ESCO TECHNOLOGIES INC
Form 10-Q
August 09, 2006

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549
FORM 10-Q

(MARK ONE)

(X) QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(D) OF THE SECURITIES EXCHANGE ACT OF 1934 FOR THE QUARTERLY PERIOD ENDED JUNE 30, 2006

OR

( ) TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(D) OF THE SECURITIES EXCHANGE ACT OF 1934 FOR THE TRANSITION PERIOD FROM -------- TO--------

COMMISSION FILE NUMBER 1-10596

ESCO TECHNOLOGIES INC.

(Exact name of registrant as specified in its charter)

MISSOURI	43-1554045
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
9900A CLAYTON ROAD ST. LOUIS, MISSOURI	63124-1186
(Address of principal executive offices)	(Zip Code)

Registrant's telephone number, including area code: (314) 213-7200

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 X No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of "accelerated filer and large accelerated filer" in Rule 12b-2 of the Exchange Act.
Large accelerated filer X Accelerated filer Non-accelerated filer

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

Indicate the number of shares outstanding of each of the issuer's class of common stock, as of the latest practicable date.

Class	Outstanding at July 31, 2006

[Common stock, $.01 par value per share] 25,821,770 shares

PART I. FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

ESCO TECHNOLOGIES INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF OPERATIONS
(Unaudited)
(Dollars in thousands, except per share amounts)

	Three Months Ended June 30, 2006	Three Months Ended June 30, 2005
Net sales	$ 123,626	108,800
Costs and expenses:		
Cost of sales (excluding amortization)	77,152	71,732
Asset impairment	-	790
Amortization of intangible assets	2,554	475
Selling, general and administrative expenses	28,385	21,662
Interest income	(195)	(534)
Other income, net	(513)	(38)
Total costs and expenses	107,383	94,087
Earnings before income taxes	16,243	14,713
Income tax expense	5,080	2,312
Net earnings	$ 11,163	12,401
Earnings per share:		
Basic	$ 0.43	0.49
Diluted	$ 0.42	0.47

See accompanying notes to consolidated financial statements.

ESCO TECHNOLOGIES INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF OPERATIONS
(Unaudited)
(Dollars in thousands, except per share amounts)

	Nine Months Ended June 30, 2006	Nine Months Ended June 30, 2005
Net sales	$ 337,096	319,335
Costs and expenses:		
Cost of sales (excluding amortization)	221,654	209,070
Asset impairment	-	790
Amortization of intangible assets	4,603	1,463

Selling, general and administrative expenses	78,574	62,395
Interest income	(1,012)	(1,317)
Other income, net	(2,440)	(1,207)
Total costs and expenses	301,379	271,194
Earnings before income taxes	35,717	48,141
Income tax expense	15,006	14,790
Net earnings	$ 20,711	33,351
Earnings per share:		
Basic	$ 0.81	1.31
Diluted	$ 0.78	1.27

See accompanying notes to consolidated financial statements.

ESCO TECHNOLOGIES INC. AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS
(Dollars in thousands)

	June 30, 2006	September 30, 2005
ASSETS	(Unaudited)	
Current assets:		
Cash and cash equivalents	$ 35,258	104,484
Accounts receivable, net	82,744	68,819
Costs and estimated earnings on long-term contracts less progress, billings of $5,618 and $7,033, respectively	2,321	4,392
Inventories	50,208	48,645
Current portion of deferred tax assets	26,616	30,219
Other current assets	11,487	8,394
Total current assets	208,634	264,953
Property, plant and equipment, net	69,363	67,190
Goodwill	143,677	68,880
Other assets	63,783	27,697
	$ 485,457	428,720
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current liabilities:		
Short-term borrowings and current maturities of long-term debt	$ -	-
Accounts payable	46,918	29,299
Advance payments on long-term contracts, less costs incurred of $13,544 and $10,949, respectively	5,471	6,773
Accrued salaries	11,715	12,024
Accrued other expenses	21,845	14,661

Total current liabilities	85,949	62,757
Deferred income	6,452	3,134
Pension obligations	17,474	17,481
Other liabilities	16,761	14,324
Long-term debt	-	-
Total liabilities	126,636	97,696
Shareholders' equity:		
Preferred stock, par value $.01 per share, authorized 10,000,000 shares	-	-
Common stock, par value $.01 per share, authorized 50,000,000 shares, issued 28,986,800 and 28,738,958 shares, respectively	290	287
Additional paid-in capital	233,865	228,317
Retained earnings	180,074	159,363
Accumulated other comprehensive loss	(4,147)	(5,566)
	410,082	382,401
Less treasury stock, at cost: 3,168,426 and 3,175,626 common shares, respectively	(51,261)	(51,377)
Total shareholders' equity	358,821	331,024
	$ 485,457	428,720

See accompanying notes to consolidated financial statements.

ESCO TECHNOLOGIES INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS
(Unaudited)
(Dollars in thousands)

	Nine Months Ended June 30,	
	2006	2005
Cash flows from operating activities:		
Net earnings	$ 20,711	33,351
Adjustments to reconcile net earnings to net cash provided by operating activities:		
Depreciation and amortization	12,407	9,263
Stock compensation expense	3,660	2,064
Changes in operating working capital	13,005	(3,020)
Effect of deferred taxes	444	3,526
Other	(2,831)	198
Net cash provided by operating activities	47,396	45,382
Cash flows from investing activities:		
Acquisition of businesses, less cash acquired	(91,468)	-

Capital expenditures	(6,753)	(6,580)
Additions to capitalized software	(24,413)	(4,951)
Net cash used by investing activities	(122,634)	(11,531)
Cash flows from financing activities:		
Borrowings from long-term debt	52,000	-
Principal payments on long-term debt	(52,000)	(122)
Purchases of common stock into treasury	-	(24,928)
Excess tax benefit from stock options exercised	1,112	-
Proceeds from exercise of stock options	2,031	2,538
Other	2,869	2,145
Net cash provided (used) by financing activities	6,012	(20,367)
Net (decrease) increase in cash and cash equivalents	(69,226)	13,484
Cash and cash equivalents, beginning of period	104,484	72,281
Cash and cash equivalents, end of period	$ 35,258	85,765

See accompanying notes to consolidated financial statements.

ESCO TECHNOLOGIES INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

1. BASIS OF PRESENTATION

The accompanying consolidated financial statements, in the opinion of management, include all adjustments, consisting only of normal recurring accruals, necessary for a fair presentation of the results for the interim periods presented. The consolidated financial statements are presented in accordance with the requirements of Form 10-Q and consequently do not include all the disclosures required by accounting principles generally accepted in the United States of America (GAAP). For further information refer to the consolidated financial statements and related notes included in the Company's Annual Report on Form 10-K for the fiscal year ended September 30, 2005. During 2005, the Company issued a 2-for-1 stock split which was effected as a 100 percent stock dividend and was paid on September 23, 2005. The prior years common stock and per share amounts have been adjusted to reflect the stock split.

The Company's business is typically not impacted by seasonality, however, the results for the three and nine-month periods ended June 30, 2006 are not necessarily indicative of the results for the entire 2006 fiscal year.

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

This Summary of Significant Accounting Policies supplements the summary in the Company's Annual Report on Form 10-K for the fiscal year ended September 30, 2005.

(a) Revenue Recognition

Filtration / Fluid Flow Operating Unit: Within the Filtration / Fluid Flow operating unit, approximately 75% of operating unit revenues (30% of consolidated revenues) are recognized when products are delivered (when title and risk of ownership transfers) or when services are performed for unaffiliated customers.

Approximately 25% of operating unit revenues (10% of consolidated revenues) are recorded under the percentage-of-completion provisions of SOP 81-1, "Accounting for Performance of Construction-Type and Certain Production-Type Contracts." Products accounted for under SOP 81-1 include the design, development and manufacture of complex fluid control products, quiet valves, manifolds and systems primarily for the aerospace and military markets. For arrangements that are accounted for under SOP 81-1, the Company estimates profit as the difference between total estimated revenue and total estimated cost of a contract and recognizes these revenues and costs based on units delivered. The percentage-of-completion method of accounting involves the use of various techniques to estimate expected costs at completion.

