and why we believe it is appropriate to exclude that item from net income.

We also display certain medical cost ratios excluding development of prior period health costs estimates. As described in the discussion of Critical Accounting Estimates Health Care Costs Payable, each quarter, we reexamine previously established estimates of health care costs payable based on actual claim submissions and other changes in facts and circumstances. Decreases (increases) in prior periods health care cost estimates represent the effect of favorable (unfavorable) development of prior period health care cost estimates on current period results of operations at each financial statement date. We believe excluding development of prior period health care cost estimates better reflects our underlying current period health care costs.

HEALTH CARE

Health Care consists of medical, pharmacy benefits management and dental and vision plans offered on both a Risk basis and an ASC basis (where the plan sponsor assumes all or a majority of the risk for medical and dental care costs). Medical plans include point-of-service (POS), health maintenance organization, preferred provider organization (PPO) and indemnity benefit products. Medical plans also include health savings accounts (HSAs) and Aetna HealthFund®, consumer-directed health plans that combine traditional POS or PPO and/or dental coverage, subject to a deductible, with an accumulating benefit account. Health Care also offers specialty products, such as medical management and data analytics services, behavioral health plans and stop loss insurance, as well as products that provide access to our provider network in select markets.

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Operating Summary for the Three and Nine Months Ended September 30, 2006 and 2005:

(Millions)	Three Months Ended September 30, 2006	Three Months Ended September 30, 2005	Nine Months Ended September 30, 2006	Nine Months Ended September 30, 2005
Premiums:				
Commerical Risk [(1)]	$4,350.2	$4,039.3	$12,972.6	$11,742.0
Medicare	469.0	252.0	1,334.6	748.5
Medicaid	1.1		1.1	
Total premiums	4,820.3	4,291.3	14,308.3	12,490.5
Fees and other revenue	683.1	616.0	2,052.7	1,760.5
Net investment income	84.7	76.9	249.3	218.2
Net realized capital gains	3.5	1.9	2.3	7.7
Total revenue	5,591.6	4,986.1	16,612.6	14,476.9
Health care costs [(2)]	3,797.4	3,390.4	11,481.9	9,683.6
Operating expenses:				
Selling expenses	212.0	193.5	651.2	562.5
General and administrative expenses [(3)]	862.6	838.3	2,694.9	2,534.5
Total operating expenses	1,074.6	1,031.8	3,346.1	3,097.0
Amortization of other acquired intangible assets	20.2	15.9	60.2	38.1
Total benefits and expenses	4,892.2	4,438.1	14,888.2	12,818.7
Income before income taxes	699.4	548.0	1,724.4	1,658.2
Income taxes	250.1	200.3	617.6	607.0
Net income	$ 449.3	$ 347.7	$ 1,106.8	$ 1,051.2

(1) Commercial Risk includes all health care risk products, except Medicare and Medicaid.

(2) The percentage of health care costs related to capitated arrangements (a fee arrangement where we pay providers a monthly fixed fee for each member, regardless of the medical services provided to the member) was 5.8% for both the three and nine months ended September 30, 2006, respectively, compared to 7.8% and 8.1%, respectively, for the corresponding periods in 2005.

(3) Includes salaries and related benefit expenses of $540.4 million and $1.6 billion for the three and nine months ended September 30, 2006, respectively, and $511.6 million and $1.6 billion, respectively, for the corresponding periods in 2005.

The table presented below reconciles operating earnings to net income reported in accordance with GAAP for the three and nine months ended September 30, 2006 and 2005:

	Three Months Ended September 30,	Nine Months Ended September 30,

(Millions)	2006	2005	2006	2005
Net income	$449.3	$347.7	$1,106.8	$1,051.2
Other items included in net income:				
Net realized capital gains	(2.3)	(1.2)	(1.5)	(5.0)
Physicians class action settlement insurance-related charge[1]			47.1	
Debt refinancing charge [2]			8.1	
Operating earnings	$447.0	$346.5	$1,160.5	$1,046.2

[1] As a result of a trial court s ruling in the second quarter of 2006, we concluded that a $72.4 million pretax receivable from third party insurers related to certain litigation we settled in 2003 was no longer probable of collection for accounting purposes. As a result, we wrote off this receivable in the second quarter of 2006. We believe this charge neither relates to the ordinary course of our business nor reflects our underlying business performance and therefore, we have excluded it from operating earnings for the nine months ended September 30, 2006.

[2] In connection with the issuance of $2.0 billion of our senior notes in the second quarter of 2006, we redeemed all $700 million of our 8.5% senior notes due 2041. In connection with this redemption, we wrote off debt issuance costs associated with the 8.5% senior notes due 2041 and recognized the deferred gain from the interest rate swaps that had hedged the 8.5% senior notes due 2041 (in May 2005, we sold these interest rate swaps; the resulting gain from which was to be amortized over the remaining life of the 8.5% senior notes due 2041). As a result of the foregoing, we recorded an $8.1 million ($12.4 million pretax) net charge in the second quarter of 2006. We believe this charge neither relates to the ordinary course of our business nor reflects our underlying business performance and therefore, we have excluded it from operating earnings for the nine months ended September 30, 2006.

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The increase in operating earnings for the three and nine months ended September 30, 2006 when compared to the corresponding periods in 2005 reflects growth in premiums and fees and other revenue and improved operating expense efficiencies (total operating expenses divided by total revenue). The growth in premiums and fees and other revenue resulted from increases in membership levels (refer to Membership) (including the premiums from our new Medicare Part D product offering, effective January 1, 2006) and rate increases for renewing membership. Total operating expenses for the three months ended September 30, 2006 increased due to higher selling expenses (reflecting an increase in commissionable premiums from membership growth) and increases in general and administrative expenses due to higher employee related costs, outside services and other expenses associated with higher membership. Total operating expenses for the nine months ended September 30, 2006 also reflect the write-off of an insurance recoverable and a net charge related to our 2006 debt issuance. Despite the overall increase in operating expenses (including the other items in net income for the nine months ended September 30, 2006), our operating expense efficiency improved in 2006 when compared to 2005. Additionally, operating earnings for the three months ended September 30, 2006 reflect higher total underwriting margins due to growth in premiums (as discussed above) that outpaced growth in health care costs. For the nine months ended September 30, 2006, underwriting margins were comparable to the corresponding period in 2005, reflecting growth in premiums (as discussed above) offset by higher health care costs. Our operating earnings for the nine months ended September 30, 2005 reflect the release of approximately $103 million pretax of reserves related to the New York Market Stabilization Pool for the nine months ended September 30, 2005. Our medical cost ratios and reserve development are discussed in the Commercial Risk and Medicare results below.

Our Commercial Risk results continued to grow for the three and nine months ended September 30, 2006

Commercial Risk premiums increased approximately $311 million and $1.2 billion for the three and nine months ended September 30, 2006, respectively, when compared to the corresponding periods in 2005. These increases reflect premium rate increases on renewing business and increased membership levels.

Our Commercial Risk medical cost ratio was 78.6% for the three months ended September 30, 2006 and 2005. Health care costs reflect favorable development of prior period health care cost estimates of approximately $33 million and $15 million pretax for the three months ended September 30, 2006 and 2005, respectively. Refer to Critical Accounting Estimates Health Care Costs Payable below for more information on our process for establishing our Health Care Costs Payable. Excluding the favorable development of prior period health care cost estimates, the adjusted Commercial Risk medical cost ratio was 79.3% and 79.0% for the three months ended September 30, 2006 and 2005, respectively (refer to the reconciliations of Commercial Risk health care costs to adjusted Commercial Risk health care costs below). The slight increase in our Commercial Risk medical cost ratio for the third quarter 2006 reflects a percentage increase in our per member health care costs that slightly outpaced the percentage increase in per member premiums. The increase in per member health care costs was driven by increases in costs related to inpatient and outpatient services, as well as physician, pharmacy and ancillary services.

	Three Months Ended September 30,	
(Millions)	**2006**	**2005**
Commercial Risk health care costs (included in total health care costs above)	$3,417.7	$3,174.9
Approximate favorable development of prior period health care cost estimates	33.0	15.0
Adjusted Commercial Risk health care costs	$3,450.7	$3,189.9

Our Commercial Risk medical cost ratio was 79.7% for the nine months ended September 30, 2006, compared to 76.9% for the corresponding period in 2005. The increase in our Commercial Risk medical cost ratio in 2006 when compared to 2005 reflects lower favorable development of prior period health care cost estimates in 2006 when compared to 2005 (which included a release of approximately $103 million pretax of reserves related to the New York Market Stabilization Pool), as well as a percentage increase in our per member health care costs that outpaced the percentage increase in per member premiums. The increase in per member health care costs in 2006 reflects an

increase in high dollar claims. Additionally, although per member premiums increased in 2006, when compared to 2005, the increase was moderated by certain observed competitive pricing behaviors of our small group customer competitors.

