

SPACEHAB INC \WA\
Form 10-K/A
July 20, 2005

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-K/A

(Amendment No. 2)

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

For the fiscal year ended June 30, 2004

Commission File No. 0-27206

SPACEHAB, Incorporated

(Exact name of registrant as specified in this charter)

Washington
(State or other jurisdiction of
incorporation or organization)

91-1273737
(I.R.S. Employer
Identification No.)

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12130 Highway 3, Building 1

Webster, Texas 77598-1504

(713) 558-5000

Securities Registered pursuant to Section 12(b) of the Act: None

Securities Registered pursuant to Section 12(g) of the Act:

| <i>Title of each class</i> | <i>Name of each exchange on which registered</i> |
|--|--|
| Common Stock (no par value) | NASDAQ National Market |

Number of shares of Common Stock (no par value) outstanding as of January 5, 2004, 12,435,827. Aggregate market value of Common Stock (no par value) held by non-affiliates of the registrant on January 5, 2004, based upon the closing price of the Common Stock on the NASDAQ National Market of \$1.92 was approximately \$23,876,788.

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. YES NO

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not 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-K or any amendment to this Form 10-K.

Indicate by check mark whether the registrant is an accelerated filer (as defined in rule 12b-2 of the Exchange Act). YES NO

EXPLANATORY NOTE

Spacehab Inc. is amending their 2004 Form 10-K as a result of a reclassification of the \$17.7 million insurance proceeds received during 3Q 2003 relating to the loss of our Research Double Module, which was previously classified as Operating Cash Flows for which we are now classifying as Investing Cash Flows in accordance with FAS 95, Footnote 5. Amendments to this document in accordance with the standard are outlined in the subsequent pages below.

Note: There are no other changes to the original Form 10-K filing other than those outlined in this document. This Form 10-K/A does not reflect events occurring after the filing of the original Form 10-K, or modify or update the disclosures therein in any way other than as required to reflect the amendment set forth below.

PART II

Item 6. Selected Financial Data.

The selected financial data presented below are derived from the audited consolidated financial statements of SPACEHAB. This selected financial information should be read in conjunction with the Consolidated Financial Statements of the Company and the notes thereto included elsewhere in this report.

| | Year Ended June 30 | Year Ended June 30 | Year Ended June 30 | Year Ended June 30 | Year Ended June 30 |
|--|-----------------------|-----------------------|-----------------------|-----------------------|-----------------------|
| | 2000 | 2001 | 2002 | 2003 (Restated) | 2004 |
| <i>(in thousands, except per share data)</i> | | | | | |
| Statement of Operations Data: | | | | | |
| Revenue | \$ 105,708 | \$ 105,254 | \$ 102,773 | \$ 94,963 | \$ 77,606 |
| Costs of revenue | 87,931 | 92,243 | 81,767 | 78,791 | 45,678 |
| Gross profit | 17,777 | 13,011 | 21,006 | 16,172 | 31,928 |
| Selling, general and administrative expenses | 17,832 ¹ | 21,796 | 19,507 ⁴ | 91,434 ⁵ | 20,982 ⁷ |
| Research and development expenses | 2,440 ² | 393 | 383 | 118 | 223 |
| Income (loss) from operations | (2,495) | (9,178) | 1,116 | (75,380) | 10,723 |
| Interest expense, net of capitalized amounts and interest and other income | 3,773 | 4,804 | 5,533 | 7,252 | 8,142 |
| Net income (loss) | (3,844) | (12,785) ³ | (2,367) | (81,775) | 2,075 |
| Net income (loss) per common share diluted | \$ (0.34) | \$ (1.12) | \$ (0.20) | \$ (6.66) | \$ 0.15 |
| Shares used in computing net income (loss) per common share diluted | 11,273 | 11,400 | 11,884 | 12,285 | 14,142 |
| Other Data: | | | | | |
| Cash provided by operations | \$ 1,424 | \$ 17,124 | \$ 8,592 | \$ 2,114 | \$ 5,273 |
| Cash provided by (used in) investing activities | (29,794) | (23,076) | (13,167) | \$ 3,037 ⁶ | 5,019 |
| Balance Sheet Data (at period end): | | | | | |
| Working capital deficit | \$ (1,601) | \$ (41,424) | \$ (22,022) | \$ (4,750) | \$ (6,351) |
| Total assets | 225,109 | 222,477 | 220,826 | 121,356 | 99,925 |
| Long-term debt, excluding current portion | 75,901 | 64,589 | 83,426 | 80,056 | 66,942 |
| Stockholders' equity | 102,702 | 90,356 | 87,670 | 5,090 | 9,410 |

¹ Includes approximately \$1.8 million of expenses associated with the startup of SMI.

² Includes approximately \$0.5 million of expenses associated with the *Enterprise* module.

³ Includes approximately \$3.3 million of non-cash expense to record a full valuation allowance on the Company's deferred tax asset.

⁴ Includes approximately \$0.8 million of non-cash expenses related to subleasing of excess facilities.

⁵ Includes approximately \$78.3 million of non-cash write-downs related to the loss of our Research Double Module, goodwill impairment at SGS, and asset impairment.

⁶ Includes approximately \$17.7 million of insurance proceeds related to the loss of our Research Double Module.

⁷ Includes approximately \$0.3 million of non-cash expenses related to subleasing of excess facilities, \$8.3 million of goodwill impairment at SGS and ASO, and a \$1.8 million non-cash write-down of investment in Guignè.

Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations.

The following discussion should be read together with the audited consolidated financial statements and the notes thereto included in this report

OVERVIEW

SPACEHAB operates through three main areas generally related to space flight activities within the aerospace industry: space assets and mission support services for manned and unmanned space exploration and research missions; commercial and exploratory satellite pre-launch services; and administrative services in support of government space operations. We also operate a retail space merchandise operation and provide space-related educational services. Because of the diversity among the operations of our activities, we report the results of each business as a separate segment in our consolidated financial statements. Our consolidated financial results also reflect corporate-level expenses such as general and administrative, interest, and depreciation and amortization, but because of their nature, these items are not reported as a separate segment.

Following is a brief discussion of each of our four business segments, including a list of key factors that have affected, and are expected to continue to affect, their respective earnings and cash flows. We also present a brief discussion of our corporate-level expenses. This Overview section concludes with a summary of our current liquidity position and items that could impact our liquidity position in fiscal year 2005 and beyond. Please note that this Overview section is merely a summary and should be read together with the remainder of Item 7, Management's Discussion and Analysis of Financial Condition and Results of Operations, as well as the audited consolidated financial statements, including the notes thereto, and the other information included in this report.

SPACEHAB Flight Services generates revenue by providing space shuttle-based, turnkey services that include customer access to space via our fleet of pressurized modules and unpressurized pallet carriers; integration and operations support to logistics suppliers transporting their cargo aboard our carriers to and from the orbiting ISS; and/or integration and operations support to scientists and technologists responsible for experiments performed aboard module and pallet research platforms.

On a space-available basis for each mission, additional revenue can be generated by SFS under commercial contracts with non-NASA customers, including both government and private customers. Commercial contracts with non-NASA customers will continue to be established directly between SPACEHAB and its commercial customers.

Additionally, during the space shuttle stand-down period, SFS is providing cargo shipment coordination services to NASA for all U.S. cargo shipped to the ISS via the Russian *Progress* space vehicle. These services are provided under contract to Lockheed Martin, the CMC contractor to NASA. We are also providing research access to space and on the ISS to JAXA through RSC Energia, a major Russian aerospace enterprise. SPACEHAB contracted through V.J.F. Russian Consulting with RSC Energia for construction of certain space research equipment, launch vehicle, and research space aboard the Russian *Progress* carrier when the originally-scheduled services on the space shuttle were suspended due to the *Columbia* tragedy.

The primary factors impacting our SFS earnings and cash flows are the number of space shuttle missions flown and the configuration of the cargo handling and research logistics required for each mission. Our revenues and earnings, if any, from each mission are dependent upon the space assets required in the cargo or research logistics configuration and the mission support services required to employ those assets. Other factors that have impacted, and are expected to continue to impact, earnings and cash flows for this business unit include:

Congress funding for NASA and the allocation of that funding to ISS operations and space shuttle cargo missions

The return to flight of the U. S. Space Shuttle Program

The role of international space research projects flying on future space shuttle missions

The growth of space exploration programs within NASA and NASA's commitment to the National Vision on Space Exploration regarding enhancement of the role of commercial enterprise in space exploration programs

Our ability to control our capital expenditures, particularly those for spare or replacement parts for space assets

Astrotech Space Operations, Inc. revenue is generated from various fixed-price contracts with launch service providers in both the commercial and government markets. The services and facilities Astrotech provides to its customers support the final assembly, checkout, and countdown functions associated with preparing a satellite for launch. This preparation may include: the final assembly and checkout of the satellite, check-out and installation of the solid rocket motors, loading of the liquid propellants, encapsulation of the satellite in the launch vehicle payload fairings, and command and control of the satellite during pre-launch countdown.

The earnings and cash flows generated from our Astrotech operations are related to the number of commercial satellite launches, which reflects the growth in the satellite-based communication industries, and the requirement to replace aging satellites. Other factors that have impacted, and are expected to continue to impact, earnings and cash flows for this business include:

Our ability to control our capital expenditures, which primarily are limited to maintenance and safety, environmental and reliability projects, and other costs through disciplined management and safe, efficient operations

The continuing unavailability of government-owned facilities at the major domestic launch sites that can offer compatible services, leading to an increase in government use of ASO services

SPACEHAB Government Services, Inc. expands SPACEHAB's core business of supporting people living and working in space. Specifically, SGS has proven capabilities supporting the Government in the areas of large-scale configuration and data management programs such as the ISS; specialized hardware design, development, and fabrication; low- to high-fidelity mockup design and construction; and safety and quality support services. This business unit offers a wide array of products and services in these varied fields and brings over thirty years of advanced ideas and solid execution of these innovations to its customers. SGS is currently under contract to provide configuration management services within the PI&C contract of which ARES Corporation is the prime contractor. Prior to this time, from May 1993 to April 2003, SGS primarily operated under the Flight Crew Systems Development (FCSDD) contract which was a \$399.1 million multi-task cost-plus award and incentive-fee contract.

Our earnings in SGS operations are dependent on our ability to continue to win contracts with NASA or other government entities through the competitive bidding process and our performance under those contracts in achieving performance bonuses. Other factors that have impacted, and are expected to continue to impact, earnings and cash flows for this business include:

Continuation through 2008 of our PI&C contract with the ISS Program

Our ability to maintain small business qualification under NASA contracting rules

Our ability to control costs within our budget commitments

Space Media, Incorporated operates a retail store and internet store offering space-themed products and is engaged in space-related educational programs and other space-themed activities. Revenue and earnings in our retail operations are dependent upon general enthusiasm for the space exploration program, advertising and promotion, and competition.

Corporate and Other. Significant items impacting future earnings and cash flows include:

Interest expense is expected to decrease in fiscal year 2005 due to the repayment of a substantial portion of our mortgage debt during fiscal year 2004 from proceeds from Boeing's early termination of their satellite preparation contract with our Astrotech subsidiary

General and administrative costs, which were reduced in fiscal year 2004 due to staff reductions and the closing of our Washington D.C. corporate office, and our ability to continue to manage future overhead costs

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The ultimate settlement of our claim against NASA for indemnification of our losses on the Space Shuttle *Columbia* mission

Income taxes, with respect to which we currently only pay alternative minimum tax and minimal state income taxes; income taxes will also be impacted by our ability to realize our significant deferred tax assets, including loss carry forwards

Liquidity. As of June 30, 2004, we had cash on hand and in short-term investments of \$7.6 million. Our \$5.0 million revolving credit facility, which includes a potential restriction on \$5.6 million of our short-term investments if fully utilized, had a balance drawn of \$1.4 million as of June 30, 2004, of which approximately \$2.0 million of restricted cash and investments is pledged against. Our ability to maintain sufficient liquidity in the future will depend on a number of factors including the amount and timing of the ultimate settlement of our claim for indemnification for losses we suffered on the Space Shuttle *Columbia* accident, the return to flight of the space shuttle and the continued activity in the commercial and governmental satellite launch industry.

For the next 12 months, we expect that our operating cash flows will be sufficient to satisfy our capital expenditures, debt maturities, interest expenses, and operating commitments. In order to increase our liquidity and to provide

capacity in the event of a further delay in the ultimate settlement of our claim for indemnification from NASA; to fund capital expenditures for stand-by spare parts for our modules; and for costs of developing and submitting proposals for new government contracts, we will seek to replace or amend our \$5.0 million revolving credit facility to remove its restriction on our short-term investments and to increase the amount available under the facility.

Over the longer term, we believe that the space shuttle return to flight and the Nation's Vision for Space Exploration will lead to increased activity and related cash flows from operations for our SFS business segment, and that we will reach an amicable settlement with NASA on our claim for indemnification of losses on the Space Shuttle *Columbia*. If these events happen, they would increase our liquidity significantly and provide resources and financial capacity for the redemption of our subordinated convertible notes when due in October 2007. The notes are convertible into our Common Stock at a rate of \$13.625 per share. However, there can be no assurance that the space shuttle will return to flight in the near term or that we will be able to reach an acceptable resolution of our claim for indemnification from NASA. Failure of either such events would have a material adverse effect on our financial condition and results of operations and could adversely affect our ability to redeem our subordinated convertible notes when they mature in October 2007.

Critical Accounting Policies

Revenue Recognition. SPACEHAB's business units' revenue is derived primarily from long-term contracts with the U.S. Government and commercial customers. Revenue under these contracts are recognized using the methods described below. Estimating future costs and, therefore, revenues and profits, is a process requiring a high degree of management judgment. Management bases its estimate on historical experience and on various assumptions that are believed to be reasonable under the circumstances including the negotiation of an equitable adjustment on the ReALMS contract which was added to the contract as a pricing amendment due to the delay in the return to flight. Costs to complete include, when appropriate, material, labor, subcontracting costs, lease costs, commissions, insurance and depreciation. Our business segment personnel perform periodic contract status and performance reviews. In the event of a change in total estimated contract cost or profit, the cumulative effect of such change is recorded in the period that the change in estimate occurs.

A Summary of Revenue Recognition Methods Follows:

| <u>Business Segment</u> | <u>Services/Products Provided</u> | <u>Contract Type</u> | <u>Method of Revenue Recognition</u> |
|-------------------------|---|--|---|
| SFS | Commercial Space Habitat Modules, Integration & Operations Support Services | Firm Fixed Price | Percentage-of-completion based on costs incurred |
| SGS | Configuration Management, Engineering Services | Cost Plus Award/Fixed Fee | Reimbursable costs incurred plus award/fixed fee |
| Astrotech | Payload Processing Facilities | Firm Fixed Price - Mission Specific | Ratably, over the occupancy period of a satellite within the facility from arrival through launch |
| | | Firm Fixed Price - Guaranteed Number of Missions | For multi-year contract payments recognized ratably over the contract period |
| SMI | Space-Themed Commercial Products/Activities | Retail | Internet and retail sales recognized when goods are shipped |

Goodwill. In assessing the recoverability of goodwill and other intangibles, we must make assumptions regarding the estimated future cash flows and other factors to determine the fair value of the respective assets. If and when these circumstances or their related assumptions change in the future, the Company may be required to record impairment charges for these assets. We adopted SFAS No. 142, Goodwill and Other Intangible Assets, on July 1, 2002, under which the Company ceased to amortize goodwill and instead analyze goodwill at least annually for impairment issues. Goodwill on the balance sheet as of December 2003 was tested for impairment and was written off in fiscal year 2004.

Long-Lived Assets. In assessing the recoverability of long-lived assets, fixed assets, assets under construction and intangible assets, we evaluate the recoverability of those assets in accordance with the provisions of SFAS No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets. This Statement requires that certain long-lived fixed assets of the Company be reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Recoverability of assets to be held and used is measured by a comparison of the carrying amount of an asset to future net cash flows expected to be generated by the asset. If such assets are considered to be impaired, the impairment to be recognized is measured by the amount by which the carrying amount of the asset exceeds the fair value of the asset. Assets to be disposed of are reported at the lower of the carrying amount or fair value less costs to sell.

RESULTS OF OPERATIONS

Overview. In this section we discuss our results of operations, both on a consolidated basis and, where appropriate, by segment for our fiscal years ended June 30, 2004, 2003, and 2002. Where we report earnings or loss on a per share basis, we have done so on a diluted earnings per share basis. The weighted average number of common shares applicable to diluted earnings for 2004, 2003, and 2002 were 14,141,949, 12,285,467, and 11,884,309 respectively. At the end of this section we have included our outlook for fiscal year 2005 for each business unit.