Communications Segment: Within the Communications segment, approximately 95% of the segment's revenue arrangements (30% of consolidated revenues) contain software components. Revenue under these arrangements is recognized in accordance with Statement of Position 97-2 (SOP 97-2), "Software Revenue Recognition," as amended by SOP 98-9, "Modification of SOP 97-2, Software Revenue Recognition, with Respect to Certain Transactions." The segment's software revenue arrangements generally include multiple products and services, or "elements" consisting of meter and substation hardware, meter reading system software, program management support during the deployment period and software support (post-contract customer support, "PCS"). These arrangements typically require the Company to deliver software at the inception of the arrangement while the hardware, and program management support are delivered over the contractual deployment period. Software support is provided during deployment and subsequent thereto. The software element included in such arrangements is essential to the functionality of the hardware and, therefore, the hardware is considered to be software-related. Hardware is considered a specified element in the software arrangement and vendor-specific objective evidence of fair value ("VSOE") has been established for this element. VSOE for the hardware element is determined based on the price when sold separately to customers. These revenue arrangements are divided into separate units of accounting if the delivered item(s) has value to the customer on a stand-alone basis, there is objective and reliable evidence of the fair value of the undelivered item(s) and delivery/performance of the undelivered item(s) is probable. For multiple element arrangements, revenue is allocated to the individual elements based on VSOE of the individual elements.

The application of these principles requires judgment, including the determination of whether a software arrangement includes multiple elements and estimates of the fair value of the elements. The VSOE of the undelivered elements is determined based on the historical evidence of stand-alone sales of these elements to customers. Hardware revenues are generally recognized at the time of shipment or receipt by customer depending upon contract terms. VSOE generally does not exist for the software element, therefore, the Company uses the residual method to recognize revenue when VSOE exists for all other undelivered elements. Under the residual method, the fair value of the undelivered elements is deferred and the remaining portion of the arrangement fee is recognized as revenue.

SOP 97-2 requires the seller of software that includes post-contract customer support (PCS) to establish VSOE of the undelivered element of the contract in order to account separately for the PCS revenue. The Company determines VSOE by a consistent pricing of PCS and PCS renewals as a percentage of the software license fees and by reference to contractual renewals, when the renewal terms are substantive. Revenues for PCS are recognized ratably over the maintenance term specified in the contract (generally in 12 monthly increments). Revenues for program management support are recognized when services have been provided. The Company determines VSOE for program management support based on hourly rates when services are performed separately.

Deferred revenue is recorded for products or services that have not been provided but have been invoiced under contractual agreements or paid for by a customer, or when products or services have been provided but the criteria for revenue recognition have not been met. If there is a customer acceptance provision or there is uncertainty about customer acceptance, revenue is deferred until the customer has accepted the product or service.

Approximately 5% of segment revenues (1% of consolidated revenues) are recognized when products are delivered (when title and risk of ownership transfers) or when services are performed for unaffiliated customers. Products include the SecurVision digital video surveillance systems.

Test Segment: Within the Test segment, approximately 60% of revenues (20% of consolidated revenues) are recognized when products are delivered (when title and risk of ownership transfers) or when services are performed for unaffiliated customers. Certain arrangements contain multiple elements which are accounted for under the provisions of EITF 00-21, "Revenue Arrangements with Multiple Deliverables." The multiple elements generally consist of materials and installation services used in the construction and installation of standard shielded enclosures to measure and contain magnetic and electromagnetic energy. The installation process does not involve changes to the features or capabilities of the equipment and does not require proprietary information about the equipment in order for the installed equipment to perform to specifications. There is objective and reliable evidence of fair value for each of the units of accounting, as a result, the arrangement revenue is allocated to the separate units of accounting based on their relative fair values. Typically, fair value is the price of the deliverable when it is regularly sold on a stand-alone basis.

Approximately 40% of the segment's revenues (9% of consolidated revenues) are recorded under the percentage-of-completion provisions of SOP 81-1, "Accounting for the Performance of Construction-Type and Certain Production-Type Contracts" due to the complex nature of the enclosures that are designed and produced under these contracts. Products accounted for under SOP 81-1 include the construction and installation of complex test chambers to a buyer's specifications that provide its customers with the ability to measure and contain magnetic, electromagnetic and acoustic energy. As discussed above, for arrangements that are accounted for under SOP 81-1, the Company estimates profit as the difference between total estimated revenue and total estimated cost of a contract and recognizes these revenues and costs based on either (a) units delivered or (b) contract milestones.

If a reliable measure of output cannot be established (which applies in less than 8% of Test segment revenues or 2% of consolidated revenues), input measures (e.g., costs incurred) are used to recognize revenue. Given the nature of the Company's operations related to these contracts, costs incurred represent an appropriate measure of progress towards completion.

The percentage-of-completion method of accounting involves the use of various techniques to estimate expected costs at completion. These estimates are based on Management's judgment and the Company's substantial experience in developing these types of estimates.

(b) Capitalized Software

The costs incurred for the development of computer software that will be sold, leased, or otherwise marketed are charged to expense when incurred as research and development until technological feasibility has been established for the product. Technological feasibility is typically established upon completion of a detailed program design. Costs incurred after this point are capitalized on a project-by-project basis in accordance with SFAS No. 86, "Accounting for the Costs of Computer Software to be Sold, Leased or Otherwise Marketed." Costs that are capitalized primarily consist of external development costs. Upon general release of the product to customers, the Company ceases capitalization and begins amortization, which is calculated on a project-by-project basis as the greater of (1) the ratio of current gross revenues for a product to the total of current and anticipated future gross revenues for the product or (2) the straight-line method over the estimated economic life of the product. The Company generally amortizes the software development costs over a three to seven year period based upon the estimated future economic life of the product. Factors considered in determining the estimated future economic life of the product include anticipated future revenues, and changes in software and hardware technologies. The carrying values of capitalized costs are evaluated for impairment on an annual basis to determine if circumstances exist which indicate the carrying value of the asset may not be recoverable. If expected cash flows are insufficient to recover the carrying amount of the asset, then an impairment loss is recognized to state the asset at its net realizable value.

3. EARNINGS PER SHARE (EPS)

Basic EPS is calculated using the weighted average number of common shares outstanding during the period. Diluted EPS is calculated using the weighted average number of common shares outstanding during the period plus shares issuable upon the assumed exercise of dilutive common share options and vesting of performance-accelerated restricted shares (restricted shares) by using the treasury stock method. The number of shares used in the calculation of earnings per share for each period presented is as follows (in thousands):

	Three Months Ended June 30,		Nine Months Ended June 30,	
	2006	2005	2006	2005
Weighted Average				
Shares Outstanding - Basic	25,790	25,424	25,678	25,442
Dilutive Options and Restricted Shares	651	764	740	784

Adjusted Shares-Diluted	26,441	26,188	26,418	26,226

Options to purchase 32,000 shares of common stock at a price of $54.88 and options to purchase 8,000 shares of common stock at prices ranging from $39.86 - $50.26 were outstanding during the three month periods ended June 30, 2006 and 2005, respectively, but were not included in the computation of diluted EPS because the options' exercise prices were greater than the average market price of the common shares. The options expire at various periods through 2013. Approximately 12,000 and 38,000 restricted shares were excluded from the respective computation of diluted EPS based upon the application of the treasury stock method for the three month periods ended June 30, 2006 and 2005, respectively.