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Medicare results for the three and nine months ended September 30, 2006 reflect growth from the corresponding periods in 2005.

Medicare premiums increased approximately $217 million and $586 million for the three and nine months ended September 30, 2006, respectively, when compared to the corresponding periods in 2005. This increase reflects increases in payments from the Centers for Medicare and Medicaid Services (CMS) and members participating in the new Medicare Part D prescription drug program which was effective January 1, 2006, as well as increased payments from both CMS and members for previously existing Medicare Advantage business due to higher membership levels. In the three months ended September 30, 2006, we also received payments from CMS representing a true-up of Medicare Advantage premium rates based on contractually specified risk adjustments. The majority of the premium true-up related to premiums earned in the six months ended June 30, 2006. Medicare premiums for the remainder of 2006 will reflect the higher risk adjusted premium rates.

The Medicare medical cost ratio for the three months ended September 30, 2006 was 80.7%, compared to 85.5% for the corresponding period in 2005. Health care costs for the third quarter of 2006 and 2005 reflect favorable development of prior period health care cost estimates of approximately $12 million and $9 million pretax, respectively. Excluding this development, the adjusted Medicare medical cost ratio was 83.2% and 89.1% for the three months ended September 30, 2006 and 2005, respectively (refer to the reconciliations of Medicare health care costs to adjusted Medicare health care costs below). The decrease in the adjusted Medicare medical cost ratio for the third quarter of 2006 was driven by a change in our product mix as a result of the introduction of the Medicare Prescription Drug Plan (PDP) and the premium true-up payments we received from CMS in the three months ended September 30, 2006 (discussed above).

(Millions)	Three Months Ended September 30, 2006	Three Months Ended September 30, 2005
Medicare health care costs (included in total health care costs above)	$ 378.4	$ 215.5
Approximate favorable development of prior period health care cost estimates	12.0	9.0
Adjusted Medicare health care costs	$ 390.4	$ 224.5

The Medicare medical cost ratio was 85.7% for the nine months ended September 30, 2006, compared to 86.6% for the corresponding period in 2005. The decrease reflects higher reimbursement rates related to our Medicare Advantage business and a change in our product mix as a result of the introduction of the PDP.

Other Sources of Revenue

Fees and other revenue increased approximately $67 million and $292 million for the three and nine months ended September 30, 2006, respectively, when compared to the corresponding periods in 2005, reflecting ASC membership growth, rate increases, sales of add-on services and other revenue from our recent acquisitions.

Net investment income increased approximately $8 million and $31 million for the three and nine months ended September 30, 2006, respectively, when compared to the corresponding periods in 2005, due primarily to higher average yields in our investment portfolio.

Net realized capital gains for the three months ended September 30, 2006 were due primarily to gains on the sale of debt securities from rebalancing our investment portfolio and real estate gains. Net realized capital gains for the nine months ended September 30, 2006 were due primarily to gains from derivatives (refer to INVESTMENTS Risk Management and Market-Sensitive Instruments for a discussion of our use of derivatives) partially offset by losses on the sale of debt securities from rebalancing our investment portfolio. Net realized capital gains for the three months ended September 30, 2005 were due to gains on the sale of debt securities from rebalancing our investment portfolio and interest payments received related to investments previously written-down, partially offset by losses from futures contracts used for correlating the maturities of invested assets with the payment of expected liabilities. Net realized capital gains for the nine months ended September 30, 2005 were due to gains on the sale of debt securities from

rebalancing our investment portfolio and interest payments received related to investments previously written-down, as well as real estate gains.

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Membership

Health Care s membership at September 30, 2006 and 2005 was as follows:

(Thousands)	2006 Risk	2006 ASC	2006 Total	2005 Risk	2005 ASC	2005 Total
Medical:						
Commercial	5,085	10,037	15,122	5,014	9,401	14,415
Medicare Advantage	124		124	102		102
Medicare Health Support Program		18	18		20	20
Medicaid	7	112	119		113	113
Total Medical Membership	5,216	10,167	15,383	5,116	9,534	14,650
Consumer-Directed Health Plans[1]			644			433
Dental	5,022	8,374	13,396	5,038	7,993	13,031
Pharmacy:						
Commercial			9,138			8,791
Medicare PDP (stand-alone)			319			
Medicare Advantage PDP			115			
Total Pharmacy Benefit Management Services			9,572			8,791
Mail Order [2]			630			546
Total Pharmacy			10,202			9,337

(1) Represents members in consumer-directed health plans included in Commercial medical membership above.

(2) Represents members who purchased medications through our mail order pharmacy operations during the third quarter 2006 and 2005, respectively.

Total medical and dental membership as of September 30, 2006 increased by 733 thousand and 365 thousand members, respectively, compared to September 30, 2005. The percentage of Risk and ASC medical membership was approximately 34% and 66% at September 30, 2006 and 35% and 65% at September 30, 2005, respectively.

GROUP INSURANCE

Group Insurance includes primarily group life insurance products offered on a Risk basis, including basic term group life insurance, group universal life, supplemental or voluntary programs and accidental death and dismemberment coverage. Group Insurance also includes group disability products offered on both a Risk and an ASC basis which consist primarily of short-term and long-term disability insurance (and products which combine both), as well as long-term care products, which provide benefits offered to cover the cost of care in private home settings, adult day care, assisted living or nursing facilities, primarily on a Risk basis. Additionally, as a result of the Broadspire Disability acquisition on March 31, 2006, Group Insurance includes absence management services, including short-term and long-term disability administration and leave management, to employers. In the fourth quarter of 2006,

we decided to exit the long-term care insurance market and no longer solicit or accept new long-term care customers. Over the next two to three years, we will work with our customers on an orderly transition of this business to other carriers. This decision will not have a material impact on our financial condition or results of operations.

Operating Summary for the Three and Nine Months Ended September 30, 2006 and 2005:

(Millions)	Three Months Ended September 30, 2006	Three Months Ended September 30, 2005	Nine Months Ended September 30, 2006	Nine Months Ended September 30, 2005
Premiums:				
Life	$ 297.5	$ 322.9	$ 956.0	$ 985.1
Disability	99.2	91.0	298.1	281.1
Long-term care	25.9	24.2	76.9	70.5
Total premiums	422.6	438.1	1,331.0	1,336.7
Fees and other revenue	26.9	7.8	60.1	24.3
Net investment income	69.5	78.8	219.8	216.2
Net realized capital gains	7.8	5.1	4.2	10.1
Total revenue	526.8	529.8	1,615.1	1,587.3
Current and future benefits	391.4	418.4	1,243.8	1,264.8
Operating expenses:				
Selling expenses	19.7	20.6	64.1	60.5
General and administrative expenses [1]	59.6	41.7	168.8	125.7
Total operating expenses	79.3	62.3	232.9	186.2
Amortization of other acquired intangible assets	1.8		3.5	
Total benefits and expenses	472.5	480.7	1,480.2	1,451.0
Income before income taxes	54.3	49.1	134.9	136.3
Income taxes	14.6	13.5	35.6	37.0
Net income	$ 39.7	$ 35.6	$ 99.3	$ 99.3

[1] Includes salaries and related benefit expenses of $38.9 million and $95.4 million for the three and nine months ended September 30, 2006, respectively, and $25.7 million and $80.6 million, respectively, for the corresponding periods in 2005.

The table presented below reconciles operating earnings to net income reported in accordance with GAAP for the three and nine months ended September 30, 2006 and 2005:

(Millions, after tax)	Three Months Ended September 30, 2006	Three Months Ended September 30, 2005	Nine Months Ended September 30, 2006	Nine Months Ended September 30, 2005
Net income	$ 39.7	$ 35.6	$ 99.3	$ 99.3
Other items included in net income:				
Net realized capital gains	(5.1)	(3.3)	(2.7)	(6.6)
Acquisition-related software charge [1]			6.2	
Operating earnings	$ 34.6	$ 32.3	$ 102.8	$ 92.7

(1) As a result of the acquisition of Broadspire Disability in the first quarter of 2006, we acquired certain software which eliminated the need for similar software we had been developing internally. As a result, we ceased our own software development and impaired amounts previously capitalized, resulting in a $6.2 million ($8.3 million pretax) charge to net income, reflected in general and administrative expenses for the nine months ended September 30, 2006. This charge does not reflect the underlying business performance of Group Insurance and therefore, we have excluded it from operating earnings for the nine months ended September 30, 2006.