We had net earnings (loss) of \$2,075,000 or \$0.15 per diluted share on revenues of \$77,606,000 for our 2004 fiscal year compared to (\$81,775,000) or (\$6.66) per share on revenues of \$94,963,000 for 2003 and (\$2,367,000) or (\$0.20) per share on revenues of \$102,773,000 for 2002. For our 2002 fiscal year, net earnings and earnings per share included \$0.09 per share of goodwill amortization expense. Amortization of goodwill ceased January 1, 2002 as a result of adoption of Statement of Financial Accounting Standards (SFAS) No. 142.

Non-GAAP Financial Measures. Management uses income from operations before charges as one measure of financial performance. Income from operations before charges is a non-GAAP financial measure and consists of operating income before unusual and infrequent events such as goodwill impairments, asset impairments, investment impairments and our loss of the RDM on the *Columbia* accident. Income from operations before charges does not include interest expense or income taxes, each of which is evaluated on a consolidated basis. Because we do not allocate interest expense and income taxes by segment, management believes that income from operations is a useful measure of our segment's operating performance for investors. Income from operations before charges should not be considered an alternative to, or more meaningful than, net income or cash flows from operations as determined in accordance with GAAP. The Other column in the presentation below is our corporate selling, general and administrative expenses that are incurred for the overall operations of the Company.

The following tables provide summary financial data regarding our consolidated and segmented results of operations for our 2004, 2003, and 2002 fiscal years, respectively (in millions):

Fiscal Year Ended June 30, 2004

| | SFS | ASO | SGS | SMI | Other | Total |
|--|--------|---------|--------|----------|----------|---------|
| Income (loss) from operations before charges | \$ 8.9 | \$ 20.0 | \$ 0.3 | \$ (0.1) | \$ (8.4) | \$ 20.7 |
| Goodwill impairment | | (2.5) | (5.7) | | | (8.2) |
| Investment impairment charge | | | | | (1.8) | (1.8) |
| Operating income (loss) | 8.9 | 17.5 | (5.4) | (0.1) | (10.2) | 10.7 |
| Other income/expense | | | | | 0.1 | 0.1 |
| Interest expense | | | | | (8.2) | (8.2) |

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| | | | | | | |
|-----------------------|--------|---------|----------|----------|-----------|--------|
| Pre-tax income (loss) | 8.9 | 17.5 | (5.4) | (0.1) | (18.3) | 2.6 |
| Income tax expense | | | | | (0.5) | (0.5) |
| Net income (loss) | \$ 8.9 | \$ 17.5 | \$ (5.4) | \$ (0.1) | \$ (18.8) | \$ 2.1 |

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Fiscal Year Ended June 30, 2003

| | <u>SFS</u> | <u>ASO</u> | <u>SGS</u> | <u>SMI</u> | <u>Other</u> | <u>Total</u> |
|--|------------|------------|------------|------------|--------------|--------------|
| Income (loss) from operations before charges | \$ 6.8 | \$ 4.5 | \$ 1.9 | \$ (0.3) | \$ (10.0) | \$ 2.9 |
| Loss on <i>Columbia</i> accident | (50.3) | | | | | (50.3) |
| Goodwill impairment | | | (11.9) | | | (11.9) |
| Asset impairment charge | (7.9) | | | | (8.2) | (16.1) |
| Operating income (loss) | (51.4) | 4.5 | (10.0) | (0.3) | (18.2) | (75.4) |
| Interest expense | | | | | (7.2) | (7.2) |
| Pre-tax income (loss) | (51.4) | 4.5 | (10.0) | (0.3) | (25.4) | (82.6) |
| Income tax benefit | | | | | 0.9 | 0.9 |
| Net income (loss) | \$ (51.4) | \$ 4.5 | \$ (10.0) | \$ (0.3) | \$ (24.5) | \$ (81.7) |

Fiscal Year Ended June 30, 2002

| | <u>SFS</u> | <u>ASO</u> | <u>SGS</u> | <u>SMI</u> | <u>Other</u> | <u>Total</u> |
|-------------------------|------------|------------|------------|------------|--------------|--------------|
| Operating income (loss) | 12.9 | 3.8 | 2.0 | (1.6) | (16.0) | 1.1 |
| Other income | | | | | 1.2 | 1.2 |
| Interest expense | | | | | (6.7) | (6.7) |
| Pre-tax income (loss) | 12.9 | 3.8 | 2.0 | (1.6) | (21.5) | (4.4) |
| Income tax benefit | | | | | 2.1 | 2.1 |
| Net income (loss) | \$ 12.9 | \$ 3.8 | \$ 2.0 | \$ (1.6) | \$ (19.4) | \$ (2.3) |

Operating Income (Loss). Operating income (loss) was \$10.7 million in fiscal year 2004, compared to (\$75.4) million and \$1.1 million for fiscal years 2003 and 2002 respectively. The following summarizes the activity in each of our operating segments:

SPACEHAB Flight Services. Operating income (loss) for our SFS segment was \$8.9 million for fiscal year 2004, compared to (\$51.4) million and \$12.9 million for fiscal years 2003 and 2002, respectively. Operating income for 2004 included general and administrative expense of \$0.7 million and depreciation and amortization expense of \$2.8 million as compared to general and administrative expenses of \$0.1 million and \$0.1 million and depreciation and amortization expense of \$5.0 million and \$8.6 million for fiscal years 2003 and 2002, respectively. Please see

Other beginning on page 27 for a consolidated discussion of general and administrative expense and depreciation and amortization expense.

Fiscal year ended June 30, 2004 as Compared to the Fiscal Year Ended June 30, 2003

SFS operating income before charges increased by \$2.1 million from fiscal year 2003 to fiscal year 2004. The following summarizes significant items:

Revenue decrease of \$8.4 million

ReALMS revenue decreased by \$14.4 million as it was terminated in January 2004

New revenue from the Lockheed Martin contract of \$7.8 million that replaced the ReALMS contract

ESP2 revenue decreased by \$4.5 million

The various other contract revenue decreased \$0.1 million

Recognized revenue from JETIS of \$2.8 million

Cost of Revenue decrease of \$10.5 million

Termination of Boeing's subcontract decreased cost of revenue by \$7.0 million

Reduced EADS subcontract costs in 2004 of \$3.6 million due to no missions in 2004

Decrease in asset depreciation in 2004 of \$1.8 million due to the loss of the RDM in fiscal year 2003

Decrease in other cost of revenue of \$0.3 million

Increase in internal labor costs of \$1.6 million due to bringing the integrations and operations of our modules in-house

Increase in selling, general and administrative expenses of \$0.6 million

All space shuttle missions have been suspended since the February 1, 2003 Space Shuttle *Columbia* accident affecting revenues and operating income of our SFS business unit for fiscal year 2004. Pending the return to flight of the space shuttle program, we have operated under equitable adjustments and subsequently in preparation for the

return to flight under the contractual arrangements in place prior to the accident. The equitable adjustment provides compensation for space flight assets committed for future contracted missions and for personnel and services in place to maintain those assets and support the return-to-flight activities.

Our SFS business unit is currently supporting NASA's return-to-flight activities and is continuing its operations in preparation for shuttle missions STS-114, 121, 116, and 118 (in order of their anticipated flight sequence). SFS is preparing a cargo carrier for STS-114, the External Stowage Platform 2 that will be deployed and permanently mounted to the ISS. SPACEHAB contracted directly with NASA's prime ISS contractor, Boeing, for the STS-114 mission. For STS-121, we are scheduled to provide our non-deployable ICC to NASA for transport of several critical ISS orbital replacement unit (ORU) spares. For both STS-116 and 118, missions previously placed under ReALMS, SPACEHAB is scheduled to provide its pressurized single module and its unpressurized non-deployable carrier for transport of critical cargo and ORUs to and from the ISS. We have completed negotiations with Boeing and NASA for the respective contract equitable adjustments required to continue uninterrupted support to ongoing mission preparation activities during the shuttle down period following the *Columbia* tragedy. As previously described, the ReALMS contract expired January 31, 2004 and support for missions STS-121, 116 and 118 is continuing under a subcontract agreement to Lockheed Martin, effective February 1, 2004. We are currently providing these services under letter agreement and we are in contract negotiations with Lockheed Martin for this new contract. Additionally, after April 15, 2004 SFS no longer is subcontracting its module mission integration, operations, and sustaining engineering technical support to Boeing. Most module mission tasks previously performed by Boeing personnel will now be performed by our SFS personnel and selected NASA cargo integration tasks on SPACEHAB module missions will now be performed by Lockheed Martin as a part of the CMC with NASA. This action enables SFS to continue providing services to NASA and is consistent with the direction of the ISS Program Office.

In January 2004, SPACEHAB initiated activity under the Japanese Experiment Thermal Incubator Service (JETIS) contract with the Mitsubishi Corporation, representing JAXA, that was entered into in 2000 and originally scheduled to fly aboard our RDM. Subsequent to the suspension of the space shuttle flights and destruction of our RDM, we contracted for construction of certain space research equipment and for research space aboard the ISS and up to three (3) Russian *Progress* cargo missions with V.J.F. Russian Consulting, representing RSC Energia, a major Russian aerospace manufacturer and mission operator.

Fiscal year ended June 30, 2003 as Compared to the Fiscal Year Ended June 30, 2002

SFS' operating income before charges decreased by \$6.1 million from fiscal year 2002 to fiscal year 2003. The following summarizes significant items:

Revenue decrease of \$4.7 million

ReALMS revenue decreased by \$8.8 million due to the completion of STS-107 and the grounding of the space shuttle fleet due to the STS-107 accident

ESP2 revenue increased by \$4.1 million due to the increased work on the project during fiscal year 2003 as compared to fiscal year 2002

Cost of Revenue increase of \$2.8 million

ESP2 cost of revenue increased by \$3.6 million due to the increased work on the project during fiscal year 2003 as compared to fiscal year 2002

ReALMS cost of revenue decreased by \$3.3 million primarily due to the closeout of STS-107

Increase of \$1.5 million in ICC and VCC lease costs in fiscal year 2003 as compared to fiscal year 2002 primarily due to a full year of VCC lease costs in fiscal year 2003

Increase in indirect costs of \$1.0 million due to recording certain costs that had been previously recorded as corporate costs as SFS indirect costs, such as, depreciation, insurance, benefits, etc

Our fiscal year 2003 operating income included a charge of approximately \$50.3 million, net of insurance proceeds of \$17.7 million on our loss of the RDM in the Space Shuttle *Columbia* tragedy. Also, due to the uncertainties in the human space flight programs following the *Columbia* accident, we decided to no longer fund certain work in process in development of future flight assets and recorded an impairment charge of \$7.9 million. During fiscal year 2003, we contracted for the RDM on shuttle mission STS-107, the ICC on STS-114, and the logistics single module and ICC on STS-116 and 118.

We participated in one space shuttle mission in fiscal year 2002 which included the ICC. In fiscal year 2003 we participated in one space shuttle mission which included our RDM. There were no space shuttle missions in our fiscal year 2004.

Astrotech Space Operations. Operating income for our ASO segment was \$17.5 million for fiscal year 2004, compared to \$4.5 million and \$3.8 million for fiscal years 2003 and 2002, respectively. Operating income for 2004 included selling, general and administrative expense of \$0.4 million and depreciation and amortization expense of \$2.0 million as compared to selling, general and administrative expense of \$0.5 million and \$0.9 million and depreciation and amortization expense of \$1.9 million and \$1.3 million for fiscal years 2003 and 2002, respectively. Please see "Other" beginning on page 27 for a consolidated discussion of selling, general and administrative expense and depreciation and amortization expense.

Fiscal year ended June 30, 2004 as Compared to the Fiscal Year Ended June 30, 2003

ASO's operating income before charges increased by \$15.5 million from fiscal year 2003 to fiscal year 2004. The following summarizes significant items:

Revenue increase of \$15.8 million

\$17.5 million early payment from Boeing termination of their financial guarantees partially offset by decreased Boeing missions in fiscal year 2004

Cost of Revenue increase of \$0.3 million

ASO supported 12 missions in 2004 versus 9 missions in 2003 which resulted in higher labor and benefit costs of \$0.2 million

Additional depreciation expense of \$0.2 million in 2004

Decrease in selling, general and administrative expense of \$0.1 million

Fiscal 2004 operating income for our ASO business unit included a contract early termination payment of \$17.5 million with regards to its financial guarantees under the contract agreement with Boeing for payload processing support services for the Delta launch vehicle program. Boeing indicated that the decision to terminate its guarantees for future Astrotech services was based on the downturn of the commercial expendable launch market rather than performance-related considerations. Astrotech was in full compliance with the contract terms at the time of the termination. Astrotech recognized the early termination payment as revenue in the quarter ended December 31, 2003. The termination of the Boeing contract guarantees had a significant impact on Astrotech's future guaranteed revenue stream. As the result of this event, the Company performed a goodwill impairment test at Astrotech in accordance with SFAS No. 142, "Goodwill and Intangible Assets." The impairment test indicated an impairment of Astrotech's remaining goodwill of approximately \$2.5 million which was recorded in the period ended December 31, 2003. The Company utilized market valuation techniques to calculate the fair value of Astrotech.

Fiscal year ended June 30, 2003 as Compared to the Fiscal Year Ended June 30, 2002

ASO's operating income before charges increased by \$0.7 million from fiscal year 2002 to fiscal year 2003. The following summarizes significant items:

Revenue increased by \$2.5 million from fiscal year 2002 to fiscal year 2003

ASO had nine launches in fiscal year 2003 as compared to seven launches for fiscal year 2002 which resulted in the \$2.5 million increase in revenue

Cost of Revenue increased by \$1.8 million

Increase is primarily due to increased facilities costs, as a result of ASO's new building in full operations for the entire fiscal year

Astrotech's operating expenses decreased \$0.4 million due to no longer recording amortization of goodwill of \$0.2 and reduction of \$0.2 million in financing fees that occurred in fiscal year 2002.

SPACEHAB Government Services. Operating income (loss) for our SGS business unit was (\$5.4) million for fiscal year 2004, compared to (\$10.0) million and \$2.0 million for fiscal years 2003 and 2002, respectively. Operating loss for 2004 included selling, general and administrative expense of \$1.3 million and depreciation and amortization expense of \$0.1 million as compared to selling, general and administrative expense of \$1.9 and \$2.0 and depreciation and amortization expense of \$0.7 million and \$1.6 million for fiscal years 2003 and 2002, respectively. Please see "Other" beginning on page 27 for a consolidated discussion of selling, general and administrative expense and depreciation and amortization expense.

Fiscal year ended June 30, 2004 as Compared to the Fiscal Year Ended June 30, 2003

SGS's operating income before charges decreased by \$1.6 million from fiscal year 2003 to fiscal year 2004. The following summarizes significant items:

Revenue decreased by \$24.5 million

The FCSD contract was completed April 30, 2003 which resulted in no revenue in fiscal year 2004 versus \$25.8 million in fiscal year 2003

Revenue recorded under the SEDC contract increased in fiscal year 2004 as compared to fiscal year 2003 of \$1.3 million due to increased project work in fiscal year 2004

The Configuration Management contract revenue decreased by \$2.4 million from fiscal year 2003 to fiscal year 2004 due to completion of the contract and the award of the PI&C contract in January 2004

The PI&A contract recognized revenue of \$2.8 million in fiscal year 2004 which was awarded in January 2004

Decrease in other contract revenue of \$0.4 million

Cost of revenue decreased by \$22.9 million

The FCSD contract was completed April 30, 2003 which resulted in \$23.9 million less cost of revenue in fiscal year 2004 as compared to fiscal year 2003

Cost of revenue increased under the SEDC contract in fiscal year 2004 as compared to fiscal year 2003 of \$1.5 million due to increased project work in fiscal year 2004

The Configuration Management cost of revenue decreased by \$1.9 million from fiscal year 2003 to fiscal year 2004 due to the completion of the contract and the award of the PI&C contract in January 2004

The PI&C cost of revenue for fiscal year 2004 was \$2.8 million which was awarded in January 2004

Decrease in Shanghai Scienceland project cost of revenue of \$0.3 million

Decrease in cost of revenue for the Destiny module of \$0.7 million in fiscal year 2004 as compared to fiscal year 2003 due to the projection completion in fiscal year 2003

Decrease in other cost of revenue of \$0.4 million

On November 5, 2003, NASA notified the Company that it was not awarded the ISS Mission Integration Contract. Additionally, the Boeing team's bid for the CMC with NASA, of which SGS was a subcontractor, was not selected for contract award. As a result of these events, we performed a goodwill impairment test at SGS in accordance with SFAS No. 142, Goodwill and Intangible Assets. The impairment test indicated an impairment of SGS's remaining goodwill of approximately \$5.7 million which was recorded in the period ended December 31, 2003. The Company utilized market valuation techniques to calculate fair value of SGS.