4. SHARE-BASED COMPENSATION

Prior to October 1, 2005, the Company accounted for its stock option plans using the intrinsic value method of accounting provided under APB Opinion No. 25, "Accounting for Stock Issued to Employees," (APB 25) and related interpretations, as permitted by FASB Statement No. 123, "Accounting for Stock-Based Compensation," (SFAS 123) under which no compensation expense was recognized for stock option grants. Accordingly, share-based compensation for stock options was included as a pro forma disclosure in the financial statement footnotes and continues to be provided for periods prior to fiscal 2006.

Effective October 1, 2005, the Company adopted the fair value recognition provisions of FASB Statement No. 123 (R), "Share-Based Payment," (SFAS 123(R)) using the modified-prospective transition method. Under this transition method, compensation cost recognized in the first nine months of fiscal 2006 includes:

a) compensation cost for all share-based payments granted through September 30, 2005, for which the requisite service period had not been completed as of September 30, 2005, based on the grant date fair value estimated in accordance with the original provisions of SFAS 123, and

b) compensation cost for all share-based payments granted subsequent to September 30, 2005, based on the grant date fair value estimated in accordance with the provisions of SFAS 123(R). Results for prior periods have not been restated.

As a result of adopting SFAS 123(R) on October 1, 2005, the Company's net earnings for the three and nine-month periods ended June 30, 2006 are $0.6 million and $1.7 million lower respectively, than if it had continued to account for share-based compensation under APB 25.

The Company provides compensation benefits to certain key employees under several share-based plans providing for employee stock options and/or performance-accelerated restricted shares (restricted shares), and to non-employee directors under a non-employee directors compensation plan.

Stock Option Plans

The Company has various stock option plans that permit the Company to grant key Management employees (1) options to purchase shares of the Company's common stock or (2) stock appreciation rights with respect to all or any part of the number of shares covered by the options. All outstanding options were granted at prices equal to fair market value at the date of grant. The options granted prior to September 30, 2003 have a ten-year contractual life from date of issuance, expiring in various periods through 2013. Beginning in fiscal 2004, the options granted have a five-year contractual life from date of issuance. No stock appreciation rights have been awarded to date. The Company's stock option awards are subject to graded vesting over a three year service period. Beginning with fiscal 2006 awards, the Company recognizes compensation cost on a straight-line basis over the requisite service period for the entire award. Prior to fiscal 2006, the Company calculated the pro forma compensation cost using the graded vesting method (FIN 28 approach).

The fair value of each option award is estimated as of the date of grant using a Black-Scholes option pricing model. The weighted average assumptions for the periods indicated are noted below. Expected volatility is based on historical volatility of ESCO's stock calculated over the expected term of the option. The expected term was calculated in accordance with Staff Accounting Bulletin No. 107 using the simplified method for "plain-vanilla" options. The risk-free rate for the expected term of the option is based on the U.S. Treasury yield curve in effect at the date of grant.

The fair value of each option grant is estimated on the date of grant using the Black-Scholes option-pricing model with the following weighted-average assumptions used for grants in the three month period ended June 30, 2006 and 2005, respectively: expected dividend yield of 0% in both periods; expected volatility of 28.2% and 27.6%; risk-free interest rate of 5.0% and 3.7%; and expected term of 3.5 years and 4.17 years. Pre-tax compensation expense related to the stock option awards was $0.6 million and $1.7 million for the third quarter of 2006 and the first nine months of 2006, respectively.

The following summary presents information regarding outstanding stock options as of June 30, 2006 and changes during the nine months then ended with regard to options under the option plans:

	Shares	Weighted Avg. Price	Aggregate Intrinsic Value (in millions)	Weighted-Average Remaining Contractual Life
Outstanding at October 1, 2005	1,324,548	$20.48		
Granted	320,380	$44.46		
Exercised	(185,561)	$16.09	$6.1	
Cancelled	(25,740)	$35.97		
Outstanding at June 30, 2006	1,433,627	$26.14	$38.9	4 years
Exercisable at June 30, 2006	797,726	$16.23	$29.5	

The weighted-average grant-date fair value of options granted during the first nine months of fiscal 2006 was $12.11.

During fiscal 2004, the Board of Directors authorized and the shareholders approved, the 2004 Incentive Compensation Plan, which states, in part, that on February 5, 2004, there shall be added to the authorized shares allocated 2,000,000 shares for the grant of stock options, stock appreciation rights, performance-accelerated restricted stock, or other full value awards. Of these, shares up to 600,000 may be utilized for performance-accelerated restricted stock or other full value awards.

Restricted Share Awards

At June 30, 2006, the maximum number of restricted shares available for issue under the 2004 Incentive Compensation Plan and the 2001 Stock Incentive Plan was 600,000 and 361,162 shares, respectively. These shares vest over five years with accelerated vesting over three years if certain performance targets are achieved. In these cases, if it is probable that the performance condition will be met, the Company recognizes compensation cost on a straight-line basis over the shorter performance period; otherwise, it will recognize compensation cost over the longer service period. Compensation cost for all outstanding restricted share awards is being recognized over the shorter performance period as it is probable the performance condition will be met. The restricted share award grants were valued at the stock price on the date of grant. Pre-tax compensation expense related to the restricted share awards was $0.2 million and $1.3 million for the three and nine-month periods ended June 30, 2006, respectively, and $0.3 million and $1.6 million for the respective prior year periods.

The following summary presents information regarding outstanding restricted share awards as of June 30, 2006 and changes during the nine-month period then ended:

	Shares	Weighted Avg. Price
Nonvested at October 1, 2005	238,436	$23.78
Granted	64,130	$43.02
Vested	(118,736)	$17.41
Cancelled	(10,500)	$32.78
Nonvested at June 30, 2006	173,330	$34.72

Non-Employee Directors Plan

The non-employee directors compensation plan includes a retainer of 800 common shares per quarter. Compensation expense related to the non-employee directors was $0.2 million and $0.7 million for the three and nine-month periods ended June 30, 2006, respectively, and $0.2 million and $0.5 million for the respective prior year periods.

The total share-based compensation cost that has been recognized in results of operations and included within SG&A was $1.0 million and $3.7 million for the three and nine-month periods ended June 30, 2006, respectively, and $0.5 million and $2.1 million for the three and nine-month periods ended June 30, 2005, respectively. The total income tax benefit recognized in results of operations for share-based compensation arrangements was $0.3 million and $1.0 million for the three and nine-month periods ended June 30, 2006, respectively and $0.2 million and $0.7 million for the three and nine-month periods ended June 30, 2005, respectively. As of June 30, 2006, there was $9.0 million of total unrecognized compensation cost related to share-based compensation arrangements. That cost is expected to be recognized over a weighted-average period of 3.75 years.

Pro Forma Net Earnings

The following table provides pro forma net earnings and earnings per share had the Company applied the fair value method of SFAS 123 for the three and nine-month periods ended June 30, 2005:

(Unaudited)
(Dollars in thousands,
except per share amounts)

	Three Months Ended June 30,	Nine Months Ended June 30,
	2005	2005
Net earnings, as reported	$ 12,401	$ 33,351
Add: stock-based employee compensation expense included in reported net earnings, net of tax	202	952
Less: total stock-based employee compensation expense determined under fair value based methods, net of tax	(704)	(2,549)
Pro forma net earnings	$ 11,899	$ 31,754
Net earnings per share:		
Basic - as reported	$ 0.49	$ 1.31
Basic - pro forma	0.47	1.25
Diluted - as reported	$ 0.47	$ 1.27
Diluted - pro forma	0.45	1.21

5. ACQUISITIONS

Effective February 1, 2006, the Company acquired the capital stock of Hexagram, Inc. (Hexagram) for a purchase price of $67.5 million subject to a potential working capital adjustment. The acquisition agreement also provides for contingent consideration of up to $6.25 million over the five year period following the acquisition if Hexagram exceeds certain sales targets. Hexagram is a RF fixed network automatic meter reading (AMR) company headquartered in Cleveland, Ohio. Hexagram's annual revenue over the past three years has been in the range of $20 million to $35 million. The operating results for Hexagram, since the date of acquisition, are included within the Communications segment. The Company recorded approximately $55 million of goodwill and trademarks as a result of the transaction, subject to post-closing adjustments including finalization of purchase accounting. The Company also recorded $6.6 million of identifiable intangible assets consisting primarily of patents and proprietary know-how, customer contracts, and order backlog which will be amortized on a straight-line basis over periods ranging from six months to seven years. The post-closing purchase accounting items are expected to be completed prior to September 30, 2006.