The increase in operating earnings for the three and nine months ended September 30, 2006 when compared to the corresponding periods in 2005, reflects higher fees and other revenue and a lower benefit cost ratio partially offset by higher general and administrative expenses. The operating earnings for the three and nine months ended September 30, 2006 also reflect increases in fees and other revenue as well as general and administrative expenses related to the March 2006 acquisition of Broadspire Disability. Our Group Insurance benefit cost ratio was 92.6% and 93.4% for the three and nine months ended September 30, 2006, respectively, compared to 95.5% and 94.6% for the corresponding periods in 2005. The decrease in our benefit cost ratio for the third quarter of 2006 was primarily due to a decrease in the life benefit cost ratio due to favorable experience. The decrease in our benefit cost ratio for the nine months ended September 30, 2006 was primarily due to a decrease in the disability benefit cost ratio due to favorable experience.

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Net realized capital gains for the three months ended September 30, 2006 were due primarily to real estate gains and gains on the sale of debt securities from rebalancing our investment portfolio. Net realized capital gains for the nine months ended September 30, 2006 were due primarily to real estate gains. Net realized capital gains for the three months ended September 30, 2005 were due primarily to gains on the sale of debt securities from rebalancing our investment portfolio, interest payments received related to investments previously written-down and real estate gains partially offset by losses from futures contracts used for correlating the maturities of invested assets with the payment of expected liabilities. Net realized capital gains for the nine months ended September 30, 2005 were due primarily to gains on the sale of debt securities from rebalancing our investment portfolio, interest payments received related to investments previously written-down and real estate gains.

Membership

Group Insurance s membership at September 30, 2006 and 2005 was as follows:

(Thousands)	**2006**	**2005**
Life	10,205	10,872
Disability [1]	4,882	2,568
Long-term care	222	235
Total	15,309	13,675

[1] Includes approximately 2.1 million members acquired in the Broadspire Disability acquisition on March 31, 2006.

Total Group Insurance membership as of September 30, 2006 increased by 1.6 million members when compared to September 30, 2005. New membership in Group Insurance was 3.9 million for the twelve months ended September 30, 2006, and lapses and in-force membership reductions were 2.3 million for the same period, primarily reflecting new membership from the Broadspire Disability acquisition offset by lapses in several large life cases.

LARGE CASE PENSIONS

Large Case Pensions manages a variety of retirement products (including pension and annuity products) primarily for tax qualified pension plans. These products provide a variety of funding and benefit payment distribution options and other services. The Large Case Pensions segment includes certain discontinued products.

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Operating Summary for the Three and Nine Months Ended September 30, 2006 and 2005:

(Millions)	Three Months Ended September 30, 2006	Three Months Ended September 30, 2005	Nine Months Ended September 30, 2006	Nine Months Ended September 30, 2005
Premiums	$ 49.9	$ 56.1	$ 151.5	$ 157.7
Net investment income	124.1	124.2	383.0	393.3
Other revenue	2.9	3.0	8.6	8.5
Net realized capital gains	4.2	1.5	15.4	.8
Total revenue	181.1	184.8	558.5	560.3
Current and future benefits (1)	162.7	163.4	489.8	513.6
General and administrative expenses (2)	3.4	5.1	12.6	13.3
Reduction of reserve for anticipated future losses on discontinued products			(115.4)	(66.7)
Total benefits and expenses	166.1	168.5	387.0	460.2
Income before income taxes	15.0	16.3	171.5	100.1
Income taxes (1)	1.7	5.7	56.5	35.0
Net income	$ 13.3	$ 10.6	$ 115.0	$ 65.1
Assets under management: (3)				
Fully guaranteed discontinued products			$ 4,409.8	$ 4,485.7
Experience-rated			3,947.1	4,390.9
Non-guaranteed (4)			14,358.2	11,536.4
Total assets under management			$ 22,715.1	$ 20,413.0

(1) In the third quarter of 2006, we reclassified tax credits primarily from our affordable housing partnership investments which were previously recorded in deferred tax liabilities, to a component of the reserve for

anticipated future losses on discontinued products.

(2) Includes salaries and related benefit expenses of $3.7 million and $10.3 million for the three and nine months ended September 30, 2006, respectively, and $3.7 million and $11.0 million, respectively, for the corresponding periods in 2005.

(3) Excludes net unrealized capital gains of $220.5 million and $424.6 million at September 30, 2006 and 2005, respectively.

(4) The increase in non-guaranteed assets under management in 2006 was due primarily to additional deposits and investment appreciation.

The table presented below reconciles operating earnings to net income reported in accordance with GAAP for the three and nine months ended September 30, 2006 and 2005:

	Three Months Ended September 30,	**Nine Months Ended September 30,**

(Millions)	2006	2005	2006	2005
Net income	$ 13.3	$ 10.6	$ 115.0	$ 65.1
Other items included in net income:				
Net realized capital gains	(2.7)	(1.0)	(10.0)	(.5)
Reduction of reserve for anticipated future losses on discontinued products [1]			(75.0)	(43.4)
Operating earnings	$ 10.6	$ 9.6	$ 30.0	$ 21.2

(1) In 1993, we discontinued the sale of our fully guaranteed large case pension products and established a reserve for anticipated future losses on these products, which we review quarterly. Changes in this reserve are recognized when deemed appropriate. In the nine months ended September 30, 2006 and 2005, we reduced the reserve for anticipated future losses on discontinued products by $75.0 million ($115.4 million pretax) and $43.4 million ($66.7 million pretax), respectively. We believe excluding any changes to the reserve for anticipated future losses on

discontinued products provides more useful information as to our continuing products and is consistent with the treatment of the results of operations of these discontinued products, which are credited/charged to the reserve and do not affect our results of operations.

The increase in operating earnings for the nine months ended September 30, 2006 compared to the corresponding period in 2005 reflects an increase in net investment income in continuing products primarily due to higher income from the receipt of mortgage loan prepayment fees, equity participation income and other investments.

The reductions of the reserve for anticipated future losses on discontinued products for the nine months ended September 30, 2006 and 2005 were primarily due to favorable investment performance and favorable mortality and retirement experience compared to assumptions underlying the reserve calculation.

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General account assets supporting experience-rated products (where the contract holder, not us, assumes investment and other risks subject to, among other things, certain minimum guarantees) may be subject to contract holder or participant withdrawal. Experience-rated contract holder and participant withdrawals for the three and nine months ended September 30, 2006 and 2005 were as follows:

	Three Months Ended September 30,		Nine Months Ended September 30,	
(Millions)	2006	2005	2006	2005
Scheduled contract maturities and benefit payments [1]	$ 87.6	$ 88.7	$ 261.4	$ 275.8
Contract holder withdrawals other than scheduled contract maturities and benefit payments	177.1	27.3	198.6	42.3
Participant-directed withdrawals	4.5	4.9	15.6	14.0

[1] Includes payments made upon contract maturity and other amounts distributed in accordance with contract schedules.

Discontinued Products

We discontinued the sale of our fully guaranteed large case pension products (single-premium annuities (SPAs) and guaranteed investment contracts) in 1993. We established a reserve for anticipated future losses on these products based on the present value of the difference between the expected cash flows from the assets supporting these products and the cash flows expected to be required to meet the product obligations.

Results of operations of discontinued products, including net realized capital gains (losses), are credited (charged) to the reserve for anticipated future losses. Our results of operations would be adversely affected to the extent that future losses on the products are greater than anticipated and favorably affected to the extent future losses are less than anticipated.

The factors contributing to changes in the reserve for anticipated future losses are: operating income or loss, realized capital gains or losses and mortality gains or losses. Operating income or loss is equal to revenue less expenses. Realized capital gains or losses reflect the excess (deficit) of sales price over (below) the carrying value of assets sold and any other-than-temporary impairments. Mortality gains or losses reflect the mortality and retirement experience related to SPAs. A mortality gain (loss) occurs when an annuitant or a beneficiary dies sooner (later) than expected. A retirement gain (loss) occurs when an annuitant retires later (earlier) than expected.