Fiscal year ended June 30, 2003 as Compared to the Fiscal Year Ended June 30, 2002

SGS's operating income before charges decreased by \$0.2 million from fiscal year 2002 to fiscal year 2003. The following summarizes significant items:

Revenue decreased by \$6.0 million from fiscal year 2002 to fiscal year 2003

The FCSD contract was completed April 30, 2003 which resulted in \$8.8 million less revenue in fiscal year 2003 as compared to fiscal year 2002

Revenue recorded under the SEDC contract, which was awarded in fiscal year 2003, was \$2.5 million

The Configuration Management contract revenue decreased by \$0.5 million from fiscal year 2002 to fiscal year 2003 due to decrease in project work

Other revenue increased by \$0.8 million

Cost of revenue decreased by \$6.2 million

The FCSD contract was completed April 30, 2003 which resulted in \$8.0 million less cost of revenue in fiscal year 2003 as compared to fiscal year 2002

Cost of revenue recorded under the SEDC contract, which was awarded in fiscal year 2003, was \$2.4 million

The Configuration Management cost of revenue decreased by \$0.4 million from fiscal year 2002 to fiscal year 2003 due to decrease in project work

In fiscal year 2002, there was \$1.0 million of cost of revenue for a project with Shanghai Scienceland that was completed in fiscal year 2002 with only minimum trailing costs in fiscal year 2003

Increase in other cost of revenue of \$0.8 million

As a result of the loss of the recomplete of the Flight Crew Systems Development contract at SGS in fiscal year 2003, a goodwill impairment test was performed. The impairment test indicated that the goodwill at SGS was impaired and a \$11.9 million impairment charge of goodwill was recorded.

Space Media, Inc. Operating loss before charges for our SMI business unit was (\$0.1) million for fiscal year 2004, compared to (\$0.3) million and (\$1.6) million for fiscal years 2003 and 2002, respectively. Operating loss for 2004 included selling, general and administrative expense of \$0.3 million and no depreciation and amortization expense as compared to selling, general and administrative expense of \$0.8 million and \$1.7 million and depreciation and amortization expense of \$0.3 million and \$0.3 million for fiscal years 2003 and 2002, respectively. Please see

Other below for a consolidated discussion of selling, general and administrative expense and depreciation and amortization expense.

Other. Other operating loss was (\$10.2) million for fiscal year 2004, compared to (\$18.2) million and (\$16.0) million for fiscal years 2003 and 2002 respectively. The \$10.2 million loss for fiscal year 2004 relates primarily to selling, general and administrative expenses and depreciation and amortization expenses which were incurred at the corporate level and an impairment charge of \$1.8 million of our investment in Guignè. The (\$18.2) million loss for fiscal year 2003 includes a \$8.2 million charge for asset impairments.

Consolidated selling, general and administrative expenses and research and development were \$11.1 million in fiscal year 2004, compared to \$13.2 million and \$19.9 million in 2003 and 2002, respectively. The \$2.1 million decrease for fiscal year 2004 to 2003 is principally the result of our ongoing cost reduction efforts and staffing reductions. In addition, for the year ended June 30, 2004, we recorded a charge of approximately \$0.3 million related to the closing of the Washington, D.C. office.

The \$6.7 million decrease for fiscal year 2002 to 2003 was primarily due to our Company-wide cost reduction actions. SMI's expenses decreased by \$1.0 million associated with the downsizing of the SMI operations during the year ended June 2002. SPACEHAB selling, general and administrative expenses were reduced by \$0.6 million in facilities, and \$0.5 million in depreciation and other expense. Astrotech's selling, general and administrative expense decreased \$0.4 million due to no longer recording amortization of goodwill of \$0.2 million and reduction of \$0.2 million in financing for that occurred in fiscal year 2002. SPACEHAB's selling, general and administrative expenses decreased due to the closing of the Huntsville operations partially offset by increased bid and proposal efforts.

Consolidated depreciation and amortization expenses were \$5.4 million in fiscal year 2004 compared to \$8.9 million and \$12.7 million in 2003 and 2002, respectively. The \$3.5 million decrease in fiscal year 2004 compared to 2003 is primarily due to the write-off of the RDM lost in the Space Shuttle *Columbia* accident, offset by the increased depreciation on the completion of the new SPF at the Astrotech Titusville, Florida campus. The decrease in depreciation of \$3.8 million for fiscal year 2003 as compared to 2002 resulted from the RDM having 12 months of depreciation in fiscal year 2002 as compared to seven months of depreciation in fiscal year 2003.

Interest Expense. Interest expense totaled \$8.2 million for fiscal year 2004, compared with \$7.2 million and \$8.0 million for 2003 and 2002, respectively. The \$1.0 million increase for 2004 as compared to 2003 resulted primarily from the termination of the interest rate swap upon restructuring our mortgage financing of our Astrotech SPF, partially offset by the lower interest payments on the lower mortgage amount after the restructuring.

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The decrease of interest expense from 2002 to 2003 was primarily due to the fact that no interest expense was capitalized in 2003 as compared to \$1.3 million of capitalized interest in 2002. In addition, fiscal year 2003 includes a full year of interest on the mortgage loan payable. Interest was capitalized on the in-progress construction of our modules and payload processing facilities in 2002.

Income Tax Provision (Benefit). For fiscal year 2004 we recorded an income tax provision of \$0.5 million, applying our net operating loss carry-forwards to the extent allowable. The income tax provision is a result of the alternative minimum tax limiting our ability to use all of our net operating loss carry forwards. We recorded an income tax benefit for fiscal years 2003 and 2002 of (\$0.9) million and (\$2.1) million, respectively. As of June 30, 2004, the Company had approximately \$22.0 million of available net operating loss carry-forwards expiring between 2008 and 2023 to offset future regular taxable income.

Inflation. The effects of inflation and changing prices have not significantly impacted the Company's revenue or income from continuing operations during the years ended June 30, 2004 and 2003.

FINANCIAL CONDITION, CAPITAL RESOURCES AND LIQUIDITY

Balance Sheet. Our total assets at June 30, 2004 were \$99.9 million compared to total assets of \$121.4 million at the end of fiscal year 2003. The following table sets forth the significant components of the balance sheet as of June 30, 2004, compared with 2003 (in thousands):

| | <u>2004</u> | <u>2003</u> | <u>Chg.</u> |
|--|------------------|-------------------|-------------|
| Assets: | | | |
| Current assets | \$ 15,950 | \$ 22,471 | \$ (6,521) |
| Property and equipment (net) | 79,600 | 83,689 | (4,089) |
| Other assets (net) | 4,375 | 15,196 | (10,821) |
| Total | \$ 99,925 | \$ 121,356 | |
| Liabilities and stockholders' equity: | | | |
| Current liabilities | \$ 22,301 | \$ 27,221 | \$ (4,920) |
| Long-term debt-less current portion | 66,942 | 80,056 | (13,114) |
| Other long-term liabilities | 1,272 | 8,989 | (7,717) |
| Stockholders' equity | 9,410 | 5,090 | 4,320 |
| Total | \$ 99,925 | \$ 121,356 | |

Fiscal Year 2004 Compared to 2003. Current assets as of June 30, 2004 decreased by \$6.5 million as compared to June 30, 2003, primarily due to a reduction in short-term investments of \$7.4 million, partially offset by an increase in accounts receivable of \$1.1 million. Short-term investments as of June 30, 2004 and June 30, 2003 included proceeds of the insurance settlement from loss of the RDM on the Space Shuttle *Columbia*. The increase in accounts receivable was primarily attributable to:

The increased volume of sales at Astrotech

Changing from NASA as our primary customer to a commercial customer

The decrease in property and equipment from June 30, 2003 to June 30, 2004 resulted primarily from the write-off of furniture, fixtures, equipment, and leasehold improvements from the closing of our Washington D.C. and Huntsville, AL offices and the relocation of those activities to our Houston facility. Net property and equipment decreased by \$4.1 million from 2003 to 2004 due to fixed asset additions during the year offset by depreciation expense for fiscal year 2004. Fiscal year 2004 included \$1.2 million for assets removed from the books upon closing of certain offices.

The decrease in other assets of \$10.8 million from June 30, 2003 to June 30, 2004 resulted primarily from the impairment of goodwill of \$8.3 million, impairment of an investment of \$1.8 million, and the reduction in deferred financing costs of \$1.3 million resulting from refinancing our Astrotech SPF mortgage and amortization of financing costs in the current fiscal year. These reductions were partially offset by an increase in other assets of \$0.6 million, primarily due to deferred mission costs for the Company's project with JAXA.

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Our current liabilities declined by \$5.0 million from June 30, 2003 to June 30, 2004. The following summarizes significant items:

We paid the balance of \$2.0 million on a convertible note to a shareholder, retiring the debt

The current portion of our mortgage loan declined by \$0.3 million due to the restructuring of the loan and the reduction of the total mortgage debt

We had an outstanding balance of \$1.4 million on our revolving credit facility at the end of the current fiscal year and no balance outstanding at June 30, 2003

Our accounts payable and accrued expenses declined from \$15.6 million to \$12.6 million due to the reduced volume of business at the end of the current fiscal year due to the termination of certain government contracts and the suspension of space shuttle flights

Our current portion of deferred revenue declined by \$1.0 million with the completion of the ReALMS contract in the current fiscal year

Our long-term debt as of June 30, 2004 decreased by \$13.1 million from the end of the prior fiscal year due primarily to the restructuring of our Astrotech facility mortgage. The restructuring included the repayment of \$9.5 million of principal and the termination of an interest rate swap of \$1.3 million held to effectively convert the floating rate interest on the mortgage into a fixed commitment. Our scheduled mortgage principal payments reduced the outstanding balance of this facility by \$2.3 million.

Other long-term liabilities declined by \$7.7 million at year end 2004 compared to 2003 due to a decrease in long-term deferred revenue, primarily from a contract with JAXA that was previously scheduled for a space shuttle mission, but due to the suspension of shuttle operations, we restructured the contract and placed the payload on a Russian *Progress* mission scheduled to fly early in our fiscal year 2005 with on-going flight operations support to 2006.

Cash Flows From Operating Activities. Cash provided by operations for the years ended June 30, 2004, 2003 (**Restated**), and 2002 was \$5.3 million, \$2.1 million, and \$8.6 million, respectively. The significant items affecting the differences in cash flows from operating activities in fiscal year 2004 compared to fiscal year 2003, and fiscal year 2003 compared to fiscal year 2002 are discussed below:

Fiscal Year 2004 Compared to 2003 (Restated). For the fiscal year 2004 compared to fiscal year 2003, the significant items affecting cash provided by operating activities were:

Net income for fiscal year 2004 was \$2.1 million compared to a net loss recorded in the prior fiscal year of \$81.8 million.

Included in fiscal year 2004 were charges for \$8.3 million of goodwill related to early termination of the Boeing satellite processing contract and certain SGS contracts in fiscal year 2004 and a charge of \$1.8 million of asset impairment for our investment in Guignè compared to charges of \$11.9 million of goodwill impairment, \$16.1 million of asset impairment, a nonrecurring charge of \$50.3 million and termination of the Enterprise project and certain SGS contract terminations in fiscal year 2003.

Charges for depreciation and amortization in fiscal year 2004 were \$3.5 million less than depreciation and amortization in fiscal year 2003 primarily resulting from the loss of our Research Double Module in fiscal year 2003.

Changes in assets and liabilities for fiscal year 2004 consumed cash from operations of \$13.3 million, primarily due to increases in accounts receivable and reductions in accounts payable as previously discussed as compared to use of \$3.7 million in fiscal year 2003 where a decrease in accounts receivable of \$7.0 million partially offset the reductions in accounts payable and accrued subcontracting costs. Deferred flight revenue decreased approximately \$8.9 million in each fiscal year resulting from the close-out of the ReALMS contract and the start-up of the JETIS contract.

Fiscal Year 2003 (Restated) Compared to 2002. For the fiscal year 2003 compared to fiscal year 2002, the significant items affecting cash provided by operating activities were primarily the net loss of \$81.8 million in fiscal year 2003 which included \$78.3 million of non-cash charges for the loss of our Research Double Module, asset impairment, and goodwill impairment. Other items that affected cash provided by operating activities in fiscal year 2003 as compared to fiscal year 2002 included the following:

Depreciation and amortization was approximately \$9.4 million for the period ended June 30, 2003 compared to \$13.4 million in the prior fiscal year resulting from the loss of our Research Double Module in February 2003 and amortization expense of \$1.1 million.

Changes in assets and liabilities for fiscal year 2003 consumed \$3.7 million of cash provided by operating activities as compared to \$2.1 million in fiscal year 2002, due primarily from a decrease in deferred revenue of \$8.9 million in fiscal year 2003 for three missions under

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contract, STS-116, STS-118 and STS-114 compared to a decrease in deferred revenue of \$1.3 million in fiscal year 2002, an increase in accounts payable and accrued expenses of \$0.6 million in fiscal year 2003 compared to a decrease in accounts payable and accrued expenses of \$6.1 million in fiscal year 2002 and a decrease in accounts receivable of \$7.0 million in fiscal year 2003 compared to a decrease of \$4.2 million in fiscal year 2002.

Cash Flows From Investing Activities. For the years ended June 30, 2004, 2003 (**Restated**), and 2002, cash flows provided by (used in) investing activities were \$5.0 million, \$3.0 million, and \$(13.2) million. The significant items affecting the differences in cash flows from investing activities in fiscal year 2004 compared to fiscal year 2003 and fiscal year 2003 compared to fiscal year 2002 are discussed below:

Fiscal Year 2004 Compared to 2003 (Restated). For the fiscal year 2004 compared to fiscal year 2003, the significant items affecting cash flows used in investing activities for 2004 were the sale of \$7.4 million of short term investments offset by the use of \$2.1 million cash flow for purchases of property and equipment, payments for buildings under construction and payments for flight assets under construction. The significant items affecting cash flows used in investing activities for 2003 were purchase of short term investments of \$14.0 million and \$2.1 million cash flow for purchases and payments, offset with insurance proceeds of \$17.7 million resulting from the loss of our Research Double Module on the Space Shuttle *Columbia*.

Fiscal Year 2003 (Restated) Compared to 2002. For the fiscal year 2003 compared to fiscal year 2002, the significant items affecting cash flow used in investing activities were as follows:

During fiscal year 2003, the primary change in the cash used in investing activities was due to the increase in the Company's investments of \$14.0 million primarily as the result of the commercial insurance received from the loss of our Research Double Module which is offset with those insurance proceeds of \$17.7 million related to the loss of our Research Double Module on the Space Shuttle *Columbia*.

Approximately \$15.4 million was spent in fiscal year 2002 for buildings under construction and equipment, primarily for the expansion of Astrotech's payload processing facilities in Titusville, Florida.

During fiscal year 2002, the Company's expenditures for flight assets under construction related primarily to the completion of the VCC for sale to EADS, adapter plates for unpressurized ICC and VCC missions, and for additional development work on the *Enterprise* module. The Company received \$4.4 million in services payments for the sale of its VCC assets to EADS and received \$1.4 million in cash, primarily for the Oriole sounding rocket business and the Clear Lake Industries sales.

Cash Flows From Financing Activities. For the years ended June 30, 2004, 2003, and 2002, cash flows (used in) provided by financing activities were (\$11.1) million, (\$6.5) million, and \$7.2 million, respectively. In January 2004 we restructured our mortgage financing of our Astrotech Titusville SPF as a three-year fixed-rate loan by reducing the outstanding balance by \$9.5 million, and terminating the interest rate swap in place at a cost of \$1.3 million. Also during fiscal year 2004, the Company paid the outstanding balance on the loan from Alenia of \$2.0 million. During fiscal year 2003, we repaid approximately \$6.3 million of debt including the New Credit Facility which expired and was repaid in July 2002, \$2.0 million on the mortgage loan, and \$1.9 million on the loan from Alenia. During fiscal year 2002, we received \$20.0 million related to the financing of the Astrotech SPF in Titusville, Florida and repaid approximately \$0.9 million of the loan. We repaid \$4.0 million of the loan payable, \$4.0 million of the note payable to shareholder, and repaid in full \$0.3 million of the note payable to insurers. In addition, we repaid \$4.6 million of the New Credit Facility during fiscal year 2002.

Liquidity. Our liquidity has been constrained over the previous three fiscal years. A significant portion of this constraint arose from funding of new operations and assets in development to support future Company growth, funding a portion of the construction cost of the Astrotech Florida facility, and funding of required debt repayments. In addition, the Company was committed to capital investments to complete certain flight assets.

Beginning in the third quarter of fiscal year 2001, we began an aggressive multi-faceted plan to improve the Company's financial position and liquidity. This plan included restructuring and repayment of certain debt obligations.