Effective November 29, 2005, the Company acquired Nexus Energy Software, Inc. (Nexus) through an all cash for shares merger transaction for approximately $29 million in cash plus contingent cash consideration over the four year period following the merger if Nexus exceeds certain sales targets. Nexus is a software company headquartered in Wellesley, Massachusetts with annual revenues in the past in excess of $10 million. The operating results for Nexus, since the date of acquisition, are included within the Communications segment. The Company recorded approximately $24 million of goodwill as a result of the transaction, subject to post-closing adjustments including finalization of purchase accounting. The Company also recorded $2.7 million of identifiable intangible assets consisting primarily of customer contracts and order backlog which will be amortized on a straight-line basis over periods ranging from one year to three years. The post-closing purchase accounting items are expected to be completed prior to September 30, 2006.

6. INVENTORIES

Inventories consist of the following (in thousands):

	June 30, 2006	September 30, 2005
Finished goods	$ 13,444	14,361
Work in process, including long- term contracts	13,246	12,512
Raw materials	23,518	21,772
Total inventories	$ 50,208	48,645

7. COMPREHENSIVE INCOME

Comprehensive income for the three-month periods ended June 30, 2006 and 2005 was $12.2 million and $11.2 million, respectively. Comprehensive income for the nine-month periods ended June 30, 2006 and 2005 was $22.1 million and $34.0 million, respectively. For the three and nine-month periods ended June 30, 2006, the Company's comprehensive income was positively impacted by foreign currency translation adjustments of $1.1 million and $1.4 million, respectively. For the three and nine-month periods ended June 30, 2005, the Company's comprehensive income was negatively impacted by foreign currency translation adjustments of $1.2 million and positively impacted by foreign currency translation adjustments of $0.7 million, respectively.

8. BUSINESS SEGMENT INFORMATION

The Company is organized based on the products and services that it offers. Under this organizational structure, the Company operates in three segments: Filtration/Fluid Flow, Communications and Test. The components of the Filtration/Fluid Flow segment are presented separately due to differing long-term economics.

Management evaluates and measures the performance of its operating segments based on "Net Sales" and "EBIT", which are detailed in the table below. EBIT is defined as earnings from continuing operations before interest and taxes. During the second quarter of fiscal 2006, the Company changed its reporting of goodwill and acquired intangible assets (including related amortization) from operating segments to Corporate as they are excluded by management in assessing the segment's operating performance. There was no impact on EBIT in the prior periods.

($ in thousands)	Three Months ended June 30,		Nine Months ended June 30,	
NET SALES	2006	2005	2006	2005
PTI	$ 11,379	10,262	$ 33,787	30,621
VACCO	6,551	9,616	22,930	28,787
Filtertek	24,628	24,774	72,335	70,223
Filtration/Fluid Flow	42,558	44,652	129,052	129,631
Communications	49,251	31,141	111,623	100,759
Test	31,817	33,007	96,421	88,945
Consolidated totals	$123,626	108,800	$337,096	319,335
EBIT				
PTI	1,479	585	4,261	2,821
VACCO	1,388	2,717	4,720	8,473
Filtertek	2,330	2,585	5,026	6,693
Filtration/Fluid Flow	5,197	5,887	14,007	17,987
Communications	11,369	8,192	20,138	28,446
Test	4,034	3,274	11,288	8,694
Corporate	(4,552)	(3,174)	(10,728)	(8,303)
Consolidated EBIT	16,048	14,179	34,705	46,824
Add: Interest income	195	534	1,012	1,317
Earnings before income taxes	$ 16,243	14,713	$ 35,717	48,141

9. ASSET IMPAIRMENT

In June 2005, the Company abandoned its plans to commercialize certain sensor products within the Filtration/Fluid Flow segment. This action resulted in an asset impairment charge of $0.8 million to write-off certain patents and a related licensing agreement to their respective fair market values. The Company ended its development efforts on this program after it determined that the market was not developing as quickly as anticipated and the expected costs and timeframe to fully commercialize the products were not acceptable.

10. RETIREMENT AND OTHER BENEFIT PLANS

A summary of net periodic benefit expense for the Company's defined benefit plans and postretirement healthcare and other benefits for the three and nine-month periods ended June 30, 2006 and 2005 are shown in the following tables. Net periodic benefit cost for each period presented is comprised of the following:

	Three Months Ended June 30,		Nine Months Ended June 30,	
(Dollars in thousands)	2006	2005	2006	2005
Defined benefit plans				
Interest cost	$ 635	663	$ 1,935	1,988
Expected return on assets	(696)	(713)	(2,046)	(2,138)
Amortization of:				
Prior service cost	6	-	6	-
Actuarial loss	55	125	305	375
Net periodic benefit cost	$ -	75	$ 200	225

Net periodic postretirement (retiree medical) benefit cost for each period presented is comprised of the following:

	Three Months Ended June 30,		Nine Months Ended June 30,	
(Dollars in thousands)	2006	2005	2006	2005
Service cost	$ 9	8	$ 26	23
Interest cost	10	10	30	30
Prior service cost	(1)	-	(3)	-
Amortization of actuarial gain	(9)	(5)	(15)	(14)
Net periodic postretirement benefit cost	$ 9	13	$ 38	39

11. RECENTLY ISSUED ACCOUNTING PRONOUNCEMENTS

In December 2004, the FASB issued FASB Staff Position FAS 109-2, "Accounting and Disclosure Guidance for the Foreign Earnings Repatriation Provision within the American Jobs Creation Act of 2004 (FSP 109-2)." The American Jobs Creation Act of 2004, (the "Act") provides for a special one-time deduction of 85 percent of certain foreign earnings repatriated into the U.S. from non-U.S. subsidiaries through September 30, 2006. During the second quarter ended March 31, 2006, the Company repatriated $28.7 million of foreign earnings which qualify for the special one-time deduction. Tax expense of $1.7 million was recorded in the second quarter of fiscal 2006 as a result of this repatriation.

The Company is currently evaluating the merits of repatriating additional funds under the Act. At June 30, 2006, the range of reasonably possible amounts of unremitted earnings that are being considered for repatriation is between zero and $10.5 million, which would require the Company to pay income taxes in the range of zero to $1.0 million. Federal income taxes on the repatriated amounts would be based on the 5.25% effective statutory rate as provided in the Act, plus applicable withholding taxes. To date, the Company has not provided for income taxes on these unremitted earnings generated by non-U.S. subsidiaries. As a result, additional taxes may be required to be recorded for any funds repatriated under the Act. The Company expects to complete its evaluation of these additional funds by September 30, 2006.

In June 2006, the FASB issued FASB Interpretation No. 48, "Accounting for Uncertainty in Income Taxes, an Interpretation of FASB Statement No. 109." This Interpretation is effective for ESCO beginning October 1, 2007. This Interpretation prescribes a recognition threshold and measurement process for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. The Company is currently evaluating the adoption of this Interpretation and does not currently have an estimate of the impact on the consolidated financial statements.

ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

RESULTS OF OPERATIONS

The following discussion refers to the Company's results from continuing operations, except where noted. References to the third quarters of 2006 and 2005 represent the fiscal quarters ended June 30, 2006 and 2005, respectively.

NET SALES

Net sales increased $14.8 million, or 13.6%, to $123.6 million for the third quarter of 2006 from $108.8 million for the third quarter of 2005 including $9.5 million from acquisitions. Net sales increased $17.8 million, or 5.6% to $337.1 million for the first nine months of fiscal 2006 from $319.3 for the first nine months of fiscal 2005 including $17.2 million from acquisitions. Favorable foreign currency values increased sales by approximately $1.1 million in the third quarter of 2006 and unfavorable foreign currency values decreased sales by approximately $0.6 million in the first nine months of fiscal 2006.