The results of discontinued products for the three and nine months ended September 30, 2006 and 2005 were as follows:

	Three Months Ended September 30,		Nine Months Ended September 30,	
(Millions)	2006	2005	2006	2005
Interest deficit [1]	$ (3.6)	$ (8.4)	$ (8.3)	$ (6.6)
Net realized capital gains	5.2	8.0	18.5	8.0
Interest earned on receivable from continuing products	4.3	4.8	14.3	15.0
Other, net	1.5	1.7	8.7	9.8

Results of discontinued products, after tax	$ 7.4	$ 6.1	$ 33.2	$ 26.2
Results of discontinued products, pretax	$ 8.7	$ 7.2	$ 42.8	$ 33.3
Net realized capital gains from bonds, after tax (included above)	$ 5.5	$ 5.3	$ 4.2	$ 5.2

(1) The interest deficit is the difference between earnings on invested assets and interest credited to contract holders.

The interest deficit for the three months ended September 30, 2006 decreased compared to the corresponding period in 2005 primarily due to higher private equity partnership income.

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Net realized capital gains for the three months ended September 30, 2006 were due primarily to gains on the sale of debt securities from rebalancing our investment portfolio and gains on futures contracts partially offset by losses on the write-down of other investments. Net realized capital gains for the nine months ended September 30, 2006 were due primarily to real estate gains, gains on the sale of debt securities from rebalancing our investment portfolio and the sale of equity securities partially offset by losses on the write-down of other investments. For the three and nine months ended September 30, 2005, net realized capital gains were due primarily to gains on the sale of debt and equity securities partially offset by losses on futures contracts.

At the time of discontinuance, a receivable from Large Case Pensions continuing products equivalent to the net present value of the anticipated cash flow shortfalls was established for the discontinued products. Interest on the receivable is accrued at the discount rate that was used to calculate the reserve. Total assets supporting discontinued products and the reserve include a receivable from continuing products of $311 million at September 30, 2006 and $372 million at December 31, 2005, net of related deferred taxes payable. These amounts were eliminated in consolidation.

The reserve for anticipated future losses on discontinued products represents the present value (at the risk-free rate at the time of discontinuance, consistent with the duration of the liabilities) of the difference between the expected cash flows from the assets supporting discontinued products and the cash flows expected to be required to meet the obligations of the outstanding contracts. Calculation of the reserve for anticipated future losses requires projection of both the amount and the timing of cash flows over approximately the next 30 years, including consideration of, among other things, future investment results, participant withdrawal and mortality rates, as well as the cost of asset management and customer service. Since 1993, there have been no significant changes to the assumptions underlying the calculation of the reserve related to the projection of the amount and timing of cash flows, except as noted below.

The projection of future investment results considers assumptions for interest rates, bond discount rates and performance of mortgage loans and real estate. Mortgage loan cash flow assumptions represent management s best estimate of current and future levels of rent growth, vacancy and expenses based upon market conditions at each reporting date. The performance of real estate assets has been consistently estimated using the most recent forecasts available. Since 1997, a bond default assumption has been included to reflect historical default experience, since the bond portfolio increased as a percentage of the overall investment portfolio and reflected more bond credit risk, concurrent with the declines in the commercial mortgage loan and real estate portfolios.

The previous years actual participant withdrawal experience is used for the current-year assumption. Prior to 1995, we used the 1983 Group Annuitant Mortality table published by the Society of Actuaries (the Society). In 1995, the Society published the 1994 Uninsured Pensioner s Mortality table, which we have used since then.

Our assumptions about the cost of asset management and customer service reflect actual investment and general expenses allocated over invested assets.

The activity in the reserve for anticipated future losses on discontinued products for the nine months ended September 30, 2006 was as follows (pretax):

(Millions)	
Reserve for anticipated future losses on discontinued products at December 31, 2005	$ 1,052.2
Operating income	9.2
Net realized capital gains	28.4
Mortality and other	5.2
Tax benefits [1]	41.6
Reserve reduction	(115.4)
Reserve for anticipated future losses on discontinued products at September 30, 2006	$ 1,021.2

[1] Amount represents tax

credits primarily
from tax
advantaged
investments
which were
reclassified
within the
liabilities
supporting
discontinued
products from
deferred tax
liabilities.

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Management reviews the adequacy of the discontinued products reserve quarterly and, as a result, $115 million ($75 million after tax) and $67 million ($43 million after tax) of the reserve was released in the second quarter of 2006 and 2005, respectively, primarily due to favorable investment performance and favorable mortality and retirement experience compared to assumptions underlying the reserve calculation. The current reserve reflects management s best estimate of anticipated future losses.

The discontinued products investment portfolio at September 30, 2006 and December 31, 2005 was as follows:

	September 30, 2006		December 31, 2005	
(Millions)	**Amount**	**Percent**	**Amount**	**Percent**
Debt securities available for sale	$ 2,897.0	63.4%	$ 3,032.3	64.3%
Loaned securities	230.0	5.0	289.3	6.1
Total debt securities	3,127.0	68.4	3,321.6	70.4
Mortgage loans	641.8	14.1	644.9	13.7
Investment real estate	81.0	1.8	103.6	2.2
Equity securities available for sale	56.4	1.2	43.1	.9
Other [1]	662.8	14.5	603.3	12.8
Total	$ 4,569.0	100.0%	$ 4,716.5	100.0%

[1] Amount includes restricted debt securities on deposit as required by regulatory authorities of $21.8 million at September 30, 2006 and $21.3 million at December 31, 2005, included in long-term investments on the Consolidated Balance Sheets.

Distributions on discontinued products for the three and nine months ended September 30, 2006 and 2005 were as follows:

	Three Months Ended September 30,		Nine Months Ended September 30,	
(Millions)	**2006**	**2005**	**2006**	**2005**
Scheduled contract maturities, settlements and benefit payments	$ 119.5	$ 121.7	$ 359.8	$ 368.8

Participant-directed withdrawals	.1	.3	.1

Cash required to fund these distributions was provided by earnings and scheduled payments on, and sales of, invested assets.

CORPORATE INTEREST

Corporate interest expense represents interest incurred on our debt and is not recorded in our business segments. After tax interest expense was $26 million and $70 million for the three and nine months ended September 30, 2006, respectively, compared to $21 million and $59 million, respectively, for the corresponding periods in 2005. The increase in interest expense for the three and nine months ended September 30, 2006, over the corresponding periods in 2005, was related to higher overall average long-term debt levels as a result of our issuance of $2.0 billion in senior notes in June 2006 and the sale of interest rate swap agreements in 2005.

INVESTMENTS

Investments disclosed in this section relate to our total portfolio (including assets supporting discontinued products and experience-rated products).

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Total investments at September 30, 2006 and December 31, 2005 were as follows:

	September 30, 2006			December 31, 2005		
(Millions)	**Current**	**Long-term**	**Total**	**Current**	**Long-term**	**Total**
Debt securities available for sale:						
Available for use in current operations	$ 13,127.5	$	$ 13,127.5	$ 13,216.9	$	$ 13,216.9
Loaned securities	895.8		895.8	1,115.7		1,115.7
On deposit, as required by regulatory authorities		501.6	501.6		522.4	522.4
Debt securities available for sale	14,023.3	501.6	14,524.9	14,332.6	522.4	14,855.0
Equity securities available for sale	31.8	40.3	72.1	34.5	26.7	61.2
Short-term investments	104.0		104.0	114.8		114.8
Mortgage loans	230.6	1,381.2	1,611.8	86.7	1,460.8	1,547.5
Investment real estate		188.1	188.1	7.4	207.2	214.6
Other investments	3.5	1,139.7	1,143.2	2.7	1,113.0	1,115.7
Total investments	$ 14,393.2	$ 3,250.9	$ 17,644.1	$ 14,578.7	$ 3,330.1	$ 17,908.8

Debt and Equity Securities

Debt securities represented 82% and 83% at September 30, 2006 and December 31, 2005, respectively, of our total invested assets and supported the following types of products:

(Millions)	**September 30, 2006**	**December 31, 2005**
Supporting discontinued products	$ 3,148.8	$ 3,342.9
Supporting experience-rated products	1,674.8	1,920.8
Supporting remaining products	9,701.3	9,591.3
Total debt securities [1]	$ 14,524.9	$ 14,855.0

[1] Total debt securities include Below Investment Grade Securities of $849 million at September 30, 2006, and $967 million at December 31, 2005, of which

23% at September 30, 2006 and 25% at December 31, 2005 supported discontinued and experience-rated products.

Debt securities reflect net unrealized capital gains of $293 million (comprised of gross unrealized capital gains of $432 million and gross unrealized capital losses of $139 million) at September 30, 2006 compared with net unrealized capital gains of $494 million (comprised of gross unrealized capital gains of $623 million and gross unrealized capital losses of $129 million) at December 31, 2005. Of the net unrealized capital gains at September 30, 2006, $159 million relate to assets supporting discontinued products and $55 million relate to experience-rated products. Of the net unrealized capital gains at December 31, 2005, $250 million relate to assets supporting discontinued products and $103 million relate to experience-rated products.