Under this plan, the Company undertook extensive efforts to reduce cash required for both operations and capital investments. Additionally, we completed planned divesting of non-core assets. Development and construction of new assets is currently limited to those assets required to fulfill existing commitments under contract. The Company has no further on-going commitments to fund development or construction of any asset. We completed the planned restructuring of certain debt obligations and continue to focus on reducing our outstanding debt. We completed the implementation of the plan in the fourth quarter of fiscal year 2002.

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On March 25, 2003, the Board of Directors authorized the Company to repurchase up to \$1.0 million of the Company's outstanding Common Stock at market prices. Any purchases under the Company's stock repurchase program may be made from time-to-time, in the open market, through block trades or otherwise in accordance with applicable regulations of the SEC. Through June 30, 2004, the Company had repurchased 116,100 shares at a cost of \$117,320. We will continue to evaluate the stock repurchase program and the funds authorized for the program.

The Company was under contract with NASA to support the STS-107 mission on its *Columbia* orbiter. The mission utilized our RDM flight asset. On February 1, 2003, the RDM was lost in the tragic STS-107 accident. The RDM

was partially covered by commercial insurance. During the three months ended March 31, 2003, the Company received \$17.7 million from commercial insurers. We do not plan on replacing the RDM. SPACEHAB has two additional modules available to support the Company's current NASA contracts. In January 2004, we submitted a detailed claim to NASA for recovery of our RDM investment in the amount of \$87.7 million. We believe we have a basis for recovery of some or all of the loss from NASA but there can be no assurance as to the timing or the amount, if any, to be received from the claim. Upon resolution of the claim, any proceeds from NASA would be recorded in the period in which the claim is resolved.

We continue to focus our efforts on improving the overall liquidity of the Company through identifying new business opportunities within the areas of our core competencies, reducing operating expenses, limiting cash commitments for future capital investments and new asset development. Please read the discussion of liquidity in the overview section (page 17) in conjunction with this section.

The Company's cash and short-term investments are approximately \$7.6 million as of June 30, 2004. We believe that the Company has sufficient liquidity to fund ongoing operations for at least the next fiscal year and expect to utilize existing cash and any potential payment from NASA to support strategies for new business initiatives and reduce debt service requirements. However, under certain scenarios the Company could be facing liquidity concerns after that point in time.

Contractual Obligations. The Company's contractual obligations as of June 30, 2004 are as follows (in thousands):

| Contractual Obligations | Total | Less than | | | Thereafter |
|---|------------------|-----------------|-----------------|------------------|-----------------|
| | | 1 year | 1-3 years | 3-5 years | |
| Long-term Debt | \$ 63,250 | \$ | \$ | \$ 63,250 | \$ |
| Loan payable under credit facility | 1,445 | 1,445 | | | |
| Mortgage Loan Payable | 5,638 | 1,946 | 3,692 | | |
| V.J.F. Russian Consultant Agreement | 360 | 180 | 180 | | |
| V.J.F. Russian Subcontract | 1,400 | 1,000 | 400 | | |
| Capital Leases | 67 | 67 | | | |
| Operating leases ¹ | 10,208 | 4,715 | 2,109 | 532 | 2,852 |
| Total Contractual Cash Obligations² (excluding interest payments) | \$ 82,368 | \$ 9,353 | \$ 6,381 | \$ 63,782 | \$ 2,852 |

¹ For fiscal years 2005, 2006, 2007, and 2008, the Company expects to receive net payments of approximately \$0.7 million, \$0.7 million, \$0.5 million, \$0.2 million, respectively, for subleases.

² Does not include commitment to Dayna Justiz for compensation that can be earned as a result of the agreement dated June 19, 2000. The agreement states that Dayna Justiz can earn up to \$375,000 as additional compensation if she meets certain financial goals in the management of The Space Store. The yearly amount is equal to five percent of the Space Store's net after-tax operating income during each fiscal year until such time an aggregate amount of \$375,000 has been earned. At this time, we have not recorded a liability for this obligation due to the uncertainty of the obligation being met.

UNCERTAINTY OF FORWARD-LOOKING STATEMENTS AND INFORMATION

This Form 10-K includes statements reflecting assumptions, expectations, projections, intentions, or beliefs about future events that are intended as forward-looking statements. All statements included or incorporated by reference in this annual report, other than statements of historical fact, that address activities, events, or developments that we or our management expect, believe, or anticipate will or may occur in the future are forward-looking statements. These statements represent our reasonable judgment on the future based on various factors and using numerous assumptions and are subject to known and unknown risks, uncertainties, and other factors that could cause our actual results and financial position to differ materially from those contemplated by the statements. These statements can be identified by the fact that they do not relate

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strictly to historical or current facts. They use words such as anticipate, estimate, project, forecast, plan, may, will, should, expect, words of similar meaning. In particular, these include but are not limited to, statements relating to the following:

Projected operating or financial results, including anticipated cash flows from operations and asset sale proceeds for fiscal year 2005

Expectations regarding capital expenditures, interest expense, and other payments

Our ability to execute the cost-saving measures we have identified

Our beliefs and assumptions relating to our liquidity position

The ultimate conclusion of our claim for indemnification for losses on the Space Shuttle *Columbia* accident

Our beliefs about the outcome of legal and administrative proceedings, in particular the outcome of the claims made by Lloyds of London regarding insurance proceeds they have paid to us

Any or all of our forward-looking statements may turn out to be wrong. They can be affected by inaccurate assumptions or by known or unknown risks, uncertainties, and other factors including, among others:

The continuation of the U.S. space exploration program

Congressional funding for NASA at levels that will support the programs that affect our business

The ultimate return to flight of the space shuttle and the frequency and configuration of flights after returning to flight

Our ability to compete in the market place to preserve our contracts upon the re-compete cycles and to acquire additional contracts

Our ability to operate our businesses efficiently, manage capital expenditures and costs (including general and administrative expenses) tightly, and generate earnings and cash flow from our asset-based businesses in relation to our debt and other obligations

The costs and other effects of legal and administrative proceedings, settlements, investigations, and claims, including legal proceedings related to our claim against NASA in regards to the *Columbia* accident and the related claim by Lloyds of London

General political conditions and developments in the U.S. and in foreign countries whose affairs affect our businesses

In addition, there may be other factors that could cause our actual results to be materially different from the results referenced in the forward-looking statements, some of which are included elsewhere in this Form 10-K. Many of these factors will be important in determining our actual future results. Consequently, no forward-looking statement can be guaranteed. Our actual future results may vary materially from those expressed or implied in any forward-looking statements.

All forward-looking statements contained in this Form 10-K are qualified in their entirety by this cautionary statement. Forward-looking statements speak only as of the date they are made, and we disclaim any obligation to update any forward-looking statements to reflect events or circumstances after the date of this Form 10-K, except as otherwise required by applicable law.

Item 8. Financial Statements and Supplementary Data.

Report of Independent Registered Public Accounting Firm

The Board of Directors and Stockholders

SPACEHAB, Incorporated and Subsidiaries:

We have audited the accompanying consolidated balance sheet of SPACEHAB, Incorporated and subsidiaries (the Company) as of June 30, 2004, and the related consolidated statements of operations, stockholders' equity and comprehensive income (loss) and cash flows for the year then ended June 30, 2004. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audit.

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 consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of the Company as of June 30, 2004, and the results of their operations and their cash flows for the year then ended, in conformity with accounting principles generally accepted in the United States of America.

/s/ Grant Thornton LLP

Houston, Texas

September 2, 2004

Report of Independent Registered Public Accounting Firm

The Stockholders and Board of Directors

SPACEHAB, Incorporated and Subsidiaries:

We have audited the accompanying consolidated balance sheet of SPACEHAB, Incorporated and subsidiaries (the Company) as of June 30, 2003, and the related consolidated statements of operations, stockholders' equity and comprehensive income (loss), and cash flows for each of the two years in the period ended June 30, 2003. 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 audits.

We conducted our audits 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 audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of SPACEHAB, Incorporated and subsidiaries as of June 30, 2003 and the consolidated results of their operations and their cash flows for each of the two years in the period ended June 30, 2003, in conformity with U.S. generally accepted accounting principles.

As discussed in Note 26 to the consolidated financial statements, the consolidated statement of cash flows for the year ended June 30, 2003 has been changed from that on which we reported previously to correct the classification of insurance proceeds received as a result of the loss of the Company's research double module.

As discussed in Note 2 to the consolidated financial statements, the Company adopted Statement of Financial Accounting Standards No. 142, Goodwill and Other Intangible Assets, effective July 1, 2002.

/s/ Ernst & Young LLP

McLean, Virginia

August 20, 2003

except for Note 26 as to which the date is

July 11, 2005

SPACEHAB, INCORPORATED AND SUBSIDIARIES

Consolidated Balance Sheets

(In thousands, except share data)

| | June 30, | |
|---|------------------|-------------------|
| | 2004 | 2003 |
| Assets | | |
| Current assets | | |
| Cash and cash equivalents | \$ 506 | \$ 1,301 |
| Restricted cash | 430 | |
| Short-term investments | 5,037 | 14,047 |
| Restricted short-term investments | 1,604 | |
| Accounts receivable, net | 7,878 | 6,780 |
| Prepaid expenses and other current assets | 495 | 343 |
| Total current assets | 15,950 | 22,471 |
| Property and equipment | | |
| Flight assets | 64,476 | 63,970 |
| Module improvements in progress | 913 | 305 |
| Payload processing facilities | 45,895 | 46,026 |
| Furniture, fixtures, equipment and leasehold improvements | 18,071 | 22,088 |
| | 129,355 | 132,389 |
| Less accumulated depreciation and amortization | (49,755) | (48,700) |
| Property and equipment, net | 79,600 | 83,689 |
| Goodwill, net | | 8,274 |
| Investment in Guignè, net | | 1,800 |
| Deferred financing costs, net | 1,163 | 2,182 |
| Other assets, net | 3,212 | 2,940 |
| Total assets | \$ 99,925 | \$ 121,356 |
| Liabilities and Stockholders Equity | | |
| Current liabilities | | |
| Revolving loan payable | \$ 1,445 | \$ |
| Convertible notes payable to shareholder, current portion | | 2,004 |
| Mortgage loan payable, current portion | 1,946 | 2,218 |
| Accounts payable | 2,424 | 3,231 |
| Accounts payable- EADS | 3,262 | 7,824 |
| Accrued interest | 1,108 | 1,365 |
| Accrued expenses | 3,600 | 2,687 |
| Accrued subcontracting services | 2,176 | 522 |
| Deferred revenue, current portion | 6,340 | 7,370 |
| Total current liabilities | 22,301 | 27,221 |
| Accrued contract costs and other | 372 | 255 |
| Deferred revenue, net of current portion | 900 | 8,734 |

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| | | |
|--|-------------------|-------------------|
| Mortgage loan payable, net of current portion | 3,692 | 16,806 |
| Convertible subordinated notes payable | 63,250 | 63,250 |
| | <u> </u> | <u> </u> |
| Total liabilities | 90,515 | 116,266 |
| | <u> </u> | <u> </u> |
| Commitments and contingencies | | |
| Stockholders' equity | | |
| Preferred stock, no par value, convertible, authorized 2,500,000 shares, issued and outstanding 1,333,334 shares, (liquidation preference of \$12,000) | 11,892 | 11,892 |
| Common stock, no par value, 30,000,000 shares authorized 12,688,062 and 12,484,779 shares issued, respectively | 83,751 | 83,446 |
| Treasury stock, 116,100 and 109,800 shares, respectively, at cost | (117) | (111) |
| Additional paid-in capital | 16 | 16 |
| Accumulated other comprehensive loss | | (1,946) |
| Accumulated deficit | (86,132) | (88,207) |
| | <u> </u> | <u> </u> |
| Total stockholders' equity | 9,410 | 5,090 |
| | <u> </u> | <u> </u> |
| Total liabilities and stockholders' equity | \$ 99,925 | \$ 121,356 |
| | <u> </u> | <u> </u> |

See accompanying notes to consolidated financial statements.

SPACEHAB, INCORPORATED AND SUBSIDIARIES

Consolidated Statements of Operations

(In thousands, except share and per share data)

| | Year ended June 30, 2004 | Year ended June 30, 2003 | Year ended June 30, 2002 |
|--|--------------------------------|--------------------------------|--------------------------------|
| Revenue | \$ 77,606 | \$ 94,963 | \$ 102,773 |
| Costs of revenue | 45,678 | 78,791 | 81,767 |
| Gross profit | 31,928 | 16,172 | 21,006 |
| Operating expenses | | | |
| Selling, general and administrative | 10,908 | 13,098 | 18,737 |
| Loss on subleases | | | 770 |
| Research and development | 223 | 118 | 383 |
| Nonrecurring charge, loss of Research Double Module | | 50,268 | |
| Goodwill impairment | 8,274 | 11,925 | |
| Asset impairment charge | 1,800 | 16,143 | |
| Total operating expenses | 21,205 | 91,552 | 19,890 |
| Income (loss) from operations | 10,723 | (75,380) | 1,116 |
| Interest expense, net of capitalized interest | (8,237) | (7,243) | (6,683) |
| Interest and other income (expense), net | 95 | (9) | 1,150 |
| Income (loss) before income taxes | 2,581 | (82,632) | (4,417) |
| Income tax expense (benefit) | 506 | (857) | (2,050) |
| Net income (loss) | \$ 2,075 | \$ (81,775) | \$ (2,367) |
| Net income (loss) per share - basic | \$ 0.17 | \$ (6.66) | \$ (0.20) |
| Shares used in computing net income (loss) per share basic | 12,450,320 | 12,285,467 | 11,884,309 |
| Net income (loss) per share - diluted | \$ 0.15 | \$ (6.66) | \$ (0.20) |
| Shares used in computing net income (loss) per share diluted | 14,141,949 | 12,285,467 | 11,884,309 |

See accompanying notes to consolidated financial statements.

SPACEHAB, INCORPORATED AND SUBSIDIARIES

Consolidated Statements of Stockholders' Equity and Comprehensive Income (Loss)

(In thousands, except share data)

| | Convertible Preferred Stock | | Common Stock | | Treasury Stock | Add I. Paid-In- Capital | Accumulated Other Comprehensive Income (Loss) | Accumulated Deficit | Total Stockholders' Equity |
|--|-----------------------------|-----------|--------------|-----------|-------------------|-------------------------------|---|------------------------|----------------------------------|
| | Shares | Amount | Shares | Amount | Amount | | | | |
| Balance at June 30, 2001 | 1,333,334 | \$ 11,892 | 11,528,145 | \$ 82,513 | \$ | \$ 16 | \$ | \$ (4,065) | \$ 90,356 |
| Common stock issued under bonus plan | | | 224,635 | 350 | | | | | 350 |
| Common stock issued under employee stock purchase plan | | | 401,685 | 341 | | | | | 341 |
| Accumulated other comprehensive loss | | | | | | | (1,010) | | (1,010) |
| Net loss | | | | | | | | (2,367) | (2,367) |
| Total comprehensive loss | | | | | | | | | (3,377) |
| Balance at June 30, 2002 | 1,333,334 | \$ 11,892 | 12,154,465 | \$ 83,204 | \$ | \$ 16 | \$ (1,010) | \$ (6,432) | \$ 87,670 |
| Common stock issued under employee stock purchase plan | | | 230,314 | 152 | | | | | 152 |
| Common stock issued under settlement | | | 100,000 | 90 | | | | | 90 |
| Treasury stock purchased, 109,800 shares | | | | | (111) | | | | (111) |
| Accumulated other comprehensive loss | | | | | | | (936) | | (936) |
| Net loss | | | | | | | | (81,775) | (81,775) |
| Total comprehensive loss | | | | | | | | | (82,711) |
| Balance at June 30, 2003 | 1,333,334 | \$ 11,892 | 12,484,779 | \$ 83,446 | \$ (111) | \$ 16 | \$ (1,946) | \$ (88,207) | \$ 5,090 |
| Common stock options exercised | | | 133,246 | 225 | | | | | 225 |
| Common stock issued under employee stock purchase plan | | | 70,037 | 80 | | | | | 80 |
| Treasury stock purchased, 6,300 shares | | | | | (6) | | | | (6) |
| Accumulated other comprehensive income | | | | | | | 1,946 | | 1,946 |
| Net income | | | | | | | | 2,075 | 2,075 |
| Total comprehensive income | | | | | | | | | 4,021 |
| Balance at June 30, 2004 | 1,333,334 | \$ 11,892 | 12,688,062 | \$ 83,751 | \$ (117) | \$ 16 | \$ | \$ (86,132) | \$ 9,410 |

See accompanying notes to consolidated financial statements.