-Filtration/Fluid Flow

Net sales decreased $2.1 million, or 4.7%, to $42.6 million for the third quarter of 2006 from $44.7 million for the third quarter of 2005. Net sales decreased $0.5 million, or 0.4%, to $129.1 million for the first nine months of fiscal 2006 from $129.6 million for the first nine months of fiscal 2005. The sales decrease during the fiscal quarter ended June 30, 2006 as compared to the prior year quarter is mainly due to the following: a decrease in defense spares and T-700 shipments at VACCO of $3.0 million; a net sales decrease at Filtertek of $0.2 million; partially offset by higher commercial aerospace shipments at PTI of $1.1 million. The sales decrease for the first nine months of fiscal 2006 as compared to the prior year period is mainly due to the following: a decrease in defense spares and T-700 shipments at VACCO of $5.9 million; partially offset by higher commercial aerospace shipments at PTI of $3.2 million and a net sales increase at Filtertek of $2.1 million driven by higher commercial shipments.

-Communications

Net sales increased $18.1 million, or 58.2%, to $49.2 million for the third quarter of 2006 from $31.1 million for the third quarter of 2005. Net sales increased $10.8 million, or 10.7%, to $111.6 million for the first nine months of fiscal 2006 from $100.8 million in the prior year period. The sales increase in the third quarter of 2006 as compared to the prior year quarter was due to the following: $9.4 million of higher shipments of DCSI's automatic meter reading (AMR) products; contributions by the Hexagram and Nexus acquisitions of $7.0 million and $2.5 million, respectively; partially offset by $0.7 million of lower shipments of Comtrak's SecurVision video security products.

The sales increase in the first nine months of fiscal 2006 as compared to the prior year period was due to the following: $2.2 million of higher shipments of DCSI's AMR products; $10.9 million in sales from Hexagram and $6.3 million in sales from Nexus; partially offset by $8.5 million of lower shipments of Comtrak's video security products.

The increase in sales of DCSI's AMR products of $2.2 million for the first nine months of fiscal 2006 as compared to the prior year period was due to the following items: an increase in sales to TXU Electric Delivery Company (TXU) of $22.8 million in the first nine months of fiscal 2006; partially offset by $14.4 million of lower AMR product sales to the COOP market due to the decrease in orders entered during the latter half of fiscal 2005 and $6.2 million of lower sales to Puerto Rico Power Authority (PREPA).

Sales of SecurVision products were $1.5 million for the third quarter of 2006 as compared to $2.3 million for the prior year third quarter and $4.4 million for the first nine months of fiscal 2006 as compared to $12.9 million in the prior year nine-month period. The decrease in sales in the third quarter and first nine months of fiscal 2006 was due to an acceleration of shipments in the prior year periods.

In June 2006, Hexagram announced it had appointed the Neptune Technology Group as its exclusive distributor for the Hexagram STAR Wireless Fixed Network System for the Water Utility, Water Sub-Metering and Government Markets in the U.S.A., Canada, Mexico and Caribbean.

-Test

For the third quarter of 2006, net sales of $31.8 million were $1.2 million, or 3.6%, lower than the $33.0 million of net sales recorded in the third quarter of fiscal 2005. Net sales increased $7.5 million, or 8.4%, to $96.4 million for the first nine months of fiscal 2006 from $88.9 million for the first nine months of fiscal 2005. The sales decrease in the third quarter of 2006 as compared to the prior year quarter was mainly due to a decrease in government shielding projects and the timing of large chamber projects in Japan.

The sales increase for the first nine months of fiscal 2006 compared to the prior year period was primarily due to the following: a $9.8 million increase in net sales from the Company's U.S. operations driven by sales of additional test chambers and higher component sales; partially offset by a $1.1 million decrease in net sales from the Company's European operations due to the prior year completion of several large test chamber projects and a $1.2 million decrease in net sales from the Company's Asian operations due to the timing of orders in Japan.

ORDERS AND BACKLOG

Backlog was $260.0 million at June 30, 2006 compared with $233.1 million at September 30, 2005. The Company received new orders totaling $109.1 million in the third quarter of 2006. New orders of $49.6 million were received in the third quarter of 2006 related to Filtration/Fluid Flow products, $29.7 million related to Communications products and $29.8 million related to Test products.

The Company received new orders totaling $363.9 million in the first nine months of 2006 compared to $321.6 million in the prior year period. New orders of $134.0 million were received in the first nine months of 2006 related to Filtration/Fluid flow products, $144.4 million related to Communications products (including $9.4 million of new orders and $6.0 million of acquired backlog from Hexagram and $14.6 million of new orders and $9.0 million of acquired backlog from Nexus) and $85.6 million related to Test products. New orders of $138.9 million were received in the first nine months of 2005 related to Filtration/Fluid flow products, $100.1 million related to Communications products and $82.6 million related to Test products.

In addition, in November 2005, DCSI signed an agreement with Pacific Gas & Electric (PG&E) with an anticipated contract value of approximately $300 million covering five million endpoints over a five year deployment period currently scheduled to begin in fiscal 2007. The Company received orders totaling $2.4 million from PG&E under this agreement during the first nine months of 2006. On November 3, 2005, Hexagram entered into a contract to provide equipment, software and services to PG&E in support of the gas utility portion of PG&E's AMI project. The total anticipated contract revenue from commencement through the five-year full deployment for this Hexagram contract is expected to be approximately $225 million. See "Pacific Gas & Electric."

AMORTIZATION OF INTANGIBLE ASSETS

Amortization of intangible assets was $2.6 million and $4.6 million for the three and nine-month periods ended June 30, 2006, respectively, compared to $0.5 million and $1.5 million for the respective prior year periods. Amortization of intangible assets in the third quarter of 2006 and first nine months of fiscal 2006 includes $1.0 million and $1.9 million, respectively, of amortization of acquired intangible assets related to the Nexus and Hexagram acquisitions, as described in Note 5 to the consolidated financial statements. The amortization of acquired intangible assets related to Nexus and Hexagram are included in Corporate's operating results. The remaining amortization expenses consist of other identifiable intangible assets (primarily software, patents and licenses). During the three and nine-month periods ended June 30, 2006, the Company recorded $0.9 million and $1.2 million, respectively, of amortization related to DCSI's TNG capitalized software.

SELLING, GENERAL AND ADMINISTRATIVE EXPENSES

Selling, general and administrative (SG&A) expenses for the third quarter of 2006 were $28.4 million (23.0% of net sales), compared with $21.7 million (19.9% of net sales) for the prior year quarter. For the first nine months of 2006, SG&A expenses were $78.6 million (23.3% of net sales) compared with $62.4 million (19.5% of net sales) for the prior year period. The increase in SG&A spending in the fiscal quarter ended June 30, 2006 as compared to the prior year quarter was primarily due to the following items: $2.7 million of SG&A expenses related to Hexagram; $2.3 million of SG&A expenses related to Nexus; and $0.6 million of stock option expense. The increase in SG&A spending in the first nine months of 2006 as compared to the prior year period was primarily due to the following items: $5.1 million of SG&A expenses related to Nexus; $4.2 million of SG&A expenses related to Hexagram; and $1.7 million of stock option expense.

OTHER (INCOME) EXPENSES, NET

Other income, net, was $0.5 million for the third quarter of 2006 compared to $0.1 million for the prior year quarter. Other income, net, was $2.4 million for the first nine months of fiscal 2006 compared to $1.2 million for the prior year period. Principal components of other income, net, for the first nine months of 2006 included the following items: $1.8 million non-cash gain in the second quarter representing the release of a reserve related to an indemnification obligation with respect to a previously divested subsidiary; $1.6 million of royalty income; partially offset by a $0.2 million write off of assets related to a terminated subcontract manufacturer. The principal components of other income, net, for the first nine months of fiscal 2005 included the following items: $1.5 million of royalty income; and a $0.5 million write down of fixed assets related to the termination of a supply agreement with a medical device customer.