Equity securities reflect gross unrealized capital gains of $4 million at September 30, 2006 compared with gross unrealized capital gains of $10 million at December 31, 2005.

If management believes a decline in the value of a particular investment is temporary, the decline is recorded as an unrealized loss in Shareholders Equity. If the decline is other-than-temporary , the carrying value of the investment is written down and a realized capital loss is recorded in the Consolidated Statement of Income consistent with the guidance of FAS No. 115, *Accounting for Certain Investments in Debt and Equity Securities,* FASB Staff Position FAS 115-1 and FAS 124-1, *The Meaning of Other-Than-Temporary Impairment and its Application to Certain Investments,* and the Securities and Exchange Commission Staff Accounting Bulletin No. 59, *Accounting for Noncurrent Marketable & Equities Securities*. Our impairment analysis is discussed in more detail in MD&A INVESTMENTS in our 2005 Annual Report.

At September 30, 2006 and December 31, 2005, we had no individually material unrealized losses on debt or equity securities which could have a material impact on our results of operations.

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Capital Gains and Losses

For the three and nine months ended September 30, 2006, net realized capital gains were $16 million ($10 million after tax) and $22 million ($14 million after tax), respectively. For the three and nine months ended September 30, 2005, net realized capital gains were $9 million ($6 million after tax) and $19 million ($12 million after tax), respectively. There were no significant investment write downs from other-than-temporary impairments during 2006 or 2005. We had no individually material realized losses on debt or equity securities that impacted our results of operations during the three and nine months ended September 30, 2006 and 2005.

Mortgage Loans

Our mortgage loan investments, net of impairment reserves, supported the following types of products at September 30, 2006 and December 31, 2005:

(Millions)		September 30, 2006		December 31, 2005
Supporting discontinued products	$	641.8	$	644.9
Supporting experience-rated products		319.1		320.8
Supporting remaining products		650.9		581.8
Total mortgage loans	$	1,611.8	$	1,547.5

The mortgage loan portfolio balance represented 9% of our total invested assets at both September 30, 2006 and December 31, 2005. There were no material problem, restructured or potential problem loans included in mortgage loans at September 30, 2006 or December 31, 2005. There were no specific impairment reserves on these loans at September 30, 2006 or December 31, 2005.

Risk Management and Market-Sensitive Instruments

We manage interest rate risk by seeking to maintain a tight match between the durations of our assets and liabilities where appropriate while credit risk is managed by seeking to maintain high average quality ratings and diversified sector exposure within the debt securities portfolio. In connection with our investment and risk management objectives, we also use financial instruments whose market value is at least partially determined by, among other things, levels of or changes in interest rates (short-term or long-term), duration, prepayment rates, equity markets or credit ratings/spreads. Our use of these derivatives is generally limited to hedging purposes and has principally consisted of using interest rate swap agreements, warrants, forward contracts and futures contracts. These instruments, viewed separately, subject us to varying degrees of interest rate, equity price and credit risk. However, when used for hedging, we expect these instruments to reduce overall risk.

We regularly evaluate the risk of market-sensitive instruments by examining, among other things, levels of or changes in interest rates (short-term or long-term), duration, prepayment rates, equity markets or credit ratings/spreads. We also regularly evaluate the appropriateness of investments relative to our management-approved investment guidelines (and operate within those guidelines) and the business objective of the portfolios.

The risks associated with investments supporting experience-rated pension and annuity products in the Large Case Pensions business are assumed by those contract holders and not by us (subject to, among other things, certain minimum guarantees). Anticipated future losses associated with investments supporting discontinued fully guaranteed large case pension products are provided for in the reserve for anticipated future losses (refer to LARGE CASE PENSIONS Discontinued Products).

Management also reviews, on a quarterly basis, the impact of hypothetical net losses on our consolidated near-term financial position, results of operations and cash flows assuming certain reasonably possible changes in market rates and prices were to occur. Based on our overall exposure to interest rate risk and equity price risk, we believe that these changes in market rates and prices would not materially affect our consolidated near-term financial position, results of operations or cash flows as of September 30, 2006. Refer to our 2005 Annual Report for a more complete discussion

of Risk Management and Market-Sensitive Instruments.

LIQUIDITY AND CAPITAL RESOURCES

Cash Flows

Generally, we meet our operating requirements by maintaining appropriate levels of liquidity in our investment portfolio and using overall cash flows from premiums, deposits and income received on investments. We monitor the duration of our debt securities portfolio (which is highly marketable) and mortgage loans, and execute purchases and sales of these investments with the objective of having adequate funds available to satisfy our maturing liabilities. Overall cash flows are used primarily for claim and benefit payments, contract withdrawals and operating expenses. The following table for the nine months ended September 30, 2006 and 2005 details the operating cash flows of Health Care and Group Insurance separately from Large Case Pensions, as changes in Large Case Pensions insurance reserves are funded from the sale of investments, which impact cash flows from investing activities (and not operating cash flows).

(Millions)	2006	2005
Health Care and Group Insurance [1]	$ 1,378.3	$ 1,283.5
Large Case Pensions	(235.0)	(174.3)
Discontinued Operations	49.7	
Net cash provided by operating activities	$ 1,193.0	$ 1,109.2

[1] Includes corporate interest.

Cash flows provided by operating activities for Health Care and Group Insurance were approximately $1.4 billion and $1.3 billion for the nine months ended September 30, 2006 and 2005, respectively. Included in these amounts were payments of approximately $245 million pretax in voluntary pension contributions in each fiscal period. The cash flows from operating activities for the nine months ended September 30, 2006 also reflect the receipt of the remaining $50 million refund resulting from the completion of certain Internal Revenue Service audits associated with businesses previously sold by our former parent company (refer to Note 16 of Condensed Notes to Consolidated Financial Statements for additional information). The cash flows provided by operating activities for the nine months ended September 30, 2005 also include payments of approximately $150 million pretax related to the 2003 physician class action settlement. Refer to the Consolidated Statements of Cash Flows for additional information.

Financings, Financing Capacity and Capitalization

In June 2006, we issued $2.0 billion of senior notes, comprised of $450 million of 5.75% senior notes due 2011, $750 million of 6.0% senior notes due 2016 and $800 million of 6.625% senior notes due 2036. The proceeds from these senior notes were used to redeem the entire $700 million aggregate principal amount of our 8.5% senior notes due 2041 and to repay approximately $400 million of commercial paper borrowings, outstanding since the March 1, 2006 maturity of the entire $450 million aggregate principal amount of our 7.375% senior notes. The remainder of the net proceeds raised were used for general corporate purposes, including share repurchases. The maximum amount of commercial paper outstanding during the nine months ended September 30, 2006 was approximately $746 million. We use short-term borrowings from time to time to address timing differences between cash receipts and disbursements. Our committed short-term borrowing capacity consists of a $1 billion revolving credit facility which terminates in January 2011 and a one-year bridge loan facility for certain of our subsidiaries with a borrowing capacity of up to $45 million. The $1 billion revolving credit facility also provides for the issuance of letters of credit at our request, up to $150 million, which count as usage of the available commitments under the facility. At September 30, 2006, there were no borrowings outstanding under our commercial paper program, and $1.5 million was outstanding under the one-year subsidiary bridge loan facility. The $1 billion revolving credit facility permits the aggregate commitments under the facility to be expanded to a maximum of $1.35 billion upon our agreement with one or more financial institutions. Our total debt to capital ratio (total debt divided by total debt plus shareholders equity), was

20% at September 30, 2006. Refer to Note 10 of Condensed Notes to Consolidated Financial Statements for additional information.

Common Stock Transactions

On January 27, 2006, the Board declared a two-for-one stock split of our common stock, which was effected in the form of a 100% common stock dividend. All shareholders of record at the close of business on February 7, 2006 (the Shareholders of Record) received one additional share of common stock for each share held on that date. The additional shares of common stock were distributed to the Shareholders of Record in the form of a stock dividend on February 17, 2006. All share and per share amounts in this MD&A have been adjusted to reflect the stock split for all periods. In connection with the stock split, the Board approved an amendment to our Articles of Incorporation. This amendment increased the number of our authorized common shares to 2.9 billion shares on February 17, 2006.