SPACEHAB, INCORPORATED AND SUBSIDIARIES

Consolidated Statements of Cash Flows

(In thousands)

| | Year ended June 30, 2004 | Year ended June 30, 2003 (Restated) | Year ended June 30, 2002 |
|--|-----------------------------|---|-----------------------------|
| Cash flows from operating activities | | | |
| Net income (loss) | \$ 2,075 | \$ (81,775) | \$ (2,367) |
| Adjustments to reconcile net income (loss) to net cash provided by operating activities: | | | |
| Nonrecurring charge, loss of Research Double Module | | 50,268 | |
| Goodwill impairment | 8,274 | 11,925 | |
| Asset impairment charge | 1,800 | 16,143 | |
| (Gain) loss on sale and write-offs of property and equipment | 615 | | (1,096) |
| Loss on subleases | | | 770 |
| Depreciation and amortization, including deferred debt issuance costs | 5,883 | 9,385 | 13,414 |
| Write-off of debt placement fees | 567 | | |
| Loss on interest rate swap | (613) | | |
| Other | | (146) | |
| Changes in assets and liabilities: | | | |
| (Increase) decrease in accounts receivable | (1,098) | 7,022 | 4,211 |
| (Increase) decrease in prepaid expenses and other current assets | (152) | 120 | 917 |
| Increase in other assets | (272) | (21) | (691) |
| (Decrease) increase in accounts payable, accrued expenses, and accrued interest | (4,596) | 575 | (6,135) |
| Increase (decrease) in accrued subcontracting services | 1,654 | (2,521) | 831 |
| Decrease in deferred revenue | (8,864) | (8,861) | (1,262) |
| Net cash provided by operating activities | 5,273 | 2,114 | 8,592 |
| Cash flows from investing activities | | | |
| Payments for flight assets under construction | (609) | (161) | (2,600) |
| Payments for building under construction and leasehold improvements | (71) | (1,003) | (15,409) |
| Purchases of property and equipment | (1,410) | (294) | (983) |
| Investments in restricted cash | (430) | | |
| Sale of Vertical Cargo Carrier | | | 4,400 |
| Proceeds from state grant | | 750 | |
| Proceeds from sale of property and equipment | 133 | 125 | 1,425 |
| Proceeds from insurance | | 17,667 | |
| Sale (purchase) of short-term investments | 7,406 | (14,047) | |
| Net cash provided by (used in) investing activities | 5,019 | 3,037 | (13,167) |
| Cash flows from financing activities | | | |
| Payments of note payable to insurers | | | (333) |
| Net borrowings (repayments) under revolving loan payable | 1,445 | (2,150) | (4,600) |
| Payments of note payable | | (218) | (4,047) |
| Payments of note payable to shareholder | (2,004) | (1,862) | (3,994) |
| Proceeds from sale of minority interest in SMI | | | 750 |
| Purchase of minority interest | | (315) | |
| Proceeds from mortgage loan | | | 20,000 |
| Payment of interest rate swap | (1,333) | | |
| Payment of mortgage loan | (9,494) | (2,039) | (882) |

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| | | | |
|---|-------------------|-------------------|-------------------|
| Purchase of treasury stock | (6) | (111) | |
| Proceeds from issuance of common stock, net of expenses | 305 | 151 | 341 |
| | <u> </u> | <u> </u> | <u> </u> |
| Net cash (used in) provided by financing activities | (11,087) | (6,544) | 7,235 |
| | <u> </u> | <u> </u> | <u> </u> |
| Net increase (decrease) in cash and cash equivalents | (795) | (1,393) | 2,660 |
| Cash and cash equivalents at beginning of year | 1,301 | 2,694 | 34 |
| | <u> </u> | <u> </u> | <u> </u> |
| Cash and cash equivalents at end of year | \$ 506 | \$ 1,301 | \$ 2,694 |
| | <u> </u> | <u> </u> | <u> </u> |

See accompanying notes to consolidated financial statements.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(1) Description of the Company and Operating Environment

SPACEHAB is a developer and operator of space flight hardware assets, a provider of manned and unmanned payload processing services, and an entrepreneurial force in space commerce applications.

A substantial portion of our revenue has been generated under contracts with the National Aeronautics and Space Administration (NASA). The Company's contracts are subject to periodic funding allocations by NASA. NASA's funding is dependent on receiving annual appropriations from the U.S. Government. During the years ended June 30, 2004, 2003, and 2002 approximately 54%, 77%, and 81% of the Company's revenues were generated under U.S. Government contracts, respectively.

The SPACEHAB Flight Services (SFS) business unit is continuing operations pending return to flight of the U. S. space shuttle program, supporting four of the next six planned space shuttle missions through the use of our pressurized laboratory and logistics supply modules and integrated cargo carrier (ICC) system, which significantly enhances the capabilities of the space shuttle fleet. We are in negotiations with Lockheed Martin Corporation (Lockheed Martin) and The Boeing Company (Boeing) to finalize contract provisions for these missions and for equitable adjustments for asset maintenance and contracted preparation activities during the period prior to NASA's return to flight.

Our most recent mission was STS-107 on NASA's *Columbia* orbiter, which utilized our research double module (RDM). The RDM was lost in the tragic accident (see note 21), and at this time we do not plan to replace this asset. SFS has two additional modules and other flight assets available to support the Company's current contracts. These modules and assets can also be used to support future NASA requirements.

In January 2004, the Company submitted a detailed claim for recovery of its RDM investment to NASA in the amount of \$87.7 million. In June 2004, SPACEHAB mutually agreed with NASA to waive the Agency's response date of June 24, 2004 on our contract claim for indemnification. The contractually stipulated indemnification is \$8.0 million but NASA's reconciliation of the losses under Federal Acquisition Regulations approximate \$47.4 million. In the event an acceptable resolution cannot be reached, SPACEHAB has the right to file for administrative and/or judicial review of its claim for indemnification. We believe we have a basis for recovery of the loss from NASA but there can be no assurance as to the timing or the amount, if any, to be received from the claim. Upon resolution of the claim, any proceeds from NASA would be recorded in the period in which the claim is resolved.

The Company's Astrotech Space Operations (Astrotech) subsidiary provides commercial satellite launch processing services and payload processing facilities in the U.S. These services are offered at the Astrotech facilities in Titusville, Florida and Vandenberg Air Force Base in California, and are provided on a fixed-price basis. Additionally, Astrotech supplies payload processing and facilities maintenance support services to Sea Launch Company, LLC for its Sea Launch program at the Home Port facilities in Long Beach, California.

Future growth of Astrotech's business base is linked to the prospects for new commercial satellite manufacturing orders and an increased market-share in the government satellite processing sector. Activity in the commercial market fell sharply in 2000 as telecom and Internet-related investments plunged, but independent observers expect a rebound ahead in the telecommunications market. Experts point to the aging of existing commercial geostationary communications satellites — up to 100 of which will reach the end of their service lives in the next five years — increased bandwidth demands from the U.S. Department of Defense, and an increasing market for satellite-based broadband services.

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Our SPACEHAB Government Services subsidiary manages projects in need of comprehensive engineering solutions and provides unique capabilities such as specialty engineering, hardware design and development, and configuration and data management. SPACEHAB Government Services (SGS) also designs and fabricates space flight hardware. We continuously review and seek new business opportunities with NASA, either through current contract expansion or teaming with other aerospace companies on new contract bid initiatives.

A majority-owned subsidiary of SPACEHAB, Space Media, Inc., is a provider for the space enthusiast. From outfitting a comprehensive space exhibit, to providing astronaut product endorsements, Space Media, Inc. (SMI) brings space down to Earth. Formed in April 2000, SMI has access to myriad engineers, marketing and industry professionals, and aerospace subcontractors, all prepared to apply their knowledge and expertise to support various space-related needs. The retail business of SMI continues to maintain steady sales and is exploring new market opportunities.

In fiscal year 2000, SPACEHAB began design and construction of a commercial space station habitat module, in partnership with RSC Energia of Korolev, Russia. Named *Enterprise*, this multipurpose module was intended to be attached to the International Space Station (ISS) for habitation, laboratory, and stowage space; communications; power; and other utilities. In evaluating our investment in *Enterprise* in June 2003, the Company identified significant uncertainties in new human space flight programs. We ceased funding development and were unable to determine if or when this investment would be recovered. Therefore, we wrote down the full investment of \$8.2 million as of June 30, 2003.

We believe that NASA, as well as future space shuttle and ISS programs will continue to be funded and supported by the U.S. Government. Furthermore, we believe that it is highly unlikely that any decision to discontinue these programs would be made during the next twelve months. However, the Company is subject to risks and uncertainties. We continue to focus efforts on improving the overall liquidity of the Company through identifying new business opportunities within the areas of our core competencies, reducing operating expenses and limiting cash commitments for future capital investments and new asset development.

The Company's cash and short-term investments are approximately \$7.6 million as of June 30, 2004, which includes \$2.0 million of restricted cash and short-term investments. We believe the Company has sufficient liquidity to fund ongoing operations for at least the next fiscal year and expect to utilize existing cash and any potential payment from NASA to support strategies for new business initiatives and reduce debt service requirements. However, under certain scenarios the Company could be facing liquidity concerns after that point in time.

(2) Summary of Significant Accounting Policies

Principles of Consolidation and Basis of Presentation

The consolidated financial statements include the accounts of SPACEHAB, Incorporated and its wholly-owned and majority-owned subsidiaries: Astrotech Space Operations (ASO), SGS, and SMI. All significant intercompany transactions have been eliminated in consolidation.

Cash and Cash Equivalents

The Company considers short-term investments with original maturities of three months or less to be cash equivalents. Cash equivalents are primarily made up of money market investments and overnight repurchase agreements recorded at cost, which approximate market value.

Investments

The Company accounts for investments in accordance with Statements of Financial Accounting Standards No. 115, Accounting for Certain Investments in Debt and Equity Securities. In fiscal year 2003 we began investing the insurance proceeds from the RDM loss in certain debt securities, primarily U.S. government and government agency securities. The Company designated all of its investments as of June 30, 2004, and 2003 to be available for sale and has classified these as current based on their intent to use these securities in operations during fiscal year 2005.

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For the years ended June 30, 2002, 2003, and 2004, interest income was immaterial. Interest income is recorded as a component of other income (expense).

Available-for-sale securities are recorded at fair value on the balance sheet, with the change in fair value during the period excluded from earnings and recorded as a component of other comprehensive income. As of June 30, 2004 and 2003, the fair market value of these securities approximated cost. Maturities of the debt securities held by the Company range from April 13, 2005 to September 29, 2006. For securities sold during 2004 and 2003, the Company had no gross realized gains or losses.

Property and Equipment

Property and equipment are stated at cost. All furniture, fixtures, and equipment are depreciated using the straight-line method over the estimated useful lives of the respective assets, which is generally five years. The Company's payload processing facilities are depreciated using the straight-line method over their estimated useful lives ranging from sixteen to forty-three years.

Effective January 1, 2002, the Company extended the estimated useful lives of its space flight assets, which is a component of property and equipment, through June 30, 2016. This change in accounting estimate is treated prospectively and is based on current available space-related programs and activities which extend the expected life of the ISS and space shuttles from 2012 through at least 2016.

Leasehold improvements are amortized over the shorter of the useful life of the building or the term of the lease. Repairs and maintenance are expensed when incurred.

Goodwill

The excess of the cost over the fair value of net tangible and identifiable intangible assets acquired in business combinations accounted for as a purchase has been assigned to goodwill. Goodwill was previously amortized on a straight-line basis over five to twenty-five years.

In June 2001, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards (SFAS) No. 141, Business Combinations, and SFAS No. 142, Goodwill and Other Intangible Assets, effective for fiscal years beginning after December 15, 2001. Under these standards, goodwill is no longer amortized but is subject to annual impairment tests in accordance with SFAS 142. Intangible assets that are not determined to have indefinite lives will continue to be amortized over their useful lives. The Company adopted these standards effective July 1, 2002.

Goodwill is related to the acquisition of Astrotech on February 12, 1997, SGS on July 1, 1998, and The Space Store on June 28, 2000, the retail operations of Space Media, Inc. The Company is required to analyze goodwill at least annually for impairment issues. Should an indicator of impairment occur earlier than the annual analysis date, the Company will analyze the goodwill of the affected business unit at that time (see note 20). As of June 30, 2004, all goodwill has been written off.

The Company's results of operations prior to fiscal year 2003 do not reflect the provisions of SFAS No. 142. A reconciliation of previously reported net loss adjusted for the exclusion of goodwill amortization, net of tax, is as follows (in thousands, except per share data):

| | Year Ended June 30, | | |
|---|---------------------|-------------|------------|
| | 2004 | 2003 | 2002 |
| Net income (loss) as reported | \$ 2,075 | \$ (81,775) | \$ (2,367) |
| Add back goodwill amortization, net of tax | | | 1,053 |
| Adjusted net income (loss) | 2,075 | (81,775) | (1,314) |
| Basic net income (loss) per share as reported | 0.17 | (6.66) | (0.20) |
| Goodwill amortization, net of tax | | | 0.09 |
| Adjusted basic income (loss) per share | 0.17 | (6.66) | (0.11) |

Investments in Affiliates

We use the equity method of accounting for our investments in, and earnings of, investees in which we exert significant influence. In accordance with the equity method of accounting, the carrying amount of such an investment is initially recorded at cost and is increased to reflect the Company's share of the investor's income and is reduced to reflect the Company's share of the investor's losses. Investments in which the Company has less than 20% ownership and no significant influence are accounted for under the cost method and are carried at cost (see note 17).

Impairment of Long-Lived Assets

We account for long-lived assets in accordance with the provisions SFAS No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets. This Statement requires long-lived assets and certain identifiable intangibles be reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Recoverability of assets to be held and used is measured by a comparison of the carrying amount of an asset to future net cash flows expected to be generated by the asset. If such assets are considered to be impaired, the impairment to be recognized is measured by the amount by which the carrying amount of the assets exceeds the fair value of the assets (see note 22). Assets to be disposed of are reported at the lower of the carrying amount or fair value less costs to sell.

Stock-Based Compensation

We account for stock-based employee compensation arrangements using the intrinsic value method as prescribed in Accounting Principles Board Opinion No. 25 (APB Opinion 25), Accounting for Stock Issued to Employees, and related interpretations. Accordingly, compensation cost for options to purchase SPACEHAB Common Stock (Common Stock) granted to employees is measured as the excess, if any, of the fair value of Common Stock at the date of the grant over the exercise price an employee must pay to acquire the Common Stock. We have adopted the disclosure requirements of SFAS No. 148, Accounting for Stock-based Compensation - Transition and Disclosure an Amendment of SFAS No. 123.

The Company applies APB Opinion 25 and related interpretations in accounting for its plans. Accordingly, as all options have been granted at exercise prices equal to the fair market value as of the date of grant, no compensation cost has been recognized under these plans in the accompanying consolidated financial statements. Had compensation cost been determined consistent with SFAS No. 123, our net income (loss) and net income (loss) per common share would have been changed to the pro forma amounts indicated below (in thousands, except per share data):

| | Year Ended June 30, | | |
|---|----------------------------|--------------------|-------------------|
| | 2004 | 2003 | 2002 |
| Net income (loss), as reported | \$ 2,075 | \$ (81,775) | \$ (2,367) |
| Deduct: Total stock-based compensation expense determined under fair value based method (SFAS No. 123) for all awards, net of related tax effects | (296) | (573) | (973) |
| Pro forma net income (loss) | <u>\$ 1,779</u> | <u>\$ (82,348)</u> | <u>\$ (3,340)</u> |
| Earnings (loss) per share: | | | |
| Basic - as reported | \$ 0.17 | \$ (6.66) | \$ (0.20) |
| Diluted - as reported | \$ 0.15 | \$ (6.66) | \$ (0.20) |
| Basic - pro forma | \$ 0.14 | \$ (6.70) | \$ (0.28) |
| Diluted - pro forma | \$ 0.13 | \$ (6.70) | \$ (0.28) |

The fair value of each option granted and each employee stock purchase right is estimated using the Black-Scholes option-pricing model. The following weighted average assumptions were used for grants:

| | 2004 | 2003 | 2002 |
|---------------------------------|-------------|-------------|-------------|
| Expected Dividend Yield | 0% | 0% | 0% |
| Expected Volatility | 1.00 | .50 | .50 |
| Risk-Free Interest Rates | 3.84% | 5.63% | 3.88% |
| Expected Option Life (in years) | 7 | 7 | 7 |

The effects of compensation cost as determined under SFAS No. 123 on pro forma net income (loss) in years ended June 30, 2004, 2003, and 2002 may not be representative of the effects on pro forma net income (loss) in future periods.