EBIT

The Company evaluates the performance of its operating segments based on EBIT, defined below. EBIT was $16.0 million (13.0% of net sales) for the third quarter of 2006 and $14.2 million (13.0% of net sales) for the third quarter of 2005. For the first nine months of fiscal 2006, EBIT was $34.7 million (10.3% of net sales) and $46.8 million (14.7% of net sales) for the first nine months of fiscal 2005. The decrease in EBIT for the first nine months of 2006 as compared to the prior year period is primarily due to the decrease in margins in the Communications segment described below.

This Form 10-Q contains the financial measure "EBIT", which is not calculated in accordance with generally accepted accounting principles in the United States of America (GAAP). EBIT provides investors and Management with an alternative method for assessing the Company's operating results. The Company defines "EBIT" as earnings from continuing operations before interest and taxes. Management evaluates the performance of its operating segments based on EBIT and believes that EBIT is useful to investors to demonstrate the operational profitability of the Company's business segments by excluding interest and taxes, which are generally accounted for across the entire Company on a consolidated basis. EBIT is also one of the measures Management uses to determine resource allocations within the Company and incentive compensation. The following table represents a reconciliation of EBIT to net earnings.

($ in thousands)	Three Months ended June 30,		Nine Months ended June 30,	
	2006	2005	2006	2005
EBIT	$16,048	14,179	$34,705	46,824
Interest income	195	534	1,012	1,317
Less: Income taxes	5,080	2,312	15,006	14,790
Net earnings	$11,163	12,401	$20,711	33,351

-Filtration/Fluid Flow

EBIT was $5.2 million (12.2% of net sales) and $5.9 million (13.2% of net sales) in the third quarters of 2006 and 2005, respectively, and $14.0 million (10.9% of net sales) and $18.0 million (13.9% of net sales) in the first nine months of fiscal 2006 and 2005, respectively. For the third quarter of 2006 as compared to the prior year quarter, EBIT decreased $0.7 million due to the following: a $1.3 million decrease at VACCO due to lower defense spares shipments; a $0.3 million decrease at Filtertek; partially offset by a $0.9 million increase at PTI due to continued strengthening of the commercial aerospace market. For the first nine months of fiscal 2006 as compared to the prior year period, EBIT decreased $4.0 million due to the following: a $3.8 million decrease at VACCO due to lower defense spares shipments; a $1.7 million decrease at Filtertek; partially offset by a $1.4 million increase at PTI. Filtertek's third quarter and first nine months of fiscal 2005 included $1.0 million and $1.9 million, respectively, of cost reimbursement related to a supply agreement with a medical device customer which was terminated in fiscal 2005. In the third quarter of fiscal 2005, PTI recorded an asset impairment charge of $0.8 million. See Note 9 to the consolidated financial statements for further discussion.

-Communications

EBIT in the third quarter of 2006 was $11.4 million (23.2% of net sales) compared to EBIT of $8.2 million (26.4% of net sales) in the prior year quarter. For the first nine months of fiscal 2006, EBIT was $20.1 million (18.0% of net sales) compared to $28.4 million (28.2% of net sales) in the prior year period. The increase in EBIT in the third quarter of 2006 was due to the following items: a $3.6 million increase at DCSI resulting from increased sales; a $0.6 million increase related to Hexagram; partially offset by a $0.6 million EBIT loss at Nexus due to customer delays and a $0.4 million decrease at Comtrak due to lower shipments of its video security products. The decrease in EBIT for the first nine months of fiscal 2006 compared to the prior year period was mainly due to the following items: a $4.5 million decrease at DCSI due to product mix, charges related to subcontractor and warranty issues recorded in the first quarter of 2006 and amortization of TNG software; a $3.6 million decrease at Comtrak due to lower shipments of its video security products; a $0.7 million EBIT loss at Nexus due to customer delays and additional SG&A spending related to marketing and new product development initiatives; partially offset by a $0.6 million increase related to Hexagram.

-Test

EBIT in the third quarter of 2006 was $4.0 million (12.6% of net sales) as compared to $3.3 million (10.0% of net sales) in the prior year quarter. For the first nine months of fiscal 2006, EBIT was $11.3 million (11.7% of net sales) as compared to $8.7 million (9.8% of net sales) in the prior year period. EBIT increased $0.7 million and $2.6 million over the prior year quarter and nine month period, respectively, due to the favorable changes in sales mix resulting from additional sales of test chambers, antennas and other components. In addition, EBIT in the first nine months of fiscal 2005 was adversely affected by installation cost overruns incurred on certain government shielding projects in foreign locations, as well as increased material costs (steel and copper).

-Corporate

Corporate costs included in EBIT were $4.6 million and $10.7 million for the three and nine-month periods ended June 30, 2006, respectively, compared to $3.2 million and $8.3 million for the respective prior year periods. In the third quarter of 2006, Corporate costs included the following: $1.0 million of pre-tax amortization of acquired intangible assets related to Nexus and Hexagram; and $0.6 million of pre-tax stock option expense. In the first nine months of 2006, Corporate costs included the following: $1.9 million of pre-tax amortization of acquired intangible assets related to Nexus and Hexagram; $1.7 million of pre-tax stock option expense; partially offset by a $1.8 million non-cash gain representing the release of a reserve related to an indemnification obligation with respect to a previously divested subsidiary.

INTEREST INCOME, NET

Interest income, net, was $0.2 million and $1.0 million for the three and nine-month periods ended June 30, 2006, respectively, compared to interest income, net, of $0.5 million and $1.3 million for the respective prior year periods. The decrease in interest income in the third quarter of 2006 as compared to the prior year quarter was due to lower average cash balances on hand.

INCOME TAX EXPENSE

The third quarter 2006 effective income tax rate was 31.3% compared to 15.7% in the third quarter of 2005. The effective income tax rate in the first nine months of fiscal 2006 was 42.0% compared to 30.7% in the prior year period. The third quarter 2006 income tax expense was favorably impacted by a $1.0 million research tax credit. The effect of the research tax credit impacted the third quarter 2006 rate by 6.0%. The increase in the effective income tax rate in the first nine months of fiscal 2006 as compared to the prior year period was also affected by the impact of repatriating $28.7 million of cash held by foreign subsidiaries into the United States under the tax provisions of the American Jobs Creation Act of 2004. The effect of the repatriation impacted the fiscal 2006 second quarter effective income tax expense by $1.7 million and the effective rate by 10.9%. In addition, lower volume of profit contributions of the Company's foreign operations (primarily Puerto Rico due to the lower sales to PREPA) impacted the tax rate. The third quarter 2005 income tax rate was impacted by an adjustment to income tax expense due to the Company finalizing certain foreign tax returns in June; an adjustment to the 2005 tax provision resulting from higher foreign sourced pretax income; and a favorable state tax rate adjustment. The third quarter 2005 effective tax rate, absent the adjustments mentioned above, would have been approximately 33%. The Company estimates the annual effective tax rate for fiscal 2006 to be approximately 41%.

During the third quarter of 2006, the Company began an analysis of available research tax credits and filed its 2005 U.S. tax return which included a $1.0 million research credit. Under current law, the research tax credit expired for research expenditures incurred after December 31, 2005. The Company expects that a research credit of $0.2 million will be reflected in its 2006 U.S. income tax return. The Company will continue to evaluate the amount of research credit that is available for years prior to 2005 and expects that this evaluation will be completed by September 30, 2006.