On February 10, 2006, approximately 5.0 million stock appreciation rights (SARs) as well as approximately .6 million restricted stock units (RSUs) were granted to certain employees. The SARs will be settled in stock, net of taxes, based on the appreciation of our stock price over $50.21 per share, the closing price of our common stock on February 10, 2006. The SARs will become 100% vested three years from the grant date, with one-third of the SARs vesting each year, although 1.0 million of the SARs will vest over a one-year period. For each RSU granted, employees receive one share of common stock, net of taxes, at the end of the vesting period. The RSUs will become 100% vested three years from the grant date. Refer to Note 9 of Condensed Notes to Consolidated Financial Statements for additional information on our Stock-Based Compensation Plans.

Under our share repurchase programs, approximately 52 million shares were repurchased during the nine months ended September 30, 2006. As of September 30, 2006, the capacity remaining under our share repurchase authorizations was approximately $937 million. Refer to Note 11 of Condensed Notes to Consolidated Financial Statements for more information.

On September 29, 2006, our Board declared an annual cash dividend of $.04 per common share to shareholders of record on the close of business on November 15, 2006. The dividend will be paid on November 30, 2006. Our Board reviews our common stock dividend annually. Among the factors considered by the Board in determining the amount of each dividend are our results of operations and the capital requirements, growth and other characteristics of our businesses.

Ratings

As of October 25, 2006 the credit ratings of Aetna Inc. and Aetna Life Insurance Company (ALIC) from the respective Nationally Recognized Statistical Rating Organizations (Rating Agencies) were as follows:

	A.M. Best	**Fitch**	**Moody s Investors Service**	**Standard & Poor s**
Aetna Inc. (senior debt) (1)	bbb+	A-	A3	A-
Aetna Inc. (commercial paper) (1)	AMB-2	F2	P-2	A-2
ALIC (financial strength) (1)	A	AA-	Aa3	A+

(1) The stated outlook from all Rating Agencies for the senior debt and financial strength ratings of Aetna Inc. and ALIC, respectively, is stable.

CRITICAL ACCOUNTING ESTIMATES

We prepare our consolidated financial statements in accordance with GAAP. The application of GAAP requires management to make estimates and assumptions that affect our consolidated financial statements and related notes. We use information available to us at the time the estimates are made; however, as described below, these estimates could change materially if different information or assumptions were used. Also, these estimates may not ultimately reflect the actual amounts of the final transactions that occur. The following provides a summary of our health care costs payable and other insurance liabilities estimates. For a detailed description of all of our critical accounting estimates, refer to the CRITICAL ACCOUNTING ESTIMATES portion of our 2005 Annual Report.

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Health Care Costs Payable

Health care costs payable reflects estimates of the ultimate cost of claims that have been incurred but not yet reported and of those which have been reported but not yet paid (collectively IBNR). At September 30, 2006 and December 31, 2005, our IBNR reserves represented approximately 80% and 79%, respectively, of total health care costs payable. The remaining amount is primarily comprised of pharmacy and capitation payables and accruals for state assessments. We develop our IBNR estimates using actuarial principles and assumptions that consider numerous factors. Of those factors, we consider the analysis of historical and projected claim payment patterns (including claims submission and processing patterns) and the assumed health care cost trend rate to be the most critical assumptions. In developing our estimate of health care costs payable, we consistently apply these actuarial principles and assumptions each period, with consideration to the variability of related factors.

We analyze historical claim payment patterns by comparing claim incurred dates (i.e., the date services were provided) to claim payment dates to estimate completion factors. We estimate completion factors by aggregating claim data based on the month of service and month of claim payment and estimating the percentage of claims incurred for a given month that are complete by each month thereafter. For any given month, substantially all claims are paid within six months of the date of service, but it can take up to 48 months or longer before all of the claims are completely resolved and paid. These historically derived completion factors are then applied to claims paid through the financial statement date to estimate the ultimate claim cost for a given month s incurred claim activity. The difference between the estimated ultimate claim cost and the claims paid through the financial statement date represents our estimate of claims remaining to be paid as of the financial statement date and is included in our health care costs payable.

We use completion factors predominantly to estimate reserves for claims with claim incurred dates greater than three months prior to the financial statement date. The completion factors we use reflect judgments and possible adjustments for such data as claim inventory levels, claim submission and processing patterns and, to a lesser extent, other factors such as changes in health care cost trend rates, changes in membership and product mix. If claims are submitted or processed on a faster (slower) pace than prior periods, the actual claims may be more (less) complete than originally estimated using our completion factors, which may result in reserves that are higher (lower) than required.

Because claims incurred within three months prior to the financial statement date have less activity (i.e., a large portion of health care claims are not submitted to us and/or processed until after the end of the quarter in which services are rendered by providers to our members), estimates of the ultimate claims incurred for these months are not based primarily on the historically derived completion factors. Rather, the estimates for these months also reflect increased emphasis on the assumed health care cost trend rate (the rate of increase in per member health care costs), which may be influenced by our historical and projected claim submission and processing times as well as seasonal patterns and changes in membership and product mix.

Our health care cost trend rate is affected by increases in per member utilization of medical services as well as increases in the per unit cost of such services. Many factors influence the health care cost trend rate, including our ability to manage health care costs through underwriting criteria, product design, negotiation of favorable provider contracts and medical management programs. The aging of the population and other demographic characteristics, advances in medical technology and other factors continue to contribute to rising per member utilization and per unit costs. Changes in health care practices, inflation, new technologies, increases in the cost of prescription drugs, direct-to-consumer marketing by pharmaceutical companies, clusters of high cost cases, changes in the regulatory environment, health care provider or member fraud and numerous other factors also contribute to the cost of health care and our health care cost trend rate.

For each reporting period, an extensive degree of judgment is used in the process of estimating our health care costs payable, and as a result, considerable variability and uncertainty is inherent in such estimates, and the adequacy of such estimates is highly sensitive to changes in assumed completion factors and the assumed health care cost trend rate. For each reporting period we recognize our best estimate of health care costs payable. We believe our estimate of health care costs payable is reasonable and adequate to cover our obligations as of September 30, 2006; however, actual claim payments may differ from our estimates. A worsening (or improvement) of our health care cost trend

rates or changes in completion factors from those that were assumed in estimating health care costs payable at September 30, 2006 would cause these estimates to change in the near term, and such a change could be material.

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Each quarter, we re-examine previously established health care costs payable estimates based on actual claim payments for prior periods and other changes in facts and circumstances. Given the extensive degree of judgment in this estimate, it is possible that our estimates of health care costs payable could develop either favorably (i.e., our actual health care costs for the period were less than we estimated) or unfavorably. We include the impact of changes in estimates in earnings when they are identified. The changes in the estimate of health care costs payable may relate to a prior fiscal quarter, prior fiscal year or earlier periods. The results of these re-examinations are also considered when we determine our current year liabilities. In the three months ended September 30, 2006, we recorded favorable development of prior period health care cost estimates of approximately $45 million pretax (refer to MD&A HEALTH CARE for additional information).

During the three months ended September 30, 2006, we observed that our health care cost trend rates for claims with dates of service three months or less before the financial statement date were slightly lower than previously estimated, which contributed to the favorable development of prior period health care cost estimates. Specifically, after considering the claims paid in 2006 with dates of service prior to June 30, 2006, we observed health care cost trend rates that were approximately 1.4% lower than previously estimated for claims associated with combined Commercial Risk and Medicare IBNR (approximately 1% when considering all components of health care costs). The lower than anticipated health care cost trend rates we observed during the three months ended September 30, 2006 for claims incurred prior to June 30, 2006 were due to moderating outpatient, ancillary and physician service trends. Historical health care cost trend rates are not necessarily representative of current trends. Therefore, we consider historical trend rates together with our knowledge of recent events that may impact current trends when developing our estimates of current trend rates. When establishing our reserves at September 30, 2006, we decreased our assumed health care cost trend rates to account for the lower than anticipated health care cost trend rates observed during the three months ended September 30, 2006. Based on our historical claim experience, it is reasonably possible that our estimated health care cost trend rates may vary by plus or minus 4.0 percentage points from actual.

After considering the claims paid in the three months ended September 30, 2006 with dates of service prior to June 30, 2006, we observed weighted average completion factors that were consistent with those previously estimated. When establishing our reserves at September 30, 2006, the assumed weighted average completion factors were consistent with those used at June 30, 2006. Based on our historical claim experience, it is reasonably possible that our estimated weighted average completion factors may vary by plus or minus .75 percentage points from actual.

The following table illustrates the sensitivity of our health care costs payable at September 30, 2006 (in millions) to certain reasonably possible changes to the estimated weighted average completion factors and health care cost trend rates. However, it is possible that the actual completion factors and health care cost trend rates will develop differently from our historical patterns and therefore could be outside of the ranges illustrated below.