Revenue Recognition

SPACEHAB recognizes revenue employing several generally accepted revenue recognition methodologies across its business segments. The methodology used is based on contract type and the manner in which

products and services are provided. Revenue generated under existing SFS contracts and for all other contract awards for which the capability to successfully complete the contract can be reasonably assured and costs at completion can be reliably estimated at contract inception, is recognized under the percentage-of-completion method based on costs incurred over the period of the contract. Revenue provided by SGS is primarily derived from cost-plus award fee contracts, whereby revenue is recognized to the extent of reimbursable costs incurred plus award fee. Award fees which provide earnings based on the Company's contract performance, as determined by NASA evaluations, are recorded when the amounts are probable and can be reasonably estimated. Changes in estimated costs to complete and provisions for contract losses and estimated amounts recognized as award fees are recognized in the period they become known. Revenue generated by Astrotech's payload processing services is recognized ratably over the occupancy period of the satellite while in the Astrotech facilities. For the multi-year contract with Lockheed Martin, revenue is billed and recognized on a quarterly basis for costs incurred. SMI recognizes revenue as merchandise is sold to customers.

Deferred Revenue

Deferred revenue represents amounts collected from customers for projects, products, or services to be provided at a future date. Deferred revenue is shown on the balance sheet as either a short-term or long-term liability, depending on when the service or product is to be provided.

Research and Development

Research and development costs are expensed as incurred.

Income Taxes

We recognize income taxes under the asset and liability method. Deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases and operating loss and tax credit carry forward. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enactment date.

Net Income (Loss) Per Share

Basic net income (loss) per share is calculated by dividing net income (loss) by the weighted average number of common shares outstanding during the period. Diluted net income (loss) per share includes all common stock options and other common stock equivalents that potentially may be issued as a result of conversion privileges, including the convertible subordinated notes payable and convertible preferred stock. See note 13.

Accounting Estimates

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The preparation of consolidated financial statements in conformity with accounting principles generally accepted in the U.S. requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the consolidated financial statements and the reported amounts of revenue and expenses during the reporting periods. Actual results could differ from these estimates.

Derivatives

The Company accounts for derivatives pursuant to SFAS No.133, Accounting for Derivative Instruments and Hedging Activities, as amended. This standard requires that all derivative instruments be recognized in the financial statements and measured at fair value regardless of the purpose or intent for holding them. We use cash flow hedges whereas changes in the fair value of derivative instruments are recognized periodically in shareholders' equity (as a component of accumulated other comprehensive income (loss)).

Reclassification

Certain 2003 and 2002 amounts have been reclassified to conform with the 2004 consolidated financial statement presentation.

(3) Statements of Cash Flows Supplemental Information

Cash paid for interest costs was approximately \$7.2 million, \$6.7 million, and \$7.3 million for the years ended June 30, 2004, 2003, and 2002, respectively. The Company capitalized interest of approximately \$1.3 million for the year ended June 30, 2002 related to the module improvements and a building in progress. No interest was capitalized in fiscal years 2003 and 2004. In fiscal year 2004, we paid approximately \$1.3 million to terminate our swap arrangement that related to our bank financing of our spacecraft processing facility expansion project in Titusville, Florida.

The Company paid income taxes of \$0.4 million for year ended June 30, 2004 and no income taxes for the years ended June 30, 2003 and 2002.

Depreciation and amortization in the statements of cash flows includes approximately \$0.5 million, \$0.5 million, and \$0.7 million related to the amortization of deferred debt issuance costs in 2004, 2003, and 2002, respectively.

(4) Accounts Receivable

At June 30, 2004 and 2003, accounts receivable consisted of the following (in thousands):

| | <u>2004</u> | <u>2003</u> |
|---|-----------------|-----------------|
| U.S. government contracts: | | |
| Billed | \$ 5,450 | \$ 3,681 |
| Unbilled: | | |
| Indirect costs incurred and charged to cost-plus-fee contracts in excess of provisional billing rates | 666 | 836 |
| Revenues in excess of milestone and time-based billings | 818 | 215 |
| | <u>6,934</u> | <u>4,732</u> |
| Total U.S. government contracts | | |
| Commercial contracts: | | |
| Billed | 628 | 1,421 |
| Unbilled | 975 | 903 |
| Allowances | (659) | (276) |
| | <u>944</u> | <u>2,048</u> |
| Total commercial contracts | | |
| Total accounts receivable | <u>\$ 7,878</u> | <u>\$ 6,780</u> |

The Company anticipates collecting all receivables within one year.

The accuracy and appropriateness of the Company's direct and indirect costs and expenses under its government contracts, and therefore its accounts receivable recorded pursuant to such contracts, are subject to extensive regulation and audit by the U.S. Defense Contract Audit Agency or by other appropriate agencies of the U.S. Government. Such agencies have the right to challenge our cost estimates or allocations

with respect to any government contract. Additionally, a substantial portion of the payments to the Company under government contracts are provisional payments that are subject to potential adjustment upon audit by such agencies. In the opinion of management, any adjustments likely to result from inquiries or audits of its contracts would not have a material adverse impact on our financial condition or results of operations.

(5) Convertible Notes Payable to Shareholder

On November 15, 2001 the Company entered into an agreement with Alenia Spazio S.P.A. to restructure the terms of its \$11.9 million principal amount of debt. The final payment under the agreement was made simultaneously with the delivery of the cancelled note and the release of the collateral in the three months ended March 31, 2004.

(6) Other Debt***Revolving Loan Payable***

In August 2002, we entered into a \$5.0 million line of credit with a new financial institution. This credit facility replaced the previous credit facility which was repaid and expired subsequent to the year ended June 30, 2002. The term of this credit facility is through June 2005. Financial covenants under this credit facility originally included, but were not limited to, leverage ratio and liquidity ratio. In September 2003, the credit agreement was amended to remove the financial covenants exclusive of the limitation on capital expenditures and add a covenant requiring a pledge of investments of 111% of the outstanding balance shown under the facility. In June 2004, the credit agreement was amended again to remove the financial covenant on capital expenditures. As of June 30, 2004, the amount drawn on this line of credit was \$1.4 million. The revolving feature of the agreement applies cash receipts immediately to the outstanding balance, if any. The weighted average interest rate for the years ended June 30, 2004 and 2003 was 5.94% and 5.25%, respectively. The terms of the agreement are prime plus one percent interest on borrowed funds and twenty-five basis points on unused funds.

Mortgage Loan Payable

On August 30, 2001, our Astrotech subsidiary completed a \$20.0 million financing of its Spacecraft Processing Facility (SPF) expansion project in Titusville, Florida with a financial institution. The proceeds of this financing were used to complete the construction of the SPF and supporting infrastructure. The loan was collateralized primarily by the multi-year payload processing contracts with Boeing and Lockheed Martin and by the building. The net book value of the building as of June 30, 2004 was \$32.9 million. Interest accrued on the outstanding principal balance is at a LIBOR-based rate, adjustable quarterly. The loan was scheduled to mature on January 15, 2011. The loan was converted from a construction loan to a term loan on December 31, 2001. Amortization of loan principal began on January 15, 2002 on a quarterly basis through the loan maturity date.

On October 1, 2003, Astrotech was notified by Boeing that it was exercising its termination rights with regards to its financial guarantees under the contract agreement with Astrotech for payload processing support services for the Delta launch vehicle program. Boeing indicated that the decision to terminate its guarantees for future Astrotech services was based on the downturn of the commercial expendable launch market rather than performance related considerations. Astrotech was in full compliance with the contract terms at the time of the termination. Under the contract provision related to termination of its financial guarantees, Boeing paid Astrotech \$17.5 million representing consideration of future contract payments previously used to collateralize the obligation. On December 31, 2003, the Company repaid \$9.5 million of principal on the debt.

In conjunction with the original financing, a swap agreement was required to be entered into to provide for a fixed rate of interest under the loan commitment beginning January 15, 2002. The fixed rate of interest on the outstanding principal balance was 5.62% plus 225 basis points. The objective of the swap was to eliminate the variability of cash flows in the interest payments for the total amount of the variable rate debt, the sole source of which are changes in the USD-LIBOR-BBA interest rate. Due to the repayment of the Boeing portion of this debt and the subsequent amendment of the loan agreement, the swap was no longer effective as a hedge. The unrealized loss in other comprehensive loss for the portion of the debt that was repaid in December 2003 was recorded as interest expense in the period ended December 31, 2003 in the amount of \$0.8 million. The Company recognized interest expense of \$0.4 million for the unamortized debt placement costs related to the debt repayment in the period ended December 31, 2003. We recognized as additional interest expense, the unamortized debt placement costs of \$0.2 million and the balance of the deferred loss on the swap in other comprehensive loss of \$0.5 million in the third quarter of the fiscal year 2004 in connection with the amendment of the loan agreement.

The loan agreement was amended on January 29, 2004, whereby the maturity date was shortened to January 2007, the interest rate was fixed at 5.5% and the hedge requirement was eliminated. For the fiscal year ended June 30, 2004, approximately \$11.4 million of principal was repaid and the outstanding balance is \$5.6 million as of June 30, 2004.

Convertible Subordinated Notes Payable

In October 1997, the Company completed a private placement offering for \$63.3 million of aggregate principal of unsecured 8% Convertible Subordinated Notes due October 2007. Interest is payable semi-

annually. The notes are convertible into the Common Stock of the Company at a rate of \$13.625 per share. This offering provided us with net proceeds of approximately \$59.9 million that were used for capital expenditures associated with the development and construction of space related assets and for other general corporate purposes.

The Company's debt repayments are due as follows (in thousands):

| | Balance | | | | | | |
|--|-----------|----------|----------|----------|-----------|------|------------|
| | 6/30/2004 | FY05 | FY06 | FY07 | FY08 | FY09 | Thereafter |
| Mortgage Loan Payable | \$ 5,638 | \$ 1,946 | \$ 2,057 | \$ 1,635 | \$ | \$ | \$ |
| Revolving Loan Payable | 1,445 | 1,445 | | | | | |
| Convertible Subordinated Notes Payable | 63,250 | | | | 63,250 | | |
| | \$ 70,333 | \$ 3,391 | \$ 2,057 | \$ 1,635 | \$ 63,250 | \$ | \$ |

(7) Fair Value of Financial Instruments

The following table presents the carrying amounts and estimated fair values of certain of the Company's financial instruments as of June 30, 2004 and 2003 in accordance with SFAS No. 107, Disclosures about Fair Value of Financial Instruments (in thousands):

| | June 30, 2004 | | June 30, 2003 | |
|--|---------------|--------|---------------|----------|
| | Carrying | Fair | Carrying | Fair |
| | Amount | Value | Amount | Value |
| Convertible notes payable to shareholder | \$ | \$ | \$ 2,004 | \$ 2,004 |
| Loan payable under credit facility | | 1,445 | | 1,445 |
| Mortgage loan payable | | 5,638 | 19,024 | 19,024 |
| Convertible subordinated notes payable | | 63,250 | 63,250 | 38,266 |

The fair value of the Company's long-term debt is based on quoted market prices or is estimated based on the current rates offered to us for debt of similar remaining maturities and other terms. The carrying amounts of cash and cash equivalents, investments, accounts receivable, accounts payable and accrued expenses approximate their fair market value because of the relatively short duration of these instruments.

(8) NASA Contracts

Research and Logistics Mission Support Contract

On December 21, 1997, the Company entered into the Research and Logistics Mission Support (ReALMS) contract to provide to NASA its flight modules and related integration services. This contract provided NASA the use of the flight modules for both science and logistics missions. This contract was subsequently amended whereby the contract value was increased to \$241.5 million and the number of missions was increased to nine. The final value of the ReALMS contract is \$214.3 million.

During the years ended June 30, 2004, 2003, and 2002, the Company recognized \$24.9 million, \$37.0 million and \$43.0 million of revenue, respectively, under this contract. Beginning in February 2004, and under NASA's new consolidated ISS contracts structure, we will provide services to NASA (similar to the services provided under the ReALMS contract) under subcontract to NASA's Cargo Mission Contract (CMC) contractor, Lockheed Martin. SFS is currently under letter contract with Lockheed Martin for unpressurized pallet and pressurized module services supporting STS-121 ICC and STS-116 and STS-118 (module and ICC) through July 2004. Final contract negotiations are expected to be completed in September 2004.

SFS's contract with the prime ISS contractor, Boeing, for the STS-114 mission carrying the deployable ICC, was not affected by the ISS contract consolidation restructure and continues as before during this period of the space shuttle stand-down. STS-114 will be the first mission flown by NASA following the *Columbia* tragedy and is expected to launch no sooner than March 2005.

Additionally, during the space shuttle stand-down period, SFS is providing cargo shipment coordination services to NASA for all U.S. cargo shipped to the ISS via the Russian *Progress* space vehicle. These services are provided under contract to Lockheed Martin, the CMC contractor to NASA.

Flight Crew Systems Development Contract

In prior fiscal years, SGS primarily operated under the Flight Crew System Development contract which was a \$399.1 million multi-task cost-plus award and incentive fee contract. The contract commenced in May 1993 and concluded in April 2003. Portions of the contract were under two different recompetitions and those portions were awarded to another bidder and transitioned to that successful bidder in April 2003 and November 2003. One of the original seven contract tasks remained under a new contract with SGS. That contract was the ISS Configuration Management contract that was completed on December 31, 2003. The configuration management task was consolidated within the Program Integration and Control (PI&C) contract of which ARES Corporation was the successful bidder. SGS is a major subcontractor to ARES providing configuration management and data integration services.

Astrotech s NASA Contracts

During fiscal year 2004, Astrotech started direct satellite processing support for NASA. Astrotech has two missions under contract and is working with NASA on an Indefinite Delivery Indefinite Quantity (IDIQ) format for future missions.

(9) Stockholder Rights Plan

On March 26, 1999, the Board of Directors adopted a Stockholder Rights Plan designed to deter coercive takeover tactics and to prevent a potential acquirer from gaining control of the Company without offering a fair price to all of the Company s stockholders. The stockholder rights plan was amended and restated in February 2004. A dividend of one preferred share purchase right (a Right) was declared on every share of Common Stock outstanding on April 9, 1999. Each Right under the plan entitles the holder to buy one one-thousandth of a share of a new series of junior participating preferred stock for \$35. If any person or group becomes the beneficial owner of 20% or more of Common Stock (with certain limited exceptions), then each Right (not owned by the 20% stockholder) will then entitle its holder to purchase, at the Right s then current exercise price, common shares having a market value of twice the exercise price. In addition, if after any person has become a 20% stockholder, and is involved in a merger or other business combination transaction with another person, each Right will entitle its holder (other than the 20% stockholder) to purchase, at the Right s then current exercise price, common shares of the acquiring company having a value of twice the Right s then current exercise price. The Rights were granted to each shareholder of record on April 9, 1999. At any time before a person or group acquires a 20% position, the Company generally will be entitled to redeem the Rights at a redemption price of \$0.01 per Right. The Rights will expire on April 9, 2009.

(10) Convertible Preferred Stock

On August 2, 1999, EADS (formerly Astrium GmbH), a related party and shareholder, purchased an additional \$12.0 million equity interest in SPACEHAB representing 1,333,334 shares of Series B Senior Convertible Preferred Stock. Under the agreement, EADS purchased all of SPACEHAB s 975,000 authorized and unissued shares of preferred stock. At the annual stockholders meeting held on October 14, 1999, the shareholders approved the proposal to increase the number of authorized shares of preferred stock to 2,500,000, in order to complete the transaction with EADS allowing them to purchase the additional 358,334 preferred shares. The preferred stock purchase increased EADS s voting interest in SPACEHAB to approximately 11.5%. The Series B Senior Convertible Preferred Stock is: convertible at the holders option on the basis of one share of preferred stock for one share of Common Stock, entitled to vote on an as converted basis the equivalent number of shares of Common Stock, and has preference in liquidation, dissolution, or winding up of \$9.00 per preferred share. No dividends are payable on

the convertible preferred shares.

(11) Common Stock Options and Stock Purchase Plans

As of June 30, 2004, 2,495,788 shares of Common Stock were reserved for future grants of stock options under the Company's three stock option plans.

Non-qualified Options

Non-qualified options are granted at the sole discretion of the Board of Directors. Prior to the adoption of the 1994 Stock Incentive Plan (the 1994 Plan), stock options granted to the Company's officers and employees were part of their employment contract or offer. The number and price of the options granted were defined in the employment agreements and such options vest incrementally over a period of four years and generally expire within ten years of the date of grant.

The 1994 Plan

Under the terms of the 1994 Plan, the number and price of the options granted to employees is determined by the Board of Directors and such options vest, in most cases, incrementally over a period of four years and expire no more than ten years after the date of grant.

The Directors' Stock Option Plan

Each new non-employee director receives a one-time grant of an option to purchase 10,000 shares of common stock at an exercise price equal to the fair market value on the date of grant. In addition, effective as of the date of each annual meeting of the Company's stockholders, each non-employee director who is elected or continues as a member of the Board of Directors of the Company shall be awarded an option to purchase 5,000 shares of common stock. Options under the Director's Plan vest after one year and expire seven years from the date of grant.