CAPITAL RESOURCES AND LIQUIDITY

Working capital (current assets less current liabilities) decreased to $122.7 million at June 30, 2006 from $202.2 million at September 30, 2005. During the first nine months of 2006, cash decreased $69.2 million, primarily due to the approximately $91 million, net, paid for the Nexus and Hexagram acquisitions offset by cash generated by operations. Accounts receivable increased by $13.9 million in the first nine months of 2006, of which $5.9 million related to the acquisitions of Nexus and Hexagram; $3.5 million related to the Filtration segment due to timing and volume of sales; and $3.5 million related to DCSI due to timing of sales. Accounts payable increased by $17.6 million in the first nine months of 2006, of which $1.7 million related to the acquisitions of Nexus and Hexagram and $10.0 million related to DCSI due to timing of vendor payments.

Net cash provided by operating activities was $47.4 million and $45.4 million for the nine-month periods ended June 30, 2006 and 2005, respectively.

Capital expenditures were $6.8 million and $6.6 million in the first nine months of fiscal 2006 and 2005, respectively. Major expenditures in the current period included manufacturing equipment used in the Filtration/Fluid Flow businesses.

At June 30, 2006, other assets (non-current) of $63.8 million included $39.5 million of capitalized software. Approximately $34.9 million of the capitalized software balance represents external development costs on software development called "TNG" within the Communications segment to further penetrate the investor owned utility (IOU) market. TNG is being developed in conjunction with a third party software contractor. TNG is being deployed to efficiently handle the additional levels of communications dictated by the size of the service territories and the frequency of reads that are required under time-of-use or critical peak pricing scenarios needed to meet the requirements of large IOUs. At June 30, 2006, the Company had approximately $4 million of commitments related to TNG version 1.6 which is expected to be spent over the next three months. The Company expects to spend up to $7 million in fiscal 2007 on TNG. Amortization of TNG is on a straight-line basis over seven years and began in March 2006. The Company has recorded $1.2 million in amortization expense related to TNG in the first nine months of fiscal 2006.

The closure and relocation of the Filtertek Puerto Rico facility was completed in March 2004. The Puerto Rico facility is included in other current assets with a carrying value of $3.6 million at June 30, 2006. The facility is being marketed for sale.

In October 2004, the Company entered into a $100 million five-year revolving bank credit facility with a $50 million increase option that has a final maturity and expiration date of October 6, 2009. At June 30, 2006, the Company had approximately $99.2 million available to borrow under the credit facility in addition to $35.3 million cash on hand. At June 30, 2006, the Company had no borrowings, and outstanding letters of credit of $1.7 million ($0.8 million outstanding under the credit facility). On February 1, 2006, the Company borrowed $47 million to partially fund the acquisition of Hexagram which was subsequently repaid from the foreign cash repatriation by March 31, 2006. The interest rate on this debt was approximately 5.3%. During April 2006, the Company borrowed $5 million which was subsequently repaid prior to April 30, 2006. The interest rate on this debt was 7.75%. Cash flow from operations and borrowings under the Company's bank credit facility are expected to meet the Company's capital requirements and operational needs for the foreseeable future.

Acquisitions

Effective February 1, 2006, the Company acquired the capital stock of Hexagram, Inc. (Hexagram) for a purchase price of $67.5 million subject to a potential working capital adjustment. The acquisition agreement also provides for contingent consideration of up to $6.25 million over the five year period following the acquisition if Hexagram exceeds certain sales targets. Hexagram is a RF fixed network AMR company headquartered in Cleveland, Ohio. Hexagram's annual revenue over the past three years has been in the range of $20 million to $35 million. The operating results for Hexagram, since the date of acquisition, are included within the Communications segment. The Company recorded approximately $55 million of goodwill and trademarks as a result of the transaction, subject to post-closing adjustments including finalization of purchase accounting. The Company also recorded $6.6 million of identifiable intangible assets consisting primarily of patents and proprietary know-how, customer contracts, and order backlog which will be amortized on a straight-line basis over periods ranging from six months to seven years. The post-closing purchase accounting items are expected to be completed prior to September 30, 2006.

Effective November 29, 2005, the Company acquired Nexus Energy Software, Inc. (Nexus) through an all cash for shares merger transaction for approximately $29 million in cash plus contingent cash consideration over the four year period following the merger if Nexus exceeds certain sales targets. Nexus is a software company headquartered in Wellesley, Massachusetts with annual revenues in the past in excess of $10 million. The operating results for Nexus, since the date of acquisition, are included within the Communications segment. The Company recorded approximately $24 million of goodwill as a result of the transaction, subject to post-closing adjustments including finalization of purchase accounting. The Company also recorded $2.7 million of identifiable intangible assets consisting of customer contracts and backlog value which will be amortized on a straight-line basis over periods ranging from one year to three years. The post-closing purchase accounting items are expected to be completed prior to September 30, 2006.

Pacific Gas & Electric

On November 7, 2005, the Company announced that DCSI had entered into a contract to provide equipment, software and services to Pacific Gas & Electric (PG&E) in support of the electric portion of PG&E's Advanced Metering Infrastructure (AMI) project. PG&E's current AMI project plan calls for the purchase of TWACS communication equipment for approximately five million electric customers over a five-year period after the commencement of full deployment. The total anticipated contract value from commencement through the five-year full deployment period is expected to be approximately $300 million. PG&E has the right to purchase additional equipment and services to support existing and new customers through the twenty to twenty-five year term of the contract. Equipment will be purchased by PG&E only upon issuance of purchase orders and release authorizations. PG&E will continue to have the right to purchase products or services from other suppliers for the electric portion of the AMI project. Full deployment is contingent upon satisfactory system testing, and final PG&E management approval, all of which are currently expected to be concluded during fiscal 2007. On July 20, 2006, the California Public Utilities Commission approved PG&E's AMI project. DCSI has agreed to deliver to PG&E versions of its newly developed TNG software as they become available and are tested. Acceptance of the final version for which DCSI has committed is currently anticipated in the latter portion of fiscal 2007. Until such acceptance is obtained, the Company will be required under U.S. financial accounting standards to defer revenue recognition. The contract provides for liquidated damages in the event of DCSI's late development or delivery of hardware and software, and includes indemnification and other customary provisions. The contract may be terminated by PG&E for default, for its convenience and in the event of a force majeure lasting beyond certain prescribed periods. The Company has guaranteed the obligations of DCSI under the contract. If PG&E terminates the contract for its convenience, DCSI will be entitled to recover certain costs.

On November 3, 2005, Hexagram entered into a contract to provide equipment, software and services to PG&E in support of the gas utility portion of PG&E's AMI project. The total anticipated contract revenue from commencement through the five-year full deployment is expected to be approximately $225 million. As with DCSI's contract with PG&E, discussed above, equipment will be purchased only upon issuance of purchase orders and release authorizations, and PG&E will continue to have the right to purchase products or services from other suppliers for the gas utility portion of the AMI project. Full deployment is contingent upon satisfactory system testing, and final PG&E management approval, which are expected to be concluded during fiscal 2006. On July 20, 2006, the California Public Utilities Commission approved PG&E's AMI project. The contract provides for liquidated damages in the event of late deliveries, includes indemnification and other customary provisions, and may be terminated by PG&E for default, for its convenience and in the event of a force majeure lasting beyond certain prescribed periods. The Company has guaranteed the performance of the contract by Hexagram.

CRITICAL ACCOUNTING POLICIES

Management has evaluated the accounting policies used in the preparation of the Company's financial statements and related notes and believes those policies to be reasonable and appropriate. Certain of these accounting policies require the application of significant judgment by Management in selecting appropriate assumptions for calculating financial estimates. By their nature, these judgments are subject to an inherent degree of uncertainty. These judgments are based on historical experience, trends in the industry, information provided by customers and information available from other outside sources, as appropriate. The most significant areas involving Management judgments and estimates may be found in the Critical Accounting Policies section of Management's Discussion and Analysis and in Note 1 to the Consolidated Financial Statements contained in the Company's Annual Report on Form 10-K for the fiscal year ended September 30, 2005 at Exhibit 13, as supplemented by Note 2 to the Consolidated Financial Statements in Item 1 hereof.