Completion Factors [1]		**Health Care Cost Trend Rates [2]**	
(Decrease) Increase in Factor	**(Decrease) Increase in Health Care Costs Payable**	**(Decrease) Increase in Factor**	**(Decrease) Increase in Health Care Costs Payable**
		(4%)	$ (109.9)
(.75%)	$ 54.9	(3%)	(82.4)
(.5%)	36.5	(2%)	(55.0)
(.25%)	18.2	(1%)	(27.5)
.25%	(18.2)	1%	27.5
.5%	(36.4)	2%	55.0
.75%	(54.5)	3%	82.4
		4%	109.9

(1) Reflects estimated impact of a

(decrease) increase in weighted average completion factors prior to the most recent three months. An increase in the completion factor results in a decrease in the remaining estimated reserves for claims.

(2) Reflects estimated impact of a (decrease) increase in health care cost trend rates for the most recent three months.

Health care costs payable as of September 30, 2006 and December 31, 2005 consisted of the following:

(Millions)	**2006**	**2005**
Commercial Risk	$ 1,823.6	$ 1,737.3
Medicare	129.6	79.5
Medicaid	1.3	.2
Total health care costs payable	$ 1,954.5	$ 1,817.0

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Premium Deficiency Reserves

In cases where we project future health care costs will exceed existing reserves plus anticipated future premiums, we establish premium deficiency reserves for the amount of the expected loss in excess of expected future premiums. Anticipated investment income is considered in the calculation of expected losses for certain contracts. Any such reserves established would normally cover expected losses until the next policy renewal dates for the related policies. We did not have any material premium deficiency reserves at September 30, 2006.

Other Insurance Liabilities

We establish insurance liabilities other than health care costs payable for benefit claims related to our Group Insurance segment. We refer to these liabilities as other insurance liabilities. These liabilities relate to our life, disability and long-term care products.

Life and Disability

The liabilities for our life and disability products reflect benefit claims that have been reported but not yet paid, estimates of claims that have been incurred but not yet reported and future policy benefits earned under insurance contracts. These reserves and the related benefit expenses are developed using actuarial principles and assumptions that consider, among other things, discount, recovery and mortality rates (each discussed below). Completion factors are also evaluated when estimating our reserves for claims incurred but not yet reported for life products. We also consider the benefit payments from the U.S. Social Security Administration for which our disability members may be eligible and which may offset our liability for disability claims (known as the Social Security offset). Each period, we estimate these factors, to the extent relevant, based primarily on historical data, and use these estimates to determine the assumptions underlying our reserve calculations. Given the extensive degree of judgment and uncertainty used in developing these estimates, it is possible that our estimates could develop either favorably or unfavorably.

The discount rate is the interest rate at which future benefit cash flows are discounted to determine the present value of those cash flows. The discount rate we select is a critical estimate, as higher discount rates result in lower reserves. We set the discount rate based on the current investment yield of the portfolio of assets supporting our life and disability reserves. If the discount rate we select in estimating our reserves is lower (higher) than our actual future portfolio returns, our reserves may be higher (lower) than necessary. Our discount rate for life and disability reserves at September 30, 2006 decreased by .22% and .03%, respectively when compared to the rates used at December 31, 2005. The discount rates we selected for disability and life reserves at September 30, 2006 were slightly lower than the rates selected at December 31, 2005 as a result of lower investment yields on the portfolio of assets supporting these reserves. Based on our historical experience, it is reasonably possible that the assumed discount rates for our life and disability reserves may vary by plus or minus .25% from year to year. A .25% decrease in the discount rates selected for our life and disability reserves would have increased current and future life and disability benefit costs by approximately $12 million for the nine months ended September 30, 2006.

For disability claims and a portion of our life claims, we must estimate the timing of benefit payments, which takes into consideration the maximum benefit period and the probabilities of recovery (i.e., recovery rate) or death (i.e., mortality rate) of the member. Benefit payments may also be affected by a change in employment status of a disabled member, for example if the member returns to work on a part-time basis. Estimating the recovery and mortality rates of our members is complex. Our actuaries evaluate our current and historical claim patterns, the timing and amount of any Social Security offset (for disability only), as well as other factors including the relative ages of covered members and the duration of disability when developing these assumptions. For disability reserves, if our actual recovery and mortality rates are lower (higher) than our estimates, our reserves will be lower (higher) than required to cover future disability benefit payments. For certain life reserves, if the actual recovery rates are lower (higher) than our estimates or the actual mortality rates are higher (lower) than our estimates, our reserves will be lower (higher) than required to cover future life benefit payments. We use standard industry tables and our historical claim experience to develop our estimated recovery and mortality rates. Claim reserves for our disability and life claims are sensitive to these assumptions. Our historical experience has been that our recovery or mortality rates for our life and disability reserves may vary by less than one percent during the course of a year. A one percent less (more) favorable assumption for our recovery or mortality rates would have increased (decreased) current and future life and disability benefit costs by approximately $5 million for the nine months ended September 30, 2006. When establishing our reserves at

September 30, 2006,

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we have adjusted our estimates of recovery and mortality rates based on our recent experience.
We estimate a reserve for claims incurred but not yet reported for life products largely based on completion factors. The completion factors we use are based on our historical experience and reflect judgments and possible adjustments for data such as claim inventory levels, claim payment patterns, changes in business volume and other factors. If claims are submitted or processed on a faster (slower) pace than historical periods, the actual claims may be more (less) complete than originally estimated using our completion factors, which may result in reserves that are higher (lower) than required to cover future life benefit payments. At September 30, 2006, we held approximately $232 million in reserves for life claims incurred but not yet reported.

Long-term Care

We establish a reserve for future policy benefits for our long-term care products at the time each policy is issued based on the present value of future benefit payments less the present value of future premiums. In establishing this reserve, we must evaluate assumptions about mortality, morbidity, lapse rates and the rate at which new claims are submitted to us. We estimate the future policy benefits reserve for long-term care products using these assumptions and actuarial principles. For long-duration insurance contracts, these original assumptions are used throughout the life of the policy and are not subsequently modified unless the reserves are deemed to be inadequate. A portion of our reserves for long-term care products also reflect our estimates relating to members currently receiving benefits. These reserves are estimated primarily using recovery and mortality rates, as described above.

Premium Deficiency Reserves

In cases where we project future policy benefit costs will exceed our existing reserves plus anticipated future premiums, we establish premium deficiency reserves for the amount of the expected loss in excess of expected future premiums. Anticipated investment income is considered in the calculation of expected losses for certain contracts. Any such reserves established would normally cover expected losses until the next policy renewal dates for the related policies. We did not have any material premium deficiency reserves at September 30, 2006.

NEW ACCOUNTING STANDARDS

Refer to Note 2 of Condensed Notes to Consolidated Financial Statements for a discussion of Statement of Financial Accounting Standards No. 123 Revised, *Share-Based Payment* , which was adopted retrospectively in 2006.

REGULATORY ENVIRONMENT

Refer to Regulatory Environment in our 2005 Annual Report for information on regulation of our business.

FORWARD-LOOKING INFORMATION/RISK FACTORS

The Forward-Looking Information/Risk Factors portion of our 2005 Annual Report contains a discussion of important risk factors related to our business.

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Item 3. Quantitative and Qualitative Disclosures About Market Risk

Refer to the information contained in MD&A INVESTMENTS.

Item 4. Controls and Procedures

Disclosure Controls and Procedures

We maintain disclosure controls and procedures, which are designed to ensure that information that we are required to disclose in the reports we file or submit under the Securities Exchange Act of 1934, as amended (the Exchange Act), is recorded, processed, summarized and reported within the time periods specified in the SEC s rules and forms, and that such information is accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, as appropriate to allow timely decisions regarding required disclosure.

An evaluation of the effectiveness of our disclosure controls and procedures as of September 30, 2006 was conducted under the supervision and with the participation of our Chief Executive Officer and Chief Financial Officer. Based on that evaluation, our Chief Executive Officer and Chief Financial Officer have concluded that our disclosure controls and procedures were adequate and designed to ensure that material information relating to Aetna Inc. and its consolidated subsidiaries would be made known to the Chief Executive Officer and Chief Financial Officer by others within those entities, particularly during the periods when periodic reports under the Exchange Act are being prepared. Refer to the Certifications by our Chief Executive Officer and Chief Financial Officer filed as Exhibits 31.1 and 31.2 to this report.

Changes in Internal Control over Financial Reporting

There has been no change in our internal control over financial reporting, identified in connection with the evaluation of such control, that occurred during our most recent fiscal quarter that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

PART II OTHER INFORMATION

Item 1. Legal Proceedings

Managed Care Class Action Litigation

From 1999 through early 2003, we were involved in purported class action lawsuits as part of a wave of similar actions targeting the health care payor industry and, in particular, the conduct of business by managed care companies. These cases, brought on behalf of health care providers (the Provider Cases), alleged generally that we and other defendant managed care organizations engaged in coercive behavior or a variety of improper business practices in dealing with health care providers and conspired with one another regarding this purported wrongful conduct.

Effective May 21, 2003, we and representatives of over 900,000 physicians, state and other medical societies entered into an agreement (the Physician Settlement Agreement) settling the lead physician Provider Case, which was pending in the United States District Court for the Southern District of Florida (the Florida Federal Court). We believe that the Physician Settlement Agreement, which has received final court approval, resolved all then pending Provider Cases filed on behalf of physicians that did not opt out of the settlement. During the second quarter of 2003, we recorded a charge of $75 million ($115 million pretax) (included in other operating expenses) in connection with the Physician Settlement Agreement, net of an estimated insurance recoverable of $72 million pretax. We believe our insurance policies with third party insurers apply to this matter and have been vigorously pursuing recovery from those insurers in Pennsylvania state court (the Coverage Litigation). During the second quarter of 2006, the Philadelphia, Pennsylvania state trial court issued a summary judgment ruling dismissing all of our claims in the Coverage Litigation. We have appealed that ruling and intend to continue to vigorously pursue recovery from our third party insurers. However, as a result of that ruling, we concluded that the estimated insurance recoverable of $72 million pretax that was recorded in connection with the Physician Settlement Agreement is no longer probable of collection for accounting purposes, and therefore, during the second quarter of 2006, we wrote-off that recoverable. We continue to work with plaintiffs representatives in implementing the Physician Settlement Agreement and the issues that may arise under that agreement.

Several Provider Cases filed in 2003 on behalf of purported classes of chiropractors and/or all non-physician health care providers also make factual and legal allegations similar to those contained in the other Provider Cases, including allegations of violations of the Racketeer Influenced and Corrupt Organizations Act. These Provider Cases seek various forms of relief, including unspecified damages, treble damages, punitive damages and injunctive relief. These Provider Cases have been transferred to the Florida Federal Court for consolidated pretrial proceedings. We intend to defend each of these cases vigorously.

Insurance Industry Brokerage Practices Matters

We have received subpoenas and other requests for information from the New York Attorney General, the Connecticut Attorney General, other attorneys general and various insurance and other regulators with respect to an industry wide investigation into certain insurance brokerage practices, including broker compensation arrangements, bid quoting practices and potential antitrust violations. We may receive additional subpoenas and requests for information from these attorneys general and regulators. We are cooperating with these inquiries.

In connection with this industry wide review, we have received, and may receive, additional subpoenas and requests for information from other attorneys general and other regulators, and we have been named in related litigation.

Other Litigation and Regulatory Proceedings

We are involved in numerous other lawsuits arising, for the most part, in the ordinary course of our business operations, including employment litigation and claims of bad faith, medical malpractice, non-compliance with state regulatory regimes, marketing misconduct, failure to timely pay medical claims, investment activities, patent infringement and other intellectual property litigation and other litigation in our Health Care and Group Insurance businesses. Some of these other lawsuits are or are purported to be class actions. We intend to defend these matters vigorously.

In addition, our current and past business practices are subject to review by, and from time to time we receive subpoenas and other requests for information from, various state insurance and health care regulatory authorities and other state and federal authorities. There also continues to be heightened review by regulatory authorities of the managed health care industry s business practices, including utilization management, delegated arrangements and claim payment practices. As a leading national managed care organization, we regularly are the subject of such reviews. These reviews may result, and have resulted, in changes to or clarifications of our business practices, as well as fines, penalties or other sanctions.

We are unable to predict at this time the ultimate outcome of the remaining Provider Cases, the insurance industry brokerage practices matters or other litigation and regulatory proceedings, and it is reasonably possible that their outcome could be material to us.

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

The following table provides information about our monthly share repurchases as part of publicly announced programs for the three months ended September 30, 2006:

Issuer Purchases Of Equity Securities

(Millions, except per share amounts)	Total Number of Shares Purchased	Average Price Paid Per Share	Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs	Approximate Dollar Value of Shares That May Yet Be Purchased Under the Plans or Programs
July 1, 2006 - July 31, 2006	1.0	$ 31.95	1.0	$ 1,127.9
August 1, 2006 - August 31, 2006	21.2	34.94	21.2	388.4

September 1, 2006 - September 30, 2006	5.2	38.69	5.2	937.2
Total	27.4	$ 35.55	27.4	N/A

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On January 27, 2006, April 28, 2006 and September 29, 2006, we announced that our Board authorized share repurchase programs for the repurchase of up to $750 million, $820 million and $750 million, respectively, of common stock ($2.3 billion in aggregate). During the third quarter of 2006, we repurchased approximately 27 million shares of common stock at a cost of $973 million, (approximately $59 million of these repurchase transactions were settled in early October 2006), completing the January 27, 2006 authorization and utilizing a portion of the April 28, 2006 authorization. At September 30, 2006, we had authorization to repurchase up to approximately $937 million of common stock remaining under the April 28, 2006 and September 29, 2006 authorizations.

On January 27, 2006, the Board declared a two-for-one stock split of our common stock, which was effected in the form of a 100% common stock dividend. All shareholders of record at the close of business on February 7, 2006 (the Shareholders of Record) received one additional share of common stock for each share held on that date. The additional shares of common stock were distributed to the Shareholders of Record in the form of a stock dividend on February 17, 2006. All share and per share amounts have been adjusted to reflect the stock split for all periods. In connection with the stock split, the Board approved an amendment to our Articles of Incorporation. This amendment increased the number of our authorized common shares to 2.9 billion shares on February 17, 2006.

Item 6. Exhibits

Exhibits to this Form 10-Q are as follows:

10 Material Contracts

10.1 Form of Aetna Inc. 2000 Stock Incentive Plan Stock Appreciation Right Terms Of Award.

10.2 Form of Aetna Inc. 2000 Stock Incentive Plan Restricted Stock Unit Terms Of Award.

10.3 Form of Aetna Inc. 2000 Stock Incentive Plan Aetna Performance Unit Award Agreement.

10.4 Form of Aetna Inc. Non-Employee Director Compensation Plan Restricted Stock Unit Agreement.

10.5 Consulting Agreement made as of October 1, 2006 between Aetna Inc. and John W. Rowe, M.D.

11 Statements re: computation of per share earnings

11.1 Incorporated herein by reference to Note 4 of Condensed Notes to Consolidated Financial Statements in this Form 10-Q.

12 Statements re: computation of ratios

12.1 Computation of ratios.

15 Letter re: unaudited interim financial information

15.1 Letter from KPMG LLP acknowledging awareness of the use of a report on unaudited interim financial information, dated October 26, 2006.

31 Rule 13a-14(a)/15d-14(a) Certifications

31.1 Certification.

31.2 Certification.

32 Section 1350 Certifications

32.1 Certification.

32.2 Certification.

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SIGNATURES

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

Aetna Inc.

Registrant

Date: October 26, 2006

By /s/ Ronald M. Olejniczak

Ronald M. Olejniczak
Vice President and Controller
(Chief Accounting Officer)

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INDEX TO EXHIBITS

Exhibit Number	Description	Filing Method
10	**Material Contracts**	
10.1	Form of Aetna Inc. 2000 Stock Incentive Plan Stock Appreciation Right Terms Of Award.	Electronic
10.2	Form of Aetna Inc. 2000 Stock Incentive Plan Restricted Stock Unit Terms Of Award.	Electronic
10.3	Form of Aetna Inc. 2000 Stock Incentive Plan Aetna Performance Unit Award Agreement.	Electronic
10.4	Form of Aetna Inc. Non-Employee Director Compensation Plan Restricted Stock Unit Agreement.	Electronic
10.5	Consulting Agreement made as of October 1, 2006 between Aetna Inc. and John W. Rowe, M.D.	Electronic
12	**Statements re: computation of ratios**	
12.1	Computation of ratios.	Electronic
15	**Letter re: unaudited interim financial information**	
15.1	Letter from KPMG LLP acknowledging awareness of the use of a report on unaudited interim financial information, dated October 26, 2006.	Electronic
31	**Rule 13a-14(a)/15d-14(a) Certifications**	
31.1	Certification.	Electronic
31.2	Certification.	Electronic
32	**Section 1350 Certifications**	
32.1	Certification.	Electronic
32.2	Certification.	Electronic