1997 Employee Stock Purchase Plan

The Company adopted an employee stock purchase plan that permits eligible employees to purchase shares of Common Stock of the Company at prices no less than 85% of the current market price. Eligible employees may elect to participate in the plan by authorizing payroll deductions from 1% to 10% of gross compensation for each payroll period. On the last day of each quarter, each participant's contribution account is used to purchase the maximum number of whole and fractional shares of Common Stock determined by dividing the contribution account's balance by the lesser of 85% of the price of a share of Common Stock on the first day of the quarter or the last day of a quarter. The number of shares of Common Stock that may be purchased under the plan is 1,500,000. Through June 30, 2004, employees have purchased 1,071,659 shares under the plan.

Space Media, Inc. Stock Option Plan

During the year ended June 30, 2000, Space Media, Inc., a majority owned subsidiary of the Company, adopted an option plan (SMI Plan) for employees, officers, directors and consultants of SMI. Under the terms of the SMI Plan, 1,500,000 shares have been reserved for future grants for which the number and price of the options granted is determined by the Board of Directors and such options vest, in most cases, incrementally over a period of four years and expire no more than ten years after the date of grant. At June 30, 2004 and June 30, 2003, there were 388,750 options issued and outstanding under the SMI Plan at a weighted average exercise price of \$1.00. The options vest equally over a four-year period and have a life of 10 years. There were 274,063 options exercisable as of June 30, 2004 and June 30, 2003 with a weighted-average exercise price of \$1.00 and a weighted-average remaining contractual life of six and seven years, respectively.

Stock Option Activity Summary

The following table summarizes the Company's stock option plans, excluding the SMI plan:

| | Non-qualified Options | | 1994 Plan | | Directors' Plan | |
|---|-----------------------|----------------|-----------|----------------|-----------------|----------------|
| | Shares | Exercise Price | Shares | Exercise Price | Shares | Exercise Price |
| Outstanding at June 30, 2001 | 330,266 | \$ 13.89 | 2,652,114 | \$ 6.62 | 315,000 | \$ 8.11 |
| Granted | | | 52,000 | 2.31 | 65,000 | 1.40 |
| Exercised | | | | | | |
| Forfeited | (316,100) | 14.03 | (804,882) | 6.97 | | |
| Outstanding at June 30, 2002 | 14,166 | \$ 10.68 | 1,899,232 | \$ 6.34 | 380,000 | \$ 6.96 |
| Granted | | | 436,000 | 0.76 | 30,000 | 0.93 |
| Exercised | | | | | | |
| Forfeited | (10,000) | 10.13 | (607,107) | 6.54 | (10,000) | 2.58 |
| Outstanding at June 30, 2003 | 4,166 | \$ 12.00 | 1,728,125 | \$ 4.86 | 400,000 | \$ 6.62 |
| Granted | | | 312,000 | 1.07 | 30,000 | 0.99 |
| Exercised | | | (88,246) | 2.42 | (45,000) | 1.26 |
| Forfeited | | | (218,548) | 5.39 | (55,000) | 5.81 |
| Outstanding at June 30, 2004 | 4,166 | \$ 12.00 | 1,733,331 | \$ 4.27 | 330,000 | \$ 6.68 |
| Options exercisable at: | | | | | | |
| June 30, 2002 | 14,166 | \$ 10.68 | 1,114,160 | \$ 7.26 | 315,000 | \$ 8.11 |
| June 30, 2003 | 4,166 | 12.00 | 1,026,840 | 6.47 | 370,000 | 7.08 |
| June 30, 2004 | 4,166 | 12.00 | 1,112,582 | 5.84 | 300,000 | 7.25 |
| Weighted-average fair value (pursuant to FAS 123) at date of grant during the fiscal year ended | | | | | | |
| June 30, 2002 | | | 52,000 | \$ 1.14 | 65,000 | \$ 0.64 |
| June 30, 2003 | | | 436,000 | 0.36 | 30,000 | 0.44 |
| June 30, 2004 | | | 312,000 | 0.57 | 30,000 | 0.44 |

The following table summarizes information about the Company's stock options outstanding at June 30, 2004:

| Range of exercise prices | Options outstanding | | | Options exercisable | |
|--------------------------|---------------------|------------------|------------------|---------------------|------------------|
| | Number Outstanding | Weighted-Average | Weighted-Average | Number Exercisable | Weighted-Average |
| | | | | | |

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| | | | Remaining | Exercise | | Exercise | | | |
|-----|-------|-------|--------------|----------|----|----------|-----------|----|-------|
| | | | Contractual | Price | | Price | | | |
| | | | Life (years) | | | | | | |
| \$. | 70 | 1.02 | 513,754 | 8.46 | \$ | 0.88 | 39,004 | \$ | 0.79 |
| | 1.06 | 4.125 | 422,000 | 6.67 | | 2.77 | 292,251 | | 3.05 |
| | 4.750 | 5.125 | 651,912 | 4.98 | | 5.00 | 605,662 | | 5.01 |
| | 6.625 | 11.75 | 475,665 | 1.00 | | 9.93 | 475,665 | | 9.93 |
| | 12.00 | 12.00 | 4,166 | 0.04 | | 12.00 | 4,166 | | 12.00 |
| | | | 2,067,497 | 5.26 | \$ | 4.67 | 1,416,748 | \$ | 6.16 |

(12) Income Taxes

The Company accounts for taxes under SFAS No. 109, Accounting for Income Taxes. Under SFAS 109, deferred tax liabilities and assets are determined based on the difference between the financial statement and tax basis of assets and liabilities using enacted rates expected to be in effect during the year in which the differences reverse.

The components of income tax expense (benefit) from continuing operations are as follows (in thousands):

| | Year Ended June 30, | | |
|-------------------------------------|---------------------|-----------------|-------------------|
| | 2004 | 2003 | 2002 |
| Current: | | | |
| Federal | \$ 455 | \$ (857) | \$ (2,134) |
| State and local | 51 | | 84 |
| Foreign | | | |
| | <u>506</u> | <u>(857)</u> | <u>(2,050)</u> |
| Deferred: | | | |
| Federal | | | |
| State and local | | | |
| Foreign | | | |
| | | | |
| Income tax expense (benefit) | <u>\$ 506</u> | <u>\$ (857)</u> | <u>\$ (2,050)</u> |

A reconciliation of the reported income tax expense to the amount that would result by applying the U.S. federal statutory rate to the income (loss) before income taxes to the actual amount of income tax expense (benefit) recognized follows (in thousands):

| | Year Ended June 30, | | |
|--|---------------------|-----------------|-------------------|
| | 2004 | 2003 | 2002 |
| Expected expense (benefit) | \$ 878 | \$ (28,095) | \$ (1,502) |
| Change in valuation allowance | (3,278) | 26,823 | (946) |
| State income taxes | 51 | (2,832) | (128) |
| Other, primarily goodwill amortization | 2,855 | 3,247 | 526 |
| | <u>506</u> | <u>(857)</u> | <u>(2,050)</u> |
| Total | <u>\$ 506</u> | <u>\$ (857)</u> | <u>\$ (2,050)</u> |

The Company's deferred tax asset as of June 30, 2004 and 2003 consists of the following (in thousands):

| | 2004 | 2003 |
|---|----------|-----------|
| Deferred tax assets: | | |
| Net operating loss carry forwards | \$ 8,340 | \$ 18,052 |
| General business credit carry forwards | 2,020 | 2,020 |
| Alternative minimum tax credit carry forwards | 748 | |
| Accrued expenses | 717 | 981 |
| Capitalized start-up and organization costs | 1,008 | 859 |
| Other | 221 | 254 |

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| | | |
|--|----------|----------|
| Total gross deferred tax assets | 13,054 | 22,166 |
| Less - valuation allowance | (10,268) | (13,546) |
| Net deferred tax assets | 2,786 | 8,620 |
| Deferred tax liabilities: | | |
| Property and equipment, principally due to differences in depreciation | 2,773 | 8,413 |
| Other | 13 | 207 |
| Total gross deferred tax liabilities | 2,786 | 8,620 |
| Net deferred tax assets (liabilities) | \$ | \$ |

At June 30, 2004, the Company had accumulated net operating losses of approximately \$22.0 million for Federal income tax purposes, which are available to offset future regular taxable income. These operating loss carry forwards expire between the years 2008 and 2023. Utilization of these net operating losses may be subject to limitations in the event of significant changes in stock ownership of the Company.

Additionally, the Company has approximately \$2.1 million of research and experimentation and alternative credit carry forwards, respectively, available to offset future regular tax liabilities. The research and experimentation credits expire between the years 2005 and 2007.

In assessing the realizability of its net deferred tax assets, management considers whether it is more likely than not that some portion or all of the net deferred tax assets are realizable. We consider the scheduled reversal of deferred tax liabilities, projected future taxable income, and tax planning strategies in making this assessment. As of June 30, 2004, the Company provided a full valuation allowance of approximately \$10.3 million against its net deferred tax assets.

The Company has received approximately \$2.8 million in refund claims related to net operating loss carry forwards for alternative minimum taxes paid in prior years.

(13) Net Income (Loss) Per Share

The following are reconciliations of the denominators of the basic and diluted net income (loss) per share computations for the years ended June 30, 2004, 2003, and 2002. There were no adjustments for the numerators.

| | June 30, | | |
|--|------------|------------|------------|
| | 2004 | 2003 | 2002 |
| Weighted average outstanding common shares - basic | 12,450,320 | 12,285,467 | 11,884,309 |
| Common stock equivalents | 1,691,629 | | |
| Weighted average outstanding common shares - diluted | 14,141,949 | 12,285,467 | 11,884,309 |

(14) Employee Benefit Plan

The Company has a defined contribution retirement plan, which covers substantially all employees and officers. For the years ended June 30, 2004, 2003, and 2002, we have contributed \$0.6 million, \$1.0 million, and \$1.4 million, respectively, to the plan. The Company has the right, but not an obligation, to make additional contributions to the plan in future years at the discretion of the Company's Board of Directors. The Company has not made any such contributions for the years ended June 30, 2004, 2003, and 2002.

(15) Commitments

Integration and Operations Contracts

On August 13, 1997, we initiated a letter agreement with Boeing, a major subcontractor for standard integration and operation services to the Company for future missions that were not already provided for under our contract for missions to the *Mir* Space Station. In August 1998, this letter agreement became a cost plus incentive fee contract whereby Boeing will provide integration and operations services required to successfully complete four research missions (one single module mission and three double module missions) and seven logistics double module missions. Additionally, there were several tasks that were separately priced to yield a contract value of up to \$128.9 million. The contract was

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terminated in April 2004. As of June 30, 2004, \$127.1 million has been incurred under this commitment. Minimal trailing termination costs and prior year rate adjustments are the only outstanding costs on this contract.

Consulting Agreement

On June 1, 2004, the Company entered into a consulting agreement with V.J.F. Russian Consulting LTD for:

Marketing and promotion of SPACEHAB capabilities and services to RSC Energia, The Russian Federation Space Agency, and other Russian entities involved in the exploration and development of space

Supporting and assisting SPACEHAB in the negotiation of service contracts and agreements between Russian entities

Providing technical expertise and services in support of SPACEHAB activities, under contracts with Russian entities

Total commitments under the consulting agreement over the next two years are \$0.4 million. In fiscal year 2004, \$15,000 was paid under this agreement.

Compensation Agreement

The Company has a commitment to Dayna Justiz for additional compensation that can be earned as a result of the agreement dated June 19, 2000. The agreement states that Dayna Justiz can earn up to \$375,000 as additional compensation if she meets certain financial goals in the management of The Space Store. The yearly amount is equal to five percent of the Space Store's net after-tax operating income during each fiscal year until such time an aggregate amount of \$375,000 has been earned. At this time, we have not recorded a liability for this obligation due to the uncertainty of the obligation being met.

Leases

The Company is obligated under capital leases for equipment and noncancelable operating leases for equipment, office space, storage space, the land for a payload processing facility, and certain flight assets. Future minimum payments under these capital leases and noncancelable operating leases are as follows (in thousands):

| <u>Year ending June 30,</u> | <u>Capital</u> <u>Leases</u> | <u>Operating</u> <u>Leases</u> |
|---|---------------------------------|-----------------------------------|
| 2005 | \$ 67 | \$ 4,715 |
| 2006 | | 1,348 |
| 2007 | | 761 |
| 2008 | | 441 |
| 2009 | | 91 |
| Thereafter | | 2,852 |
| Subtotal | 67 | 10,208 |
| Less: payments due for sublease | | (2,112) |
| Total | \$ 67 | \$ 8,096 |
| Less: amount representing interest between 9% and 12% | (6) | |
| Present value of net minimum capital lease payments | \$ 61 | |

Rent expense for the years ended June 30, 2004, 2003, and 2002 was approximately \$5.7 million, \$6.4 million, and \$5.0 million, respectively, including lease expense for the ICC and vertical cargo carrier (VCC) asset leases of \$3.8 million in fiscal year 2004, \$3.9 million in fiscal year 2003, and \$2.4 million in fiscal year 2002. For fiscal years 2005, 2006, 2007, and 2008, we expect to receive net payments of approximately \$0.7 million, \$0.7 million, \$0.5 million, and \$0.2 million, respectively, for subleases. In the year ended June 30, 2002, we recognized \$0.8 million of expenses for excess facilities that have been sublet. In the year ended June 30, 2004, we recognized \$0.2 million of expenses for excess facilities that have been sublet.

At June 30, 2004, the capitalized lease assets are recorded at \$80,976 and the annual amortization is \$67,000.

(16) Segment Information

Based on our organization, we operate in four business segments: SFS, Astrotech, SGS, and SMI. SFS was founded to commercially develop space habitat modules to operate in the cargo bay of the space shuttles. SFS provides access to the modules and integration and operations support services for both NASA and commercial customers. Astrotech provides payload processing facilities and services to serve the satellite manufacturing and launch services industry. SGS is primarily engaged in providing engineering services and products to the Federal government including NASA. SMI was established in April 2000, to develop space-themed commercial business activities.

On April 3, 2003, the Company changed the name of its Johnson Engineering Corporation (JE) subsidiary to SPACEHAB Government Services, Incorporated, to more appropriately reflect the subsidiary's strategic direction of operating in the government business section. As part of the realignment of our operating units, the Strategic Programs operating unit, which was included in the Other segment, was moved into SGS in the fourth quarter of our fiscal year ending June 30, 2003. In the fourth quarter of our fiscal year ending June 30, 2004, the Other segment represents corporate selling, general and administrative expenses. Segment amounts have been restated based on the revised reporting structure.

The Company's chief operating decision maker utilizes both revenue and income (loss) before income taxes, in assessing performance and making overall operating decisions and resource allocations. The Other segment represents corporate selling, general and administrative expenses and interest expense for the Company. In fiscal year 2002, the Other segment also includes bid and proposal costs for a proposal in Huntsville, Alabama. In fiscal years 2004 and 2003 there were no costs for the Huntsville location due to closing the office in Huntsville.

The accounting policies of the segments are the same as those described in the summary of significant accounting policies (note 2). Information about the Company's segments is as follows (in thousands):

| Year Ended June 30, 2004: | Revenue | Income (loss) before income taxes | Net Fixed Assets | Depreciation And Amortization |
|----------------------------------|------------------|--|---------------------------------|--|
| SPACEHAB Flight Services | \$ 38,384 | \$ 8,872 | \$ 32,188 | \$ 2,750 |
| SPACEHAB Government Services | 10,229 | (5,387) | 104 | 65 |
| Astrotech | 28,258 | 17,486 | 46,976 | 2,045 |
| Space Media | 735 | (74) | | |
| Other | | (18,316) | 332 | 571 |
| | <u>\$ 77,606</u> | <u>\$ 2,581</u> | <u>\$ 79,600</u> | <u>\$ 5,431</u> |

| Year Ended June 30, 2003: | Revenue | Income (loss) before income taxes | Net Fixed Assets | Depreciation And Amortization |
|----------------------------------|------------------|--|---------------------------------|--|
| SPACEHAB Flight Services | \$ 46,757 | \$ (51,414) | \$ 34,160 | \$ 5,501 |
| SPACEHAB Government Services | 34,742 | (9,996) | 262 | 745 |
| Astrotech | 12,410 | 4,533 | 48,372 | 1,892 |
| Space Media | 1,054 | (313) | | 332 |
| Other | | (25,442) | 895 | 454 |
| | <u>\$ 94,963</u> | <u>\$ (82,632)</u> | <u>\$ 83,689</u> | <u>\$ 8,924</u> |

| Year ended June 30, 2002: | Revenue | Income (loss) before income taxes | Net Fixed Assets | Depreciation And Amortization |
|----------------------------------|-------------------|--|---------------------------------|--|
| SPACEHAB Flight Services | \$ 51,366 | \$ 12,888 | \$ 120,031 | \$ 8,418 |
| SPACEHAB Government Services | 40,785 | 2,016 | 1,553 | 1,633 |
| Astrotech | 9,936 | 3,752 | 50,074 | 1,266 |
| Space Media | 678 | (1,587) | 71 | 293 |
| Other | 8 | (21,486) | 4,122 | 1,074 |
| | <u>\$ 102,773</u> | <u>\$ (4,417)</u> | <u>\$ 175,851</u> | <u>\$ 12,684</u> |

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Foreign revenue for the years ended June 30, 2004, 2003, and 2002 was approximately \$2.8 million, \$9.5 million, and \$5.9 million, respectively. The foreign revenue is mainly generated in China and Japan. Domestic revenue for the years ended June 30, 2004, 2003, and 2002 was approximately \$74.8 million, \$85.4 million, and \$96.8 million, respectively.

(17) Investment in Guigné

During June 1998, the Company entered into a joint venture agreement with Guigné Technologies Limited (GTL), a Canadian Company, for the purpose of developing, fabricating, marketing and selling of Space-DRUMS services, a containerless processing facility intended to be deployed on the ISS. In accordance with the joint venture agreement, the Company contributed, in exchange for a 50% interest in the joint venture, an aggregate of \$2.0 million of working capital through December 1999. Our contributions were made in the form of an unsecured non-interest bearing note.

The joint venture agreement contained an option whereby we could exchange our interest in the joint venture and the \$2.0 million note for a common equity interest in Guignè Inc. (GI), the ultimate parent of GTL. In December 1999 the Company notified GI of its intention to exercise its option, which resulted in us obtaining a 15% common equity interest in GI. The Company accounts for its investment in GI under the cost method. During the quarter ended December 31, 1999, at the time of our exercise of the option, we recognized a \$0.2 million impairment against our investment in GI based on our estimate of the fair value of GI. During the quarter ended December 31, 2003, the Company recognized a \$1.8 million impairment against its investment in GI due to Guignè experiencing an adverse financial event that, in the opinion of management, impairs the value of SPACEHAB s investment.

(18) Asset Sales

On November 30, 2000, EADS entered into an agreement with the Company to purchase our ICC and VCC flight assets. The total purchase price of \$15.4 million is comprised of both cash and services payments. The transaction occurred in two phases. The first phase was for the purchase of the ICC assets and the second phase was for the purchase of the VCC assets. Phase one of the transactions was completed in the three months ended March 31, 2001. Phase two was completed in June 30, 2002. The sale was approximately at book value and the Company recognized a minimal loss. We have entered into an agreement with EADS to lease these assets for a period of four years with two additional four-year options.

On August 2, 2001, SPACEHAB s Astrotech subsidiary sold the assets of its Oriole Sounding Rocket program and related property for approximately \$1.2 million to DTI Associates of Arlington, Virginia. The sale turned over all physical and intellectual property assets of Astrotech s Sounding Rocket program, including the design of the Oriole Rocket, except for those assets required for Astrotech to fulfill the terms of an agreement with an existing customer. The terms of the sale were as follows: an initial cash payment at closing, five equal monthly payments beginning September 2001, and a promissory note of \$655,000 bearing interest and secured by the Astrotech Sounding Rocket Program intellectual property and due July 26, 2002. Astrotech recognized a gain of approximately \$1.1 million on the sale in the quarter ended September 30, 2002. All payments due under the arrangement have been received by Astrotech.

(19) Minority Investment in Consolidated Subsidiary

Pursuant to agreements entered into as of September 27, 2001, eScottVentures II, LLC (ESV), of Melbourne, Florida, purchased 5,914,826 newly issued shares of SMI s Series A redeemable, convertible preferred stock for \$750,000. On June 21, 2002 ESV filed Case Number 1:02CV01236 in the U.S. District Court for the District of Columbia against Space Media, Inc., SPACEHAB, Inc., Shelley A. Harrison and Julia A. Pulzone (collectively, Defendants). This suit, relating to ESV s investment in SMI, sought rescission of the stock purchase agreement and return of its \$750,000 investment, plus unspecified expenses, consequential damages exemplary and punitive damages, prejudgment interest, and costs and disbursements, including attorney and expert fees. The Defendants and ESV settled the suit through mediation. A stipulation and order of dismissal was filed with the Court by the parties on January 22, 2003, following the payment of cash and issuance of restricted shares of SPACEHAB s Common Stock to ESV. ESV is no longer a shareholder of SMI.

(20) Goodwill Impairment

On November 5, 2003, NASA notified the Company that it was not awarded the ISS Mission Integration contract for which a proposal was submitted. Additionally, the Boeing team s bid for the CMC with NASA, of which SGS was a subcontractor, was not selected for contract award. As the result of these events, we performed a goodwill impairment test at SGS in accordance with SFAS No. 142, Goodwill and Intangible Assets. The impairment test indicated an impairment of SGS s remaining goodwill of approximately \$5.7 million, which was recorded in the period ended December 31, 2003. We utilized market valuation techniques to calculate the fair value of SGS.

On October 1, 2003, Astrotech was notified by Boeing that it was exercising its termination rights with regards to its financial guarantees under the contract agreement with Astrotech for payload processing support services for the Delta launch vehicle program. Boeing indicated that the

decision to terminate its guarantees for future Astrotech services was based on the downturn of the commercial expendable launch market rather

than due to performance related considerations. Astrotech was in full compliance with the contract terms at the time of the termination. The termination of these financial guarantees had a significant impact on Astrotech's future guaranteed revenue stream. As the result of this event, we performed a goodwill impairment test at Astrotech in accordance with SFAS No. 142, Goodwill and Intangible Assets. The impairment test indicated an impairment of Astrotech's remaining goodwill of approximately \$2.5 million which was recorded in the period ended December 31, 2003. We utilized market valuation techniques to calculate the fair value of Astrotech.

As a result of the loss of the recomplete of the Flight Crew Systems Development contract, we performed a goodwill impairment test of the goodwill at SGS in accordance with SFAS No. 142, Goodwill and Other Intangible Assets. The impairment test indicated an impairment of SGS's goodwill of approximately \$11.9 million, which was recorded in the three months ended March 31, 2003. We utilized discounted cash flows and market valuation techniques to calculate the fair value of SGS.

(21) Loss of Research Double Module

The Company was under contract with NASA to support the STS-107 mission on its *Columbia* Orbiter. The mission utilized our RDM flight asset. On February 1, 2003, the RDM was lost in the tragic STS-107 accident. The RDM was partially covered by commercial insurance. The commercial insurance on the module was \$17.7 million and the net book value of the RDM was \$67.9 million. The Company recorded a nonrecurring charge of approximately \$50.3 million in the three months ended March 31, 2003 in the SFS business unit.

In January 2004, the Company submitted a detailed claim for recovery of its RDM investment in the amount of \$87.7 million. In June 2004, SPACEHAB mutually agreed with NASA to waive the Agency's response date of June 24, 2004 on our contract claim for indemnification. The contractually stipulated indemnification is \$8.0 million but NASA's reconciliation of the losses under Federal Acquisition Regulations approximate \$47.4 million. In the event an acceptable resolution cannot be reached, SPACEHAB has the right to file for administrative and/or judicial review of its claim for indemnification. We believe we have a basis for recovery of the loss from NASA but there can be no assurance as to the timing or the amount, if any, to be received from the claim. Upon resolution of the claim, any proceeds from NASA would be recorded in the period in which the claim is resolved.

Our insurer, Certain Underwriters at Lloyd's of London (Lloyd's), on the Space Shuttle *Columbia* accident paid the full proceeds of \$17.7 million to the Company shortly after the accident. Subsequently, Lloyd's has filed suit against SPACEHAB seeking recovery of the \$17.7 million alleging that: (i) such proceeds were paid erroneously primarily due to the fact that NASA had not paid indemnification due to the Company prior to the payment of the insurance proceeds, (ii) the Company and our insurance broker misled Lloyd's in issuing the policy, and (iii) the Company has not cooperated with Lloyd's in protecting Lloyd's right of subrogation. We believe that the Lloyd's complaint is without merit and while cooperating with Lloyd's in protecting their interests, have responded accordingly.

(22) Asset Impairments

The Company conducted an impairment test of certain assets within its SFS business segment in accordance with SFAS No. 144. We recorded a non-cash impairment charge of \$0.4 million to write down these assets in the fourth quarter of fiscal year 2004. The impairment was due to the Company closing the Huntsville, Alabama location where our subcontractor, Boeing, was housed.

The Company conducted an impairment test of its work-in-process flight assets in accordance with SFAS No. 144 during fiscal year 2003. The Company recorded a non-cash impairment charge of \$16.1 million to write down certain assets under development, primarily *Enterprise* and the SPACEHAB Universal Communications System, in the SFS segment, that are no longer being funded due to uncertainties in human space flight programs during the three months ended June 30, 2003. The Company utilized projected undiscounted cash flows to conclude the assets were impaired and calculated the fair value based on the net present value of projected cash flows.

(23) Closing of the Washington, D.C. Office

On October 1, 2003 the Company announced that it would be closing its corporate office in Washington, D.C. by December 31, 2003 and would consolidate those operations into its headquarters in Webster, Texas. We took these actions as part of our continuing efforts to further reduce operating expenses and improve

profitability. We have entered into a sublease of the Washington, D.C. facility which is under lease through May 31, 2006, for the remainder of the lease term. The Company has recorded a charge in the amount of \$0.3 million for severance and facilities costs as required under SFAS No. 146, Accounting for Costs Associated with Exit or Disposal Activities, as of December 31, 2003. All amounts were subsequently paid by June 30, 2004 and these were no significant adjustments to the original accrual.

(24) Related Party Transactions

The Company engaged in certain transactions with directors, executive officers, shareholders, and certain former officers during fiscal year 2004. Following is a description of these transactions:

Orbital Sciences Corporation

The Company provides satellite processing services and other space-related services to Orbital Science Corporation (Orbital), an entity providing commercial satellite launch and related aerospace services. Mr. James R. Thompson, a director of the Company, is President and Chief Operating Officer of Orbital. During the years ended June 30, 2004, 2003 and 2002 respectively, Orbital provided revenues to the Company of approximately \$0.7 million, \$0.1 million and \$0.0 million, respectively.

EADS Space Transportation

The Company issued subordinated notes for a portion of the amount due to Alenia Spazio S.p.A. (Alenia), a subsidiary of EADS Space Transportation, a shareholder, under a previously completed construction contract for the Company's flight modules. Dr. Graul is the Executive Vice President for EADS Space Transportation. Under the subordinated notes, Alenia had the right to elect to convert, in whole or part, the remaining principal amount into equity, on terms and conditions to be agreed with the Company.

On November 15, 2001, the Company entered into an agreement with Alenia to restructure the terms of its \$11.9 million debt. The terms of the restructuring provided for a \$3.0 million payment of principal and interest on December 31, 2001 and quarterly amortization of the remaining principal beginning March 2002 through December 2003. In addition, the interest rate was reduced to 8% effective January 1, 2002. The obligation was collateralized by one of the Company's flight assets. The Company paid interest of approximately \$0.1 million, \$0.2 million, and \$0.6 million during the years ended June 30, 2004, 2003 and 2002, respectively. The Company paid the shareholder subordinated notes in full and received a release of the lien as of December 31, 2003.

EADS provides unpressurized payload and integration efforts to SPACEHAB on a fixed price basis in addition to providing engineering services as required. For the years ended June 30, 2004, 2003 and 2002, EADS's payload and integration services included in cost of revenue was approximately \$6.8 million, \$8.5 million and \$4.3 million, respectively.

V.J.F. Russian Consulting

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On January 30, 2004, the Company entered into a subcontract agreement with V.J.F. Russian Consulting. The president of V.J.F. Russian Consulting, Vladimir Fishel, is a former Vice President of SPACEHAB was receiving severance payments from the Company and working on a part-time employment arrangement for other consulting activities. The services being provided under the subcontract agreement (valued at \$2.6 million) is in support of a contract that SPACEHAB has with the Mitsubishi Corporation in support of the Japan Aerospace Exploration Agency. The amount paid for fiscal year 2004 was \$1.3 million.

On June 1, 2004 the Company entered into a consulting agreement with V.J.F. Russian Consulting LTD for:

- (1) Marketing and promotion of SPACEHAB capabilities and services to RSC Energia, The Russian Federation Space Agency, and other Russian entities involved in the exploration and development of space;
- (2) Supporting and assisting SPACEHAB in the negotiation of service contracts and agreements between Russian entities; and
- (3) Providing technical expertise and services in support of SPACEHAB activities, under contracts with Russian entities.

Total commitments under the consulting agreement are \$0.4 million.

(25) Summary of Selected Quarterly Financial Data (Unaudited)

The following is a summary of selected quarterly financial data (in thousands, except per share data):

| | Three months ended | | | |
|-------------------------------------|--------------------|--------------------------|-----------------------|----------------------|
| | September 30 | December 31 ³ | March 31 ¹ | June 30 ² |
| Year ended June 30, 2004 | | | | |
| Revenue | \$ 18,850 | \$ 32,816 | \$ 14,800 | \$ 11,140 |
| Income (loss) from operations | 2,391 | 6,507 | 2,433 | (608) |
| Net income (loss) | 666 | 3,468 | 267 | (2,326) |
| Net income (loss) per share basic | 0.05 | 0.28 | 0.02 | (0.19) |
| Net income (loss) per share diluted | 0.05 | 0.25 | 0.02 | (0.19) |
| Year ended June 30, 2003 | | | | |
| Revenue | \$ 26,812 | \$ 28,050 | \$ 26,413 | \$ 13,688 |
| Income (loss) from operations | 1,750 | 2,552 | (61,069) | (18,613) |
| Net income (loss) | (94) | 1,175 | (62,719) | (20,137) |
| Net income (loss) per share basic | (0.01) | 0.10 | (5.06) | (1.63) |
| Net income (loss) per share diluted | (0.01) | 0.09 | (5.06) | (1.63) |

¹ The loss for the three months ended March 31, 2003 includes a \$50.3 million charge from the uninsured loss of the RDM and a goodwill impairment charge of \$11.9 million.

² The decrease in revenue for the three months ended June 30, 2003 reflects the loss of the recompile for the Flight Crew Systems Development contract. The loss includes the asset impairment charge of \$16.1 million. The loss from operations for the three months ended June 30, 2004 includes \$0.9 million for an incentive fee charge from Boeing for work on the ReALMS contract and \$0.4 million for asset impairment at SFS.

³ The revenue for the three months ended December 31, 2003 includes a \$17.5 million payment from Boeing for termination of financial guarantees under the contract agreement with ASO. The loss for the same period includes an \$8.3 million write-down of remaining goodwill for ASO and SGS and a \$1.8 million write-down of remaining investment in Guignè.

(26) Statement of Cash Flows

The fiscal year 2003 statement of cash flows has been changed from that reported previously to classify the insurance proceeds received relating to the loss of our Research Double Module as an investing cash flow consistent with the guidance in footnote 5 of Financial Accounting Standards No. 95, Statement of Cash Flows. The insurance proceeds were reported previously as an operating cash flow.

PART IV

Item 15. Exhibits and Financial Statement Schedules

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

1. Financial Statements.

The following consolidated financial statements of SPACEHAB, Incorporated and its wholly-owned and majority-owned subsidiaries and related notes, are set forth herein as indicated below.

| | <u>Page</u> |
|--|-------------|
| <u>Report of Grant Thornton LLP, Independent Registered Public Accounting Firm</u> | 18 |
| <u>Report of Ernst & Young LLP, Independent Registered Public Accounting Firm</u> | 19 |
| <u>Consolidated Balance Sheets</u> | 20 |
| <u>Consolidated Statements of Operations</u> | 21 |
| <u>Consolidated Statements of Stockholders' Equity and Comprehensive Income (Loss)</u> | 22 |
| <u>Consolidated Statements of Cash Flows</u> | 23 |
| <u>Notes to Consolidated Financial Statements</u> | 24 |

2. Exhibits.

| <u>Exhibit No.</u> | <u>Description of Exhibit</u> |
|--------------------|--|
| 23.1 | Consent of Grant Thornton LLP |
| 23.2 | Consent of Ernst & Young LLP |
| 31.1 | Certification Pursuant to 18 U.S. C. Section 1350, as Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002. |
| 31.2 | Certification Pursuant to 18 U.S. C. Section 1350, as Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002. |
| 32 | Certification Pursuant to 18 U.S. C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. |

SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

SPACEHAB, Incorporated

Date: July 18, 2005

By: /s/ Michael E. Kearney

Michael E. Kearney
President and Chief Executive Officer
and Director

By: /s/ Brian K. Harrington

Brian K. Harrington
Vice President and Chief Financial
Officer