OTHER MATTERS

Contingencies

As a normal incident of the businesses in which the Company is engaged, various claims, charges and litigation are asserted or commenced against the Company. In the opinion of Management, final judgments, if any, which might be rendered against the Company in current litigation are adequately reserved, covered by insurance, or would not have a material adverse effect on its financial statements.

RECENTLY ISSUED ACCOUNTING PRONOUNCEMENTS

In December 2004, the FASB issued FASB Staff Position FAS 109-2, "Accounting and Disclosure Guidance for the Foreign Earnings Repatriation Provision within the American Jobs Creation Act of 2004 (FSP 109-2)." The American Jobs Creation Act of 2004, (the "Act") provides for a special one-time deduction of 85 percent of certain foreign earnings repatriated into the U.S. from non-U.S. subsidiaries through September 30, 2006. During the second quarter ended March 31, 2006, the Company repatriated $28.7 million of foreign earnings which qualify for the special one-time deduction. Tax expense of $1.7 million was recorded in the second quarter of fiscal 2006 as a result of this repatriation.

The Company is currently evaluating the merits of repatriating additional funds under the Act. At June 30, 2006, the range of reasonably possible amounts of unremitted earnings that are being considered for repatriation is between zero and $10.5 million, which would require the Company to pay income taxes in the range of zero to $1.0 million. Federal income taxes on the repatriated amounts would be based on the 5.25% effective statutory rate as provided in the Act, plus applicable withholding taxes. To date, the Company has not provided for income taxes on these unremitted earnings generated by non-U.S. subsidiaries. As a result, additional taxes may be required to be recorded for any funds repatriated under the Act. The Company expects to complete its evaluation of the repatriation of these additional funds by September 30, 2006.

In June 2006, the FASB issued FASB Interpretation No. 48, "Accounting for Uncertainty in Income Taxes, an Interpretation of FASB Statement No. 109." This Interpretation is effective for ESCO beginning October 1, 2007. This Interpretation prescribes a recognition threshold and measurement process for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. The Company is currently evaluating the adoption of this Interpretation and does not currently have an estimate of the impact on the consolidated financial statements.

FORWARD LOOKING STATEMENTS

Statements in this report that are not strictly historical are "forward looking" statements within the meaning of the safe harbor provisions of the federal securities laws. Forward looking statements include those relating to the estimates or projections made in connection with the Company's accounting policies, annual effective tax rate, research tax credits, timing of Communications segment commitments and expenditures, outcome of current claims and litigation, future cash flow, capital requirements and operational needs for the foreseeable future, the ultimate values and timing of revenues under the DCSI / PG&E contract and the Hexagram / PG&E contract, the start of deployment under the Company's PG&E contracts, the future delivery and acceptance of the TNG software by PG&E, timing of spending for TNG commitments, completion of Hexagram and Nexus post-closing purchase accounting items, the amounts, if any, and timing of additional foreign earnings repatriated into the U.S. and the additional taxes resulting from such repatriation. Investors are cautioned that such statements are only predictions, and speak only as of the date of this report. The Company's actual results in the future may differ materially from those projected in the forward-looking statements due to risks and uncertainties that exist in the Company's operations and business environment including, but not limited to: PG&E's Board of Directors and PG&E's management impacting PG&E's AMI projects; the timing and success of DCSI's software development efforts; the timing and content of purchase order releases under PG&E's contracts; the Company's successful performance under the PG&E contracts; weakening of economic conditions in served markets; changes in customer demands or customer insolvencies; competition; intellectual property rights; successful execution of the planned sale of the Company's Puerto Rico facility; material changes in the costs of certain raw materials including steel, copper and petroleum based resins; delivery delays or defaults by customers; termination for convenience of customer contracts; timing and magnitude of future contract awards; performance issues with key suppliers, customers and subcontractors; collective bargaining and labor disputes; changes in laws and regulations including changes in accounting standards and taxation requirements; changes in foreign or U.S. business conditions affecting the distribution of foreign earnings; costs relating to environmental matters; litigation uncertainty; and the Company's successful execution of internal operating plans.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Market risks relating to the Company's operations result primarily from changes in interest rates and changes in foreign currency exchange rates. There has been no material change to the Company's risks since September 30, 2005. Refer to the Company's Annual Report on Form 10-K for the fiscal year ended September 30, 2005 for further discussion about market risk.

ITEM 4. CONTROLS AND PROCEDURES

The Company carried out an evaluation, under the supervision and with the participation of Management, including the Company's Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of the Company's disclosure controls and procedures as of the end of the period covered by this report. Based upon that evaluation, the Company's Chief Executive Officer and Chief Financial Officer concluded that the Company's disclosure controls and procedures were effective as of that date. Disclosure controls and procedures are controls and procedures that are designed to ensure that information required to be disclosed in Company reports filed or submitted under the Securities Exchange Act of 1934 (the "Exchange Act") is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission's rules and forms. There has been no change in the Company's internal control over financial reporting (as defined in Rule 13a-15(f) under the Exchange Act) during the period covered by this report that has materially affected, or is reasonably likely to materially affect, the Company's internal control over financial reporting.

PART II OTHER INFORMATION

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

In August 2004, the Company's Board of Directors approved the extension of the previously authorized (February 2001) open market common stock repurchase program originally authorizing up to 2.6 million shares, which is subject to market conditions and other factors and covers the period through September 30, 2006. At June 30, 2006, the Company had 1,152,966 shares remaining for repurchase under this program. There were no stock repurchases during the first nine months of fiscal 2006.

ITEM 6. EXHIBITS

a) Exhibits

Exhibit Number		
3.1	Restated Articles of Incorporation	Incorporated by reference to Form 10-K for the fiscal year ended September 30, 1999, at Exhibit 3(a)
3.2	Amended Certificate of Designation Preferences and Rights of Series A Participating Cumulative Preferred Stock of the Registrant	Incorporated by reference to Form 10-Q for the fiscal quarter ended March 31, 2000, at Exhibit 4(e)
3.3	Articles of Merger effective July 10, 2000	Incorporated by reference to Form 10-Q for the fiscal quarter ended June 30, 2000, at Exhibit 3(c)
3.4	Bylaws, as amended and restated.	Incorporated by reference to Form 10-K for the fiscal year ended September 30, 2003, at Exhibit 3.4
4.1	Specimen Common Stock Certificate	Incorporated by reference to Form 10-Q for the fiscal quarter ended June 30, 2000, at Exhibit 4(a)
4.2	Specimen Rights Certificate	Incorporated by reference to Current Report on Form 8-K dated February 3, 2000, at Exhibit B to Exhibit 4.1
4.3	Rights Agreement dated	Incorporated by reference

	as of September 24, 1990 (as amended and Restated as of February 3, 2000) between the Registrant and Registrar and Transfer Company, as successor Rights Agent	to Current Report on Form 8-K dated February 3, 2000, at Exhibit 4.1
4.4	Credit Agreement dated as of October 6, 2004 among the Registrant, Wells Fargo Bank, N.A., as agent, and the lenders listed therein	Incorporated by reference to Form10-K for the fiscal year ended September 30, 2004, at Exhibit 4.4
4.5	Consent and waiver to Credit Agreement (listed as 4.4, above) dated as of January 20, 2006	Incorporated by reference to Current Report on Form 8-K dated February 2, 2006 at Exhibit 4.1
31.1	Certification of Chief Executive Officer relating to Form 10-Q for period ended June 30, 2006	
31.2	Certification of Chief Financial Officer relating to Form 10-Q for period ended June 30, 2006	
32	Certification of Chief Executive Officer and Chief Financial Officer relating to Form 10-Q for period ended June 30, 2006	

SIGNATURE

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

ESCO TECHNOLOGIES INC.

/s/ Gary E. Muenster
Gary E. Muenster
Senior Vice President and Chief Financial Officer
(As duly authorized officer and principal accounting officer of the registrant)

Dated: August 9, 